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The Hubris of the Central Banker and the Ghosts of Deflation Past, Part 1

by Richard M. Ebeling

Nearly 75 years after the great stock-market crash of 1929, monetary policy is still haunted by the ghost of the Great Depression. The severity of the American stock-market decline during the last three years has again awakened fears among some policymakers that the economic downturn might bring about a deflationary period of collapsing output and employment like that experienced during the early 1930s.

Prominent members of the board of governors of the Federal Reserve System, as well as a senior member of the executive board of the European Central Bank, have delivered public addresses attempting to assure the financial community that it is in the power and ability of monetary central planners to prevent a repetition of the Great Contraction of 1930–33. On November 21, 2002, Federal Reserve governor Benjamin S. Bernanke delivered his address “Deflation: Making Sure ‘It’ Doesn’t Happen Here” to the National Economists Club in Washington, D.C.

About a month later, on December 19, 2002, Federal Reserve Chairman Alan Greenspan discussed the dangers of and remedies for any deflationary threat at the Economic Club of New York in an address entitled “Issues for Monetary Policy.” And on December 2, 2002, European Central Bank Executive Board member Otmar Issing evaluated “The Euro after Four Years: Is There a Risk of Deflation?” at the 16th European Finance Convention in London, England.

What is deflation? Its general connotation, of course, is something “bad.” During a period of deflation, prices in general in the economy are decreasing and this is considered to generate negative consequences in terms of falling output, rising unemployment, investment uncertainty, and broad market instability and collapse.

But before the rationales for an “activist” monetary policy to combat deflation can be judged, it is first necessary to know what can be the causes behind a general decline in prices. And it is additionally useful to clarify the role of government in past episodes of price deflation.

It is possible to distinguish at least three causal factors behind a general fall in prices. They are: supply-side deflation, price-wage rigidity deflation, and monetary deflation.

Supply-side deflation

A general decline in prices may accompany significant increases in output resulting from productivity increases and cost efficiencies. One of the competitive forces in the market economy is the never-ending drive of entrepreneurs to devise better and less-expensive goods and services to market to the consuming public. New technologies and cost-saving innovations introduced within business enterprises enable more goods to be manufactured and sold at lower per-unit costs. Sellers, in one sector of the economy after another, increase their supplies offered on the market, and competitive pressure results in a lowering of the prices of those goods over time to reflect their lower costs of production. The cumulative effect is that the general level of prices will have declined when measured by various statistical price indices over a period of time.

In the period between the end of the American Civil War in 1865 and 1900, the general level of prices in the United States declined by about 50 percent. While the American economy did experience short periods of economic depression during those years (mostly due to the federal government’s manipulation of the monetary standard), the nearly half-century era during America’s Industrial Revolution saw a dramatic rising standard of living even though accompanied by an expanding population.

An open, free-market system tends to foster the incentives and profitable rewards for capital investment and innovation that bring forth increasing prosperity. Greater output at falling prices provides people with higher real income as each dollar they earn now buys a larger quantity of goods and services in the marketplace. Supply-side deflation, therefore, is an indication of a growing and dynamic market system that is improving the economic conditions and opportunities of the general population.

Price-wage rigidity deflation

All economic change brings with it shifts in market demand-and-supply conditions. Continuous adjustment and balance within the market requires those affected by change to adapt to the new circumstances. In a world of constant change, the demands for some goods increase while other demands decline. Innovations and technological advancements as well as changing resource availability bring with it shifts in the demand and supply of various forms of labor and capital. The information about these changes and the incentives to appropriately respond to them are provided to people in the market through changes in the structure of relative prices and wages.

Any failure of prices and wages to correctly reflect the new patterns of market supply and demand only generates distortions, imbalances, and maladjustments between the two sides of the market. Under the influence of Keynesian economics, for most of the last 70 years, the resulting unemployment and falling output due to price and wage rigidities has been called “aggregate-demand failures.”

The presumption has been that the level of total demand for goods and services in the economy in general falls short of the total supply of goods and services available for sale at prices equal to their costs of production. The problem, it is said, is not that prices and wages are “wrong” on the supply side but rather that aggregate spending is “too low” on the demand side. The policy presumption has been that government and its monetary authority must increase total demand, either through government deficit spending or the central bank’s printing money and providing it for private investment and other purposes.

The free-market economist W.H. Hutt gave a refutation to this Keynesian reasoning in his two works *A Rehabilitation of Say’s Law* (1974) and *The Keynesian Episode* (1979). Hutt argued that when the Keynesians referred to excess aggregate supply and an apparent weakness of aggregate demand to purchase that supply, they were looking through the wrong end of the telescope. There cannot be an “aggregate” excess supply unless there is a super-abundance of all resource inputs and consumer-demanded outputs, at which point there would no longer be an “economic problem” because there would no longer be scarcity. Why bother whether all are employed when the society has reached the point where it is so rich in all desired things that there is no longer any work left to be done?

What can exist is an oversupply of particular goods relative to the demand for them at the prices at which they are being offered for sale. What is preventing the buying of more of these goods is not that the aggregate demand is “too low” but rather that the particular prices for these goods are set too high, given the consumer demands for them.

In other words, the sellers of these goods or labor services are pricing themselves out of the market. As Hutt expressed it, “No one can purchase unless someone else sells.... Every act of selling and buying requires that the would-be seller price his product to permit the sale and that the would-be buyer offer a price which the seller accepts.”

It is in the unwillingness of resource owners to price their products and services at levels commensurate with consumer demand that Hutt found the cause of prolonged depressions. “Discoordination in one sector of the economy will, if there are price rigidities in other sectors, bring about those successively aggravating reactions, one decline in the flow of services inducing another,” he said. When a supplier is unwilling to lower his price or wage to induce greater sales when demand for his particular good or service turns out to be less than he had, perhaps, expected, then a part of his supply remains unsold and a portion of the labor services available for hire remains unemployed.

The loss of income due to a producer’s or worker’s maintaining his supply price too high relative to actual market demand results in a decrease in his ability to purchase the goods and services of others being offered on the market. If the suppliers of those goods and services, in turn, refuse to adjust their prices and wages downwards, given the now-lower demand for their output, then the circle of unsold products and unemployed labor starts to expand. A “cumulative contraction” of output and employment may develop in the face of such a network of relatively rigid prices and wages. As Hutt’s old teacher at the London School of Economics, Edwin Cannan, expressed the problem in 1933 during the Great Depression, “General unemployment appears when asking too much is a general phenomena.”

This problem arose in the early 1930s following an inflationary monetary policy by the Federal Reserve during most of the 1920s. What fooled many people at the time was the illusion of price-level stability through most of the 1920s. The high level of productivity increases and cost efficiencies during those years would have resulted in gently falling prices, as outputs of many goods and services were expanding. But the Federal Reserve’s expansionary policy prevented prices from falling as measured by most of the standard price indices.

This monetary expansion, however, fed an unsustainable investment boom that finally burst in 1929. The malinvestment of capital and the misallocation of resources, including labor, during the boom years required significant adjustments through various sectors of the economy to restore balance and economic growth. But numerous government economic policies prevented or delayed the necessary price and wage adjustments, causing the rising tide of increasing unemployment,

falling production, business bankruptcies, and bank failures. (See “[Monetary Central Planning and the State](#),” in *Freedom Daily*, Parts 1–20, January 1997–August 1998.)

Hutt also emphasized that since the problem is incorrect pricing of particular goods and services, or “disequilibrium,” the lowering of any such price or wage to its market-clearing level “will tend to initiate a positive ‘real multiplier’ effect — a cumulative rise in activity and real income. . . .” In other words, whenever a price or wage that is too high is lowered closer to its equilibrium or market-clearing level, suppliers of those goods and services increase their sales and potentially earn higher income. Their higher incomes from pricing their goods and services more correctly, in turn, enable them to increase their demands for other goods and services and thus start a process of expanding the circle of employment and production opportunities in the market. Market-guided pricing puts the unemployed back to work and releases the flow of demand for a growing circle of goods in the economy.

Monetary deflation

A general decline in prices can also be brought about by a monetary deflation. A contraction in the supply of money and credit reduces the amount of money in people’s hands with which they can demand the various goods and services they wish to buy in the market. With less money to spend, there invariably results a downward pressure on prices and wages in general in the economy. If there are the kinds of price and wage rigidities discussed above, then the process of restoring balance between market supplies and demands at a required lower scale or level of prices can be prolonged and punctuated by “depressionary” unemployment and lower production.

Under central banking, monetary contractions are government-made. There have been instances when governments have intentionally contracted the money supply. The British government did so after the war with Napoleon in the early 19th century and then again after the First World War in the early 1920s. Other times it has happened as a result of the central-bank-managed fractional-reserve system, under which outstanding bank liabilities are a multiple of the actual reserves to meet all depositor obligations. In the early 1930s, bank loans went bad, depositors withdrew their funds out of fear of bank closings, and the amount of bank credit outstanding contracted as a multiple of the reserves withdrawn by depositors.

Throughout the second half of the 1990s, the Federal Reserve System maintained an expansionary monetary policy. By various measurements of the monetary aggregates, between 1995 and 2000 the supply of money and credit in the United States economy increased between 35 and 50

percent. During this same period, general consumer prices annually increased in the neighborhood of 1 to 2.5 percent. A leading explanation for the failure of prices to dramatically rise during these years was the significant increases in productivity, cost reductions, and increases in output of many goods across the economy. In other words, a replay in many ways of what was experienced in the second half of the 1920s before 1929.

But whereas there was a 30 percent decrease in the U.S. money supply between 1929 and 1933, since the stock-market decline began in 2000 the Federal Reserve has kept the monetary spigots wide open. Between 2000 and the end of 2002, the supply of money in the United States economy increased by about 18 percent, or about 9 percent a year. There is nothing in recent Fed monetary policy to suggest that there has been a decline in the supply of money and credit. If anything, the Federal Reserve has followed a high expansionary policy.

What then are Benjamin Bernanke, Alan Greenspan, and Otmar Issing concerned about? Each of them in his public address insisted that there were no signs or indications of present or immediate deflationary tendencies in either the U.S. or EU economies. They each seemed determined to assure those in the financial markets that if there were any tendencies for a deflationary process setting in, they — the monetary authorities of the United States and Europe — were ready and willing to work whatever monetary magic was needed to prevent a replay of the early 1930s.

Thus, they were soothing psychological fears, especially in a situation of already low interest rates. If nominal interest rates sank to zero percent, how could the central bank manipulate interest rates to try to stimulate private-sector investment spending? Wouldn't the central banking authority then be left with no weapons to fight a deflationary spiral, if one were to set in? How then would the economy escape from a collapse similar to that experienced in the Great Depression?

The questions, of course, imply that (a) the central bank should adopt an activist policy to influence the direction and currents of the market; (b) the central bank has the wisdom and ability to stabilize the economy; and (c) central-bank intervention and manipulation will not make the situation worse than if the market is left to find its own path back to balance and coordination.

Bernanke, Greenspan, and Issing are confident on all three points. But their believing does not make it so. Indeed, their statements and analyses of the danger of deflation show just how deeply ingrained is the hubris of the monetary central planners around the world.

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