



11350 Random Hills Road, Suite 800, Fairfax, Virginia 22030 Phone (703) 934-6101 Fax (703) 352-3678

[fff@fff.org](mailto:fff@fff.org) [www.fff.org](http://www.fff.org)

---

## **The Hubris of the Central Banker and the Ghosts of Deflation Past, Part 2**

**by Richard M. Ebeling**

In spite of the fact that the monetary policies of the Federal Reserve System in the United States and the European Central Bank (ECB) have been highly expansionary during the current economic downturn, central bankers at both institutions have taken the time to deliver addresses assuring their listeners that there is no need for the public to fear a return to the deflationary experiences of the early 1930s. Alan Greenspan and Benjamin Bernanke of the board of governors of the Federal Reserve Bank and Otmar Issing of the executive board of the European Central Bank have laid out their understanding of what deflation means and its consequences as well as their proposals to combat deflation if it appears. (See “[The Hubris of the Central Banker and the Ghosts of Deflation Past, Part 1](#)” in *Freedom Daily*, February 2003.)

Bernanke defined deflation as a persistent decline in the general level of prices and assigned its cause to

a collapse of aggregate demand — a drop in spending so severe that producers must cut prices on an ongoing basis in order to find buyers. Likewise, the economic effects of a deflationary episode, for the most part, are similar to those of any other sharp decline in aggregate spending — namely, recession, rising unemployment, and financial stress.

Greenspan added, “Although the U.S. economy has largely escaped any deflation since World War II, there are some well-founded reasons to presume that deflation is more of a threat to economic growth than is inflation.” And Issing insisted that “the ECB is concerned about risks of deflation as well as inflation.”

**Lowering interest rates**

The first piece of monetary weaponry at the disposal of the central bankers, they explained, is the tried and true method of lowering short-term interest rates by buying short-term government securities and supplying additional lending reserves to the banking system. The increased reserves at lower interest rates are meant to stimulate private-sector investment spending to generate the additional “aggregate demand” for goods and services in the economy.

But what if a deflationary process has set in and nominal interest rates have fallen to zero? How will the central bankers stimulate borrowing when there is no longer any room to lower interest rates?

Have no fear, because then the Federal Reserve can always start buying longer-term government securities with maturities extending out anywhere from 10 to 30 years. If this were still to fail to do the trick, then the Federal Reserve can coordinate its money-creation process with direct expenditure by the U.S. government by printing all the money required to cover additional government deficit spending.

As Greenspan expressed it,

If deflation were to develop, options for an aggressive monetary response are available.... The Federal Reserve has authority to purchase Treasury securities of any maturity and indeed already purchases such securities as part of its procedure to keep the overnight [interest] rate at its desired level. This authority could be used to lower interest rates on longer maturities.

And in the words of Bernanke,

Indeed, under a fiat (that is, paper) money system, a government (in practice the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero.... The U.S. government has a technology, called a printing press (or, today, its electronic equivalent) that allows it to produce as many U.S. dollars as it wishes at essentially no cost.... We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

Since prevention is always better than having to suffer from a cure, the central bankers emphasize that the generally accepted standard of “price stability” for monetary policy does not mean zero inflation, i.e., a stable price level as measured by various price indices. *No, price stability is defined as low inflation.*

Issing says that the risk of any deflation “can be substantially reduced by making sure that inflation does not fall below some safety margin — say below a threshold of 1 percent — on a sustained basis.”

Bernanke concurs that “the Fed should try to preserve a buffer zone for the inflation rate; that is, during normal times it should not try to push inflation down all the way to zero.” Instead, the Federal Reserve should have an inflation target between 1 and 3 percent a year.

### **Monetary bubbles**

Greenspan sees the source of many economic downturns, and any deflationary dangers that may accompany them, in the bursting of asset-price bubbles on the financial markets.

The problem, in his view, is that “bubbles tend to deflate not gradually and linearly but suddenly, unpredictably, and often violently.”

Thus the “evidence of recent years, as well as the events of the late 1920s, casts doubt on the proposition that bubbles can be defused gradually.”

But where do such “bubbles” come from? It is difficult to see how they are inherent in a free-market economy that is not being fed by increases in the supply of money and credit. If there is a wave of innovations that spark an increase in investment demand, the additional demand for borrowing would push up interest rates.

That would create an incentive for some income earners in the society to decrease their consumption spending and increase their savings to take advantage of the higher rate of interest.

Any direct purchase of equity shares of possibly more profitable enterprises available on the stock exchange also would have to be financed either through a decline in consumption or a decrease in bond purchases. Either way, there are no inflationary pressures, because the increase in one type of expenditure must be matched with a decrease in some other kinds, given no change in the total supply of money in the economy.

Of course, when there is investment in new products and technologies, there is always the possibility and danger of over-optimism about the cost-efficiencies being introduced or the degree of future consumer demand before the new product is actually marketed to the buying public. But even if there are losses suffered, due to a decline in the share prices of the companies applying the new technologies or marketing the new products, there would be share prices of other

companies that would now be more attractive to purchase, given the actual pattern of consumer demand.

The only way that asset prices on the financial markets can be significantly rising while consumer goods and other prices do not decline, or even rise as well, is for the total quantity of money and credit available in the economy to have been increased. Then people would have enough money to maintain both their levels and patterns of spending and retain the additional means to increase their demand for equity shares or bonds. If there is a financial and speculative “bubble,” it is due to the central bank’s providing the monetary means to feed it. Thus, the very financial bubble that has so worried Greenspan and other central bankers is the result of the expansionary policies of their own central banks.

### **Monetary policy and recession**

If either the Federal Reserve or the European Central Bank pursues as its policy goal a rate of monetary expansion sufficient to keep prices from falling over time in a growing economy, or even if they pursue a policy of low inflation, they are likely to set the stage for the very type of economic downturn that they are so determined to prevent.

As Austrian economist Friedrich Hayek argued long ago, in a growing economy experiencing productivity increases and cost-efficiencies, prices for goods will have to fall over time as more goods and less expensively produced goods come on the market. Given the consumer demands for those goods, the only way the larger supplies coming on the market can find willing buyers is through decreases in the prices at which they are offered to the public.

If, however, the central bank wishes to prevent this “supply-side deflation” from occurring, it can do so only by injecting additional money into the economy. In the United States the Federal Reserve increases funds by purchasing government securities (through what are known as “open-market” purchases). This, in turn, increases the supply of reserves available in the banking system for lending purposes. To attract additional borrowing, banks lower their interest rates, which often stimulates an increase in longer-term investment projects.

But the additional borrowing at the lower rate of interest now causes total investment spending to be greater than the total amount of actual savings set aside for lending purposes by income earners in the society. In fact, savings may actually decrease: at the now lower market rates of interest the attractiveness of savings decreases even while investment spending is expanding.

Thus, in the name of price stability (possibly defined as “low inflation”), an imbalance is created between savings and investment in the economy.

This imbalance eventually requires correction, with investment spending reduced and redirected to be consistent with the actual available supply of savings. When this investment “bubble” bursts, the market value of some capital investments will have to be written down or possibly even written off. Labor suppliers in some of the overextended sectors of the economy will have to be redirected into alternative employment consistent with the actual patterns of consumer demands for various goods. The same applies to the utilization and applications of many other resources and raw materials.

If capital-asset owners or resource suppliers, including workers, resist the necessary and inevitable decline in the prices and wages for their products and services in these misdirected employments, they succeed only in pricing themselves out of the market. Their incomes fall and their ability to demand other goods declines commensurately.

The demands for an array of other goods now experience a decrease, with resulting downward pressure on prices and wages in the affected sectors of the economy. If those producing the goods and supplying the labor in those sectors also resist required reductions in prices and wages, then the circle of unemployment and idle resources expands. And the pressure for prices and wages to adjust downwards only intensifies over time as the overhang of unsold goods and unemployed labor increases.

It should be clear that this type of “price-wage rigidity deflation” cannot be cured by the magic of paper-money inflation, contrary to what Bernanke and Greenspan may think. It may be true that such a monetary expansion can directly increase the demand for goods and services when financing government deficit spending. And it may be true that if the central bank has room to lower interest rates, it might stimulate some investment borrowing that might not otherwise be occurring if interest rates remained at a higher level. But this does not solve the fundamental problems of malinvestments and misallocation of labor and resources resulting from the preceding “boom” and “bubble.”

### **Monetary policy and inflation**

The product demand and employment opportunities created by direct government spending clearly can be maintained only for as long as the government continues its higher level of real spending. Any decrease in the amount of deficit expenditure for the particular goods and services

demanded by the government will bring about a fall in the production of those goods and a decline in the employment opportunities of the workers drawn into those activities by the initial higher level of government spending.

Likewise, central-bank stimulus of additional private-sector investment spending to create production and employment opportunities in the face of deflationary pressures merely sets the stage for a future decline in investment activity. The investment projects that may have begun are dependent for their completion and maintenance on a continuing expansion of money and credit to sustain their existence.

Thus, an unstable inflationary process is set into motion in an attempt to get around the problem of unsold products, diminished investment activity, and unemployed workers caused by the unwillingness of some to adjust their price and wage demands in a downward direction to more correctly reflect the actual conditions prevailing on the market. As Austrian economist Ludwig von Mises noted years ago,

The course of the boom is not any different because, at its inception, there are unused productive capacity, unsold stocks of goods, and unemployed workers.... The beginning of every credit expansion encounters such remnants of older, misdirected capital investments and apparently "corrects" them.

In actuality, it does nothing but disturb the workings of the adjustment process."

The continuing hubris of the central banker can be seen in his failure to fully appreciate that it has been his own monetary policies that have created the unstable booms and bubbles that he complains about and criticizes. And even when he admits that central bankers have erred in the past and have produced those very consequences to which they object, he continues to believe that "next time" they will get it right.

Otmar Issing has been more open about the limitations on the powers of central banking than others of his clan. For example, in an address delivered in Paris on December 9, 2002, he discussed these problems in "Monetary Policy in a World of Uncertainty." He admitted that central bankers (a) know little about the prevailing economic conditions in the market because of imperfect information and faulty factual data; (b) have no way of knowing what the appropriate equilibrium patterns throughout the market should be, because they have no demonstrably "correct" model of the economy and its precise interdependent relationships; and (c) cannot be sure how and in what form private-sector actors in the market will interpret and react to policies implemented by the central bank, and thus what interdependent outcomes will be forthcoming when the policies of the central bank intersect with the actions of the market participants.

At the same time, if the central banker is to have some capacity to influence the direction of market activities, Issing believes that “there are limits to the degree of transparency that central banks can realistically be expected to supply.” In other words, the central banker cannot tell the public what it plans to do or why because then the market actors might respond in ways that would more or less completely foil the central banker’s plan.

Yet Issing wants monetary “policy to be predictable in order to reduce uncertainty and volatility in financial markets.” Thus, he wants the central banker to have his cake and eat it too. The reason he wants such secretive flexibility is that “a monetary authority should lead financial markets and not ‘follow them.’”

Why? Because, he says, private traders in financial markets operate on the basis of “ludicrously short time horizons” while the central banker maintains the proper “long-term” perspective.

Here is the monetary central planner who admits his inherent inability to know enough to plan but who just cannot give up the ghost and let the multitudes of market participants find their own way in the marketplace. The lingering appeal of social engineering just remains too strong. The hubris just cannot be foresworn.

*Richard Ebeling is the Ludwig von Mises Professor of Economics at [Hillsdale College](#) in Michigan and serves as vice president of academic affairs at The Future of Freedom Foundation.*

**This article was originally published in the March 2003 edition of *Freedom Daily*.**