What Hayek Would Do
How Austrian economists would fix the crisis and stop it happening again

Robert CB Miller
The views expressed in this report are those of the author and do not necessarily reflect any views held by the publisher or copyright owner. They are published as a contribution to public debate.

Robert CB Miller is a former Senior Research Fellow at the Institute of Economic Affairs.

Copyright © Adam Smith Research Trust 2013

All rights reserved.

Published in the UK by ASI (Research) Ltd.
Printed in England
## Contents

1) What could Hayek have said to the Queen? 5  
2) Austrian Economics and the crisis  
   a) Austrian information economics 9  
   b) Austrian Business Cycle Theory (ABCT) 11  
   c) Critique of Monetarists and Keynesians 20  
3) How Hayek would fix the economy  
   a) Cutting the Recession Short 24  
   b) Fixing Money 29  
   c) The Freiburg Plan – Fixing the Loose Joint 39  
4) Sound money in a free society 49  
5) Further reading 52
What could FA Hayek have said to the Queen?

Mainstream economics has been humiliated by the current Great Recession. Economists and central bankers believed they had largely solved the problem of economic stability and had established a framework for steady economic growth. During the ‘Great Moderation’ 1987-2007, conventional economics ruled and it seemed that the key had been found to economic growth uninterrupted by serious recessions. A judicious combination of monetarist and Keynesian ideas held the answer to making the economies of the western world prosper.

How wrong they were! Conventional economists were embarrassed and surprised by the cataclysm of 2008 – on their thinking, it ought not to have happened, and they had to scramble to cobble together an explanation after the event.

Austrian economists, who have been on the margins of economics since the 1930s, had been unconvinced by the conventional consensus. Suspicious of the seeming stability of the Great Moderation, they saw trouble coming, and in some cases predicted a crash. It is time now that their arguments should be heard. Indeed Austrian economists could have answered the Queen’s famous question at the London School of Economics in November 2008: “Why did no one see this coming?” with: “Well, Ma’am, we did!”
Austrian economics and Austrian Business Cycle Theory (ABCT) offer a more convincing analysis of the economic crisis than the available brands of mainstream economics, but has not received the attention that it is due. This is strange as F A Hayek (1899-1992), the best-known Austrian economist, has become popular as a counter-balance to Keynes and he has been the subject of TV programmes and even rap videos.

Austrian economics and its analysis of the crisis have been acknowledged to provide interesting insights into the cause of the Great Recession, but in the main it have been misrepresented and misunderstood. Austrian prescriptions have been derided as proposing that the banking system should be allowed to collapse and suggesting that the only way to fix the economy would be a return to the gold standard with banks forced to match cash 100% with gold. This is a parody of the truth. Isolated statements (often from the 1930s) by individual economists have been taken to represent those of a whole school.

A modern analysis and proposal

The purpose of this paper is to challenge this distorted idea of the Austrian approach, and to set out a modern Austrian analysis of why the crisis happened and a number of proposals for accelerating the recovery and preventing its recurrence. It focuses largely on Hayek, the great Nobel economist and philosopher, who thought about the problems, and practical solutions, in great depth. The proposals for reform set out in this book, The Freiburg Plan, are feasible and could be introduced gradually. They are based largely but not exclusively on Hayek’s own views and are in the tradition of liberal (in the European sense) economic reform. The plan is so named because Hayek retired to Freiburg, in Germany, where he did much of his creative thinking on competing currencies. If put into effect, the Freiburg Plan would make it much more difficult for the banks to have the malign role in the economy that the current Basel based regime allowed (and will still allow even after the full introduction of the Basel III regime in 2019).

But reform of the banks is only half the story. Austrian economists have always emphasised two facts that other brands of economics have ignored or minimised. First, that saving, foregone current consumption, and the accumulation and maintenance of capital are vital for generating economic growth and maintaining prosperity. Second, that markets must be free to allow price signals to inform businesses and consumers about the scarcity of resources, business opportunities
and the preferences of savers and investors. This means that government and central bank intervention that distorts these signals and perpetuates inaccurate information must be drastically curtailed. Intervention and red tape must be removed if the recession is to be cut short. Recovery from recession just means increasing economic growth, and here the effective treatment is well known if infrequently practised: low taxes, free trade, limited regulation, and sound money.

Who are the Austrians?

But who are the Austrian economists and why should we take notice of what they say? The Austrian school is so called because it was founded by Carl Menger (1840-1921) who was a professor at the University of Vienna and one of the discoverers of marginal analysis, a key tool of economics today. In the 20th century Ludwig von Mises (1881-1973) and FA Hayek were the leaders of the school. Both left Austria: Mises went to the United States and Hayek to the London School of Economics and then to Chicago. Hayek, who became a British citizen, was one of the very few economists to predict the Great Crash of 1929. In 1974 he received the Nobel Prize for Economics and he was made a Companion of Honour in 1984.

But Austrian economists are well outside the mainstream. There are a number of reasons for this. They have little enthusiasm for economic forecasting and they argue that most government intervention is counterproductive at best and positively harmful at worst. This makes them unsuited to government service and in advising politicians – though Hayek is known to have influenced Margaret Thatcher.

The Austrian approach focuses on markets as transmitters of information, guiding businesses and consumers on what they can do. Consequently they are strong critics of socialism, which they see as both restricting freedom and interrupting the flow of information through the price system. Central planners are bound to be wrong as they can never have the right information on which to act.

Other important Austrian theme is the ‘granularity’ of the economy so that productive capacity cannot be treated as a homogenous lump; the importance of freedom for prosperity. Another is the fact that economics is not a natural science like physics where confident and accurate predictions can be made. Austrian economists developed a theory for explaining the ups and downs of the nineteenth-century trade cycle – Austrian Business Cycle Theory – which they have applied successfully to analysing and explaining today’s Great Recession. Many Austrian
economists expected that the boom of the early 2000s would lead to trouble while orthodox economists remained complacent and were surprised and puzzled when it occurred.

Though marginalised for decades, Austrian thinking remains a creative force, with theories and prescriptions being continuously refined and improved. Leading figures include the US and UK academics Roger Garrison, Kevin Dowd, Steve Horwitz, and George Selgin.

*Plan of this paper*

Part I of this paper describes Austrian Business Cycle Theory (ABCT) and shows how it offers a convincing explanation of the extraordinary boom of the 2000s and the bust of 2008 which led to the Great Recession.

Part 2 sets out proposals based in Austrian economics to cut short the recession and reform the banking system, The Freiburg Plan, which would make it much more difficult for the boom bust cycle to recur.
Austrian Economics and the crisis

\(a)\) Austrian information economics

Austrian economics is based on the concept of ‘market process’. In other words, businesses and consumers are in a continuous process of trial and error as they try to close on a point where supply equals demand. They can make progress but they can never achieve final success because unexpected new processes, goods, scarcities and products emerge. One of Hayek’s essays is titled ‘Competition as a Discovery Procedure’ and there is a parallel between the trial and error process of experiments in science and the activities of those participating in a market economy.

*The economy is information*

One of the main themes of Austrian economics is that the economy is an information system and that the role of prices is to co-ordinate the activities of businesspeople and consumers who may not know each other and may be greatly separated in space and time (some projects, for example, may involve estimates of demand many years in the future). Because economic information is not (and cannot be) held in by some central bureau or computer, centralised economic planning must always fail for lack of relevant information. What is more, contrary to the assumptions of textbook economists, information is not freely available but is
discovered by the process of competition. Prices formed and continuously revised by competitive trial and error are, for the Austrian economist, the lifeblood of a free market economy. And insofar as prices are set freely they transmit information to businesspeople and consumers about the demand and supply of goods, about time and risk preferences, and about business opportunities.

One consequence is that interference with the market process can have undesirable and unintended consequences. Politicians sometimes think that business and entrepreneurship are much like administration. But this is a misunderstanding. Business is always risky – unexpected developments are always to be expected and businesspeople will build in an allowance for error into their plans. It follows that any policy that feeds false price and business information into the economy can cause businesspeople and consumers to make unnecessary mistakes.

*Treating totals and averages with caution*

Much conventional economics consists in theories which are based on economic aggregates – treating the money value of various activities in a particular economy as if they were entities in their own right. Thus if wages increase then employment (everything else being equal) will fall. But in reality ‘wages’ are only the average of wages in all or part of the economy and employment is the total for the whole economy. These averages and totals are shorthand for the actions of large numbers of individuals. The total of employment may remain the same but its constituents may change in ways that profoundly affect the whole economy. It follows that economists who focus on the total may miss changes in its constituents that could have major consequences. As we shall see this is particularly important when it comes to capital where changes in its composition can have enormous consequences for economic stability. Aggregates are mere summary numbers: they never act on each other, and Austrian economists claim that errors can result from analysing them as if they did.

While the use of economic aggregates, totals and averages may be essential in some analyses of the workings of the economy as whole, it is vital to remember that they represent the behaviour of millions of individuals. Take ‘consumer spending’ as an example. While the total may change little from quarter to quarter, its constituents may change greatly. Spending on cars may rise and spending on food may fall. A large sustained rise in the price of oil may have a large effect on the total of consumer spending – though if we look below the totals, we may find that this is largely confined to the demand for cars. Accordingly, Austrian economists are
more conscious than their mainstream fellows that aggregates can, and often do, mislead.

**Entrepreneurship**

An important strand in Austrian economics is entrepreneurship. It is not limited to any class of individuals but is a fundamental characteristic of human beings. It is the ability to spot opportunities for profit and avoid loss. All human beings are active creators of value, and do not merely respond passively to stimuli. Being universal, entrepreneurship needs to be set in a proper framework of rewards and penalties. Thus bureaucrats can be entrepreneurial but they serve their own ends by expanding their own role, rather than being led by profit seeking and loss-avoidance to serve other people.

**Capital**

Austrians believe explicitly that economic growth comes from the accumulation of capital. Resources diverted from consumption are used to make the economy more productive – new houses, factories, information, networks and skills. Austrian economists emphasise that this process cannot be assumed to take place willy-nilly and they argue that capital forms a structure which must be properly fitted together if it is to work.

*Austrian economics is just reality economics*

Austrian economics reflects the lumpiness of economic reality better than its competitors. Thus capital and consumer demand are shorthand for purchases of particular goods – not goods in general and that it matters for the economy as whole what particular goods and services are produced. Similarly, capital is a highly complex structure that can fail because some parts get out of kilter with others. Austrian economics better reflects this granularity of economic reality than its mainstream competitors.

*b) Austrian Business Cycle Theory (ABCT)*

*Austrian economics – about savings and capital*

Austrian economics focuses on capital and savings, which conventional economics treat as unimportant. Mainstream economists accept that it is important in a very
general sense and assume that savings and investment will take care of themselves if the demand for goods is maintained at a sufficient amount. What is forgotten is that savings, which are forgone current consumption, are essential for economic growth. Countries become rich because they have accumulated more capital than poor countries. Their productive capacity is greater because they have set aside resources from consumption and built more machines, factories, communications and transport networks, and have invested in an educated and skilled workforce. This is not to deny the importance of natural endowments like natural resources, location, climate and soil, but none of these can be exploited without the investments that foregone consumption make possible.

This simple and evident truth is nowhere denied but it is regularly ignored, with all the efforts of policymakers focussed on maintaining and increasing consumption. But there can be no consumption without the means of satisfying it – the capital investments that savings make possible. Savings are particularly important in the recovery from recession, where many production plans have failed due to lack of resources and fresh investment is needed, to complete current production projects or to create new ones.

Treating capital as if it were a homogenous lump of productive capacity may seem to be commonsense. But capital forms a complex structure. If some parts of the structure are broken then the effectiveness of the whole may be damaged.

Professor Steve Horowitz has compared capital to a Lego model. The model is made up of a number of Lego parts which all have to fit together if the model is to work. It does not matter if there are a large number of parts available: what matters for the completion of the model are particular bits. If you are building a model truck with Lego an excess of windows will not make up for the fact that there are three wheels rather than the four needed for the truck to move. Conventional economics assumes that all the parts for the required Lego models are interchangeable. But this assumption is mistaken, leaving an economic problem to which conventional economists are blind.

In reality, much of the activity in a modern market economy involves the co-ordination of long and complex chains of production activity. Some involve horizontal co-ordination, such as getting ore to the mill, ingots to the car factory and the car to the consumer. Others include assembling long vertical chains, with processes that take long periods of time: the exploitation of a new oil field, for example, involves a
time-consuming process lasting many years of exploration, drilling, pipeline laying and the expansion of refinery capacity.

_Austrian business cycle theory is about misinformation_

If Austrian economics is about information, then the Austrian Business Cycle Theory (ABCT) is all about misinformation and its sometimes dire effects on the economy. The theory assumes that businesspeople and consumers act on information about market conditions – what is available and at what price. Information about prices, relative scarcities and the plans and preferences of others allow them to plan for the future, taking into account the possibility of failure, misunderstandings and unexpected events good or bad. The chances of being mistaken are huge. Bankruptcies, job losses, mistaken investments and disappointments are ever-present possibilities. It is in fact very hard to understand what other people are going to do – especially when events occur and decisions are taken half a world away. It follows that anything that gives false or misleading information is going to make this already difficult process of planning for the future even more difficult, and could well cause economic mayhem.

ABCT is based on the idea that this is indeed what happens in the boom. The economy is fed systematically false information, but businesses and consumers act on this information assuming that it is correct. For as long as the stream of misinformation continues, their plans and decisions will be misconceived. A good analogy is propaganda – false political (rather than false economic) information. Consider how a propagandist, like Dr Goebbels, works. He spreads false information through all the media under his control. If all the newspapers and other media tell you a consistent story, you will be inclined to believe it for a while, even though the story does not reflect reality. But as time passes it becomes increasingly difficult for the propaganda ministry to maintain the illusion. No amount of special editions and justificatory editorials can maintain the fiction that the war is being won and that the air raids are not doing serious damage. Sooner or later reality breaks through and the deceived turn with fury on those who have lied to them.

ABCT is really a theory about how economic propaganda can cause businesspeople and consumers to makes mistakes in their business plans and waste the resources they employ. Businesspeople react to false information given them as a result of credit expansion. It is difficult for businesspeople and investors (and others) to see through the bullish economic propaganda that flows from credit expansion.
Austrian Business Cycle Theory is essentially a theory of misinformation. During the boom, businesspeople are led to make decisions based on false information data. They are given signals that give the false information that resources are available when they are not, and that conditions for business are better (often far better) than is actually the case. During the inevitable crisis that follows, they come to realise that they have been misled. The recession is the process of recovery from these forced errors.

*Propaganda and the banks*

But what how does inaccurate information get into the economy? What is the economic equivalent of the propaganda ministry? It is usually an unholy alliance of the government, the central bank and the banking system. (Of course it is unlikely that the government and the banks actually intend to deceive, as is the case with political propaganda, but the effect is the same.)

The banks, tolerated or encouraged by the central bank and aided and abetted by the government, increase their lending by more than people are saving. They do this because the more they lend, the greater they expect their profits to be. Because banks do not back deposits 100% with cash – they lend out most of it – they can create new money out of thin air. This means that such fractional reserve banking systems (FRBS) can generate misleading price signals that cause the appearance of prosperity, which turns out to be unsustainable.

The process can be explained by imagining an edition of Dragon’s Den representing the economy. Now imagine an edition when the Dragons are flush with money. Money is easy and their banks are letting them – and their customers – borrow at extremely low interest rates. As a result the Dragons are feeling optimistic, gym memberships are up in Glasgow, lingerie sales are through the roof and West Country hotels are bursting at the seams. In this environment a number of hopeful entrepreneurs enter the den. Unlike previous editions, when the banks were not so generous, it is easy to imagine what the Dragons might say to themselves when confronted by two teenagers with a plan for an online Tibetan recipe site with a valuation of £10m asking for £500k for 5% of the business. In normal circumstances the Dragons would have been unanimous with a chorus of: “I’ll tell you where I am at. This is not a business and I am OUT.” But now, optimistic and flush with cash, they say collectively: “I like these young guys. You never can tell. Let’s give it a whirl,” and make them offers.
A year later, software engineers and designers have been hired and are hard at work. A supply chain buying exotic ingredients from Tibet has been established, a refrigerated warehouse has been rented and the two teenagers are busy in a purpose-built kitchen testing recipes. Now imagine that the Dragons’ banks suddenly say: “Well actually, Dragons, all that money we thought we could lend you – in fact we can’t. We thought we could but we made a mistake.” The reaction of the Dragons to this news is easy to imagine. Within days (if not hours) the teenage entrepreneurs will be back at school working for their A-levels. Their mothers will have got cheap deals on the kitchen utensils but the Yak offal will have been binned.

This fairy story explains the Austrian explanation of the boom bust cycle, showing how misinformation is the source of the trouble. The fact of the Dragons being told that there were more resources available than was actually the case had a really bad effect on the two luckless teenagers, and the Dragons themselves will have suffered too. And the collapse of one online Tibetan soup business, multiplied over the economy as a whole, shows what the recession is all about – a clustering of entrepreneurial failure.

Of course the analogy is not exact. What happens in reality is that the central bank reduces interest rates. This encourages the banks to increase their lending which in turn encourages optimism amongst businesspeople and consumers (and Dragons). And one important factor that has occurred without being noticed (except by Austrian economists) is that the link between increased lending and increased saving has been broken. Businesspeople (and indeed everybody else) are under the illusion that because bank lending has increased, savings must have done too. But this is not the case. Low interest rates will actually discourage the savers that the banks need in order to continue lending. Businesses are put in the alarming position of basing their business plans on false information – that there are more resources available than is actually the case.

But the fairy story helps to explain one of the technicalities of ABCT – the contrast between the ‘natural rate’ and the ‘market rate’ of interest, a distinction first made by the Swedish economist Knut Wicksell. Interest rates reflect both the preference for present over future consumption and the riskiness of investments. The natural rate is the undistorted rate that would be set by savers and investors without interference. The market rate, by contrast, is the one set or tolerated by the central bank – which may be higher or lower than the natural rate. And that is how false incentives arise.
Reverting to the propaganda metaphor, if the central bank allows actual market interest rates to diverge much from the undistorted interest rate, it is feeding misinformation, economic propaganda, into the economy. Businesses and consumers will act on this false information and as a result they will make mistakes – or more mistakes than they would have otherwise. Admittedly it may be difficult for the central bank to discern whether market interest rates are below the natural rate, particularly at the beginning of an economic expansion. But to state that it is impossible is disingenuous: central bankers who permit bubbles should be sacked, as they have failed in their primary responsibility. On the other hand, much of the blame that has been put upon ordinary bankers is misplaced: they made the reasonable assumption that the central bank was maintaining a sound interest-rate policy as they were supposed to do.

It is important to realise that the banks are intermediaries between savers and investors. Savings, the resources released for investment by the consumption foregone, are for the most part matched by investments. But suppose that the central banks on purpose or by oversight allow a credit expansion. This can create the illusion that there are more resources available for investment than is actually the case.

The immediate consequences are very pleasing (especially for politicians and central bankers). Everyone is under the impression that good times have at last arrived. The increase in credit lowers interest rates. Investors come to believe that longer-term and more complex investments will be more profitable than formerly, and that the whole business environment is less risky. Some sectors will experience even greater booms than others, since it is likely that the new credit will be not be distributed evenly but will be focussed on particular sectors. In the 2000s this was housing; at other times and places it has often been focussed on the latest new technology of the time – such as the internet in the 1990s and electricity in the 1920s. If the boom is big enough there may even be talk of a ‘New Economy’ where it is believed that growth will be continuous and that recessions have been banished.

We can see the effects of the boom by reverting to our example of the Dragon’s Den and our imaginary teenage entrepreneurs. Remember that with the banks prepared to lend on easy terms to the Dragons, their usual exacting standards dropped. Instead of briskly sending the teenagers back to their books, they indulged them. And this is exactly what happens in the real economy. If the banks are flush with
money, they are prepared to lend on easy terms to second-rate entrepreneurs who ordinarily would get short shrift.

But there are other effects too. Remember the Lego example. Imagine that there are 15 children in a nursery school and the teacher in charge dumps a huge pile of Lego on the floor and says that she will give a prize to any child that makes a (recognisable) model truck. Notice first that the bigger the pile of Lego the more elaborate the model trucks can be – some may even have six wheels and transparent windows. But now imagine that there is only enough Lego for 12 trucks. At the start of the process all is sweetness with happy children playing nicely with their Lego. But tears will flow towards the end of the morning when three children realise that there is not enough Lego for them to complete their trucks and to receive the prizes.

Back in the real economy, there is another process going on during the boom. All businesses and consumers hold stocks of money and other assets as precautions against unexpected events. This can take the form cash held against a ‘rainy day’ in the case of individuals. In the case of businesses, it can include stocks of raw materials or inventories, commodity hedges, credit lines with banks, and so on. But in the boom, and particularly if it is long lasting, consumers and businesses may come to believe that a new age of prosperity has dawned which will last a lifetime and the precautionary assets will be run down as boom psychology becomes entrenched. This is a highly dangerous development as it makes business more vulnerable to a downturn just as a downturn is becoming more likely. It is like German civilians taking Dr Goebbels’ propaganda at face value and deciding not to build bomb shelters even in the face of an Allied bomber offensive.

In summary, Austrian economists argue that there are two processes in operation during the boom and both are unsustainable. First, the new money fed into the economy leads businesspeople to believe that more resources are available for investment than is actually the case. As a result they plan more elaborate and complex production processes, which lack the resources to make them workable. Second, interest rates that are lower than the undistorted natural rate can lead businesspeople to believe that investment is less risky than is really the case, prompting them to make riskier investments than they would have in ordinary circumstances. As a result, investments become more elaborate than otherwise: and more elaborate investments are likely to be riskier than less complex ones.
Treacle economics

One might think, and many conventional economists do, that if the economy is booming and prosperity has arrived at last it does not matter how it was achieved. Surely it should be possible to keep the boom going by further injections of new credit? But this is a huge mistake. The prosperity is built on sand: consumers and businesspeople are working on the false assumption that there are more resources available than is really the case. So long as the illusion can be maintained, the unsustainable prosperity can continue. But like Dr Goebbels during the Second World War, it becomes more and more difficult to maintain people's belief in ultimate victory in the face of day and night air raids, food shortages, approaching Russians and heavy battle casualties. The process can be compared to treacle being poured into saucepan on a stove. So long as the treacle continues to pour, it will form a cone in the middle of the pan. The cone represents the boom. But notice that the cone will disappear if the treacle stops being poured and if the stove is gradually heated. In other words once the credit expansion stops the boom will come to end. Even if it does not, an increasing understanding that the prosperity is unsustainable will have the same effect.

How the boom turns into bust

To understand the bust phase of the cycle, revert again to the Lego fairy story. This time, instead of a huge pile of Lego being dumped in the middle of the nursery floor, each child gets a pile of Lego bits of roughly equal size. Also the children are allowed to swap. As in the previous example, there are prizes, but this time there are prizes only for the five best model trucks. As before there is only enough Lego for 10 trucks. In addition every half hour over the morning the exasperated teacher throws some extra piles of Lego for which the children can scrabble for additional bits to complete their trucks.

As the morning progresses the children swap bits so that they can complete and improve their models. But as it gets closer to lunch the mood changes; six or seven children realise that unless they are very careful (or lucky) they will not have enough of the right pieces and will not be able to complete their trucks and win a prize. Increasingly they will do unfavourable swaps for the pieces that they need and they will eye the new pieces thrown onto the floor with great eagerness. The vital pieces will be highly coveted.
This story does not have a happy ending. Just half an hour before lunch and the end of the competition when the teacher throws the last bits of additional Lego onto the floor a fight breaks out for the last available wheel without which the last truck cannot be completed.

And that is how the boom turns to bust. The crisis is caused by the realisation that not all the plans developed in the boom can be completed, and there is a scramble for what resources are available. Many businesses will be unsuccessful in the scramble and they will be left with the real-life equivalents of Lego trucks with only three wheels or no doors. These incomplete assets must be either abandoned as scrap, or re-employed in other ways where their value is likely to be much less. The same applies to labour: workers who were hired in the boom as part of a complex and/or risky business plan find that their skills cannot be fitted into a plan where the necessary resources are not available.

The temporary exhilaration of the boom is bought at a high price in terms of economic and human misery. Because of the misinformation fed into the system at the outset, businesspeople have made unnecessary errors. But these are ultimately the fault of the central bank (often aided and abetted by politicians) in allowing the boom to burgeon.

One way of interpreting the bust is to see it as the reassertion of the consumer preferences that have been ignored or distorted by the boom. Once people see through the false propaganda, they change their plans. Similarly, when competition for the resources needed to complete their business plans forces up prices, businesses (and consumers) begin to reassess those plans and to make them less complicated and less risky. If there are fewer, and more expensive, resources available than was originally thought, it pays to make do and mend. On the basis of misinformation, people had made investment mistakes. Once the reality of market prices has made these mistakes apparent, people will redirect their resources into a pattern that accords better with economic reality.

*The Austrian recovery and the importance of savings*

The Austrian prescription for economic recovery is different from that of conventional economists, who tend to see the recession as an unmitigated disaster with no redeeming features. Austrians accept that the recession is unwelcome; but maintain that it is the inevitable result of the boom that was set in motion by the
bad credit policy of the authorities. The boom encouraged investment mistakes, with resources wasted in business plans that had no hope of success. When reality asserts itself, many of the assets created in the boom turn out to be the wrong things in the wrong place at the wrong time.

The task now is to make the best of a bad job, and reshuffle these assets to where they are more useful. There will be losses. It will not be easy. But the process is a vital part of the recovery, say the Austrian economists. And just as important as physical assets is the reshuffling of human capital. In the same way that physical assets, buildings, factories and machinery have to be redeployed, so workers and businesspeople have to re-adjust. This will involve periods of unemployment and retraining, and accepting that wages will have to fall from their boom-time levels. But such events are an inevitable consequence of the boom and it is a mistake to think that they can be avoided.

Conventional economists focus on the importance of increasing (or at least maintaining) consumer demand as an antidote to the downturn. Without strong demand, they say, the economy will falter. But on the Austrian view, this policy makes two important mistakes. First, it puts the cart before the horse. If there is nothing to meet the demand, inflation will result. Demand is always present: the problem is to make it effective. This means reshuffling productive assets to meet the demand at prices that consumers can afford. Second, the policy ignores the structural problems that resulted from the boom. The wrong assets are in the wrong places. And savings are insufficient to maintain the boom-time production plans. The structure of production simply has to adjust, which inevitably means losses and inevitably takes time.

c) Critique of Monetarists and Keynesians

As we have seen, Austrian economists assume that the economy is made up of heterogeneous parts like Lego models which have to be fitted together correctly if they are to work properly. They reject the assumption of mainstream economics that capital is a homogenous lump of productive capacity. This means that conventional economists have an imperfect view of economic activity and are unable to explain satisfactorily the structural dislocations of the real economy that are thrown up by the economic cycle. There are the two main strands of conventional economics, Monetarism and Keynesianism, and these are mixed in different proportions – some economists have a higher proportion of one in the mix and others a larger fraction
of the other. Nevertheless, each part of the mixture has its flaws and failings. If the Austrians are right, the current policy of fiscal and monetary stimulus will fail to fix the distortions left by the boom, will delay recovery and will raise the threat of inflation.

**Monetarists**

Monetarists fail to recognise that credit expansion and monetary growth can cause distortions in the structure of the economy that cannot be easily or painlessly reversed. The monetarists’ strength is that they have seen the importance of the money supply as determining inflation and that excessive money growth can dislocate the banking system. Their weakness is that they not to appreciate that monetary excess can cause substantial distortions in the real economy.

Modern monetarism has a distinguished history going back to Milton Friedman and Anna Schwartz’s famous book ‘A Monetary History of the United States 1860-1965’. They argue that inflation is the result of excessive increases in the money supply. As Milton Friedman said: “Inflation over any substantial period is always and everywhere a monetary phenomenon.” But the argument also applies in reverse. Reductions in the money supply cause deflation – and Friedman and Schwartz explain that the Great Depression of the 1930s was so serious because the Federal Reserve allowed banks to fail and the money supply to collapse by a third. Hence, one important stand in the conventional consensus is that it was correct for the Federal Reserve and other central banks to stop the collapse of the banking system in 2008 by replacing the money supply which was being destroyed by the banks. Hayek would agree that this was the correct policy in the circumstances.

Less agreeable has been the programme of Quantitative Easing, or money creation, which has been designed not to stabilise the money supply but actually to expand it as a means of stimulating the economy. But increasing the money supply to stimulate the economy ignores the real dislocations caused in the boom. It also risks replacing the threat of deflation with an actual inflation and a new recession.

**Keynesians**

Keynesians also fail to understand the corrective role of the crisis as the economy attempts to re-align resources after the distortions created in the boom. Instead they focus almost exclusively on the need to maintain consumer demand, and on
increased government spending and borrowing as the means of achieving this. But this ‘fiscal stimulus’, if continued for long, creates its own problems. Once the stimulus is withdrawn, the economy just reverts to the position that existed before: unemployed workers may find work on building a bridge financed by government borrowing, but once the bridge is completed, the workers become unemployed again. And another hazard of deficit finance is that the deficits steadily increase government debt. America’s national debt has increased from $10trn in 2008 to over $16trn currently. Stimulus at such a rate cannot go on forever and rapidly becomes unsustainable. Take the example of Japan, whose lengthy programme of budget deficits has left it with barely noticeable economic growth and a budget deficit which is over 250% of GDP.

The other disadvantage of stimulating the economy by budget deficits is that the deficit may crowd out borrowing by businesses for productive purposes. In other words, savings will be become monopolised by the government and the private projects on which the recovery depends may be sidelined.

One strand in contemporary economics is the old commonsense idea reinvigorated by Keynes that prosperity can be achieved by increasing aggregate money expenditure. Hayek denounced this doctrine as superstition and pointed out that it was a fallacy against which economists had struggled for two centuries. While some money creation is desirable to prevent a reduction in the money supply as banks reduce their loans following the losses engendered by the boom, there is no case for pressing ahead with money creation until the recovery starts. Hayek and similarly minded Austrian economists would strongly favour money creation to counteract money destruction but they would strongly oppose money creation which did not have this purpose. They would argue that continuing Quantitative Easing in order to generate increased economic activity would risk first inflation in the form of generally rising prices and second a further boom which would be followed by an inevitable recession. In other words this supposed cure for the recession is to perpetuate economic instability and to create another cycle of boom and bust.

Austrian economists have a convincing reply to those who argue that the recession could be mitigated by increasing total demand for goods and services. They point out that that demand is never a demand for goods in the abstract. It is always for particular goods and services and if this is not matched by that particular mixture of supply, any increase in total demand will have only limited effect. This will be the case where the supply of goods (including investment goods) has been dislocated
in the preceding boom.

One Keynesian idea that has reappeared in debates on the crisis is that of the liquidity trap. It is suggested in a recession businesses might hoard cash and that the resulting lack of demand would keep the economy in recession. But it is impossible for total liquidity in an economy to change, as all money has to be held by someone. Hence if there is an increased demand for money then the real value of cash in terms of goods and services would increase. This would not prevent the full employment of resources given flexible wages and prices. Of course such a wholesale re-pricing is neither necessary nor desirable and would be painful and time-consuming. But we shall see Hayek that argued that central banks should actually intervene to stabilise money national income – increasing the money supply to offset such surges in the demand for money. He also argued for reforms which would make such action unnecessary.

A plague on both houses

Both strands in the current conventional consensus suffer similar flaws, although the monetarist strand is less at fault. Both analyse and prescribe in macroeconomic terms without paying any sufficient attention to the distortions that flow from a boom. Both treat the structure of production as a homogenous lump. Consequently, economists of both strands are puzzled by events for which Austrian economists have a clear understanding.

Both strands in contemporary economics also underestimate the importance for a return of prosperity of changes in relative prices in bringing about the necessary adjustments in the structure of the economy. While some Austria economists would accept the need for deficit spending in an emergency, all would agree that deficit spending does nothing to promote the adjustments necessary for a return to prosperity.
How Hayek would fix the economy

There are two parts to an Austrian programme for economic reform. First, steps to make sure that recovery is as quick and as strong as possible. Second, a series of feasible reforms to the monetary system that would prevent the crisis recurring.

a) Cutting the recession short

The paradox of the economic crisis is that it is the boom and its apparent prosperity which is the cause of the subsequent recession. The recession is the painful process of recovery as businesspeople and consumers attempt to readjust and to correct the errors made during the boom. The unsustainable jumble of assets created in the boom must be corrected. The recovery requires assets which have been misapplied to be reshuffled into a new pattern. Resources misapplied during the boom need to be moved in order to create a sustainable structure which accords with actual saving decisions and risk preferences – based on reality rather than on the illusion created by abundant credit. This reshuffling process will necessarily involve unemployment of labour and resources as they move from sectors over extended to areas where there is sustainable demand.

This restorative rearrangement of labour and resources can be frustrated by the authorities fixing prices and wages above levels at which markets would clear.
Wages may rise in some industries and fall in others, but given that the boom will have destroyed resources by deploying them where they have little or no economic function, wage rates generally may have to fall as the economy having become less productive. If these price changes are resisted, the result will be an unnecessary lengthening of the recovery process – a longer and deeper recession than necessary.

An important corollary of this reshuffling process is that assets and workers should be freely available to move and that the signalling system of prices is allowed to operate freely. Prices reflect changing patterns of supply and demand: they tell people what they should do and how they should do it. This is true in ordinary times, but in the recession the responsiveness of this signalling system is especially important, as more changes will be necessary and they are likely to be bigger than in normal times. Resources need to shift from industries over-expanded in the boom to those that were starved, and prices will drive that redeployment.

*An end to anti-business rhetoric and actions*

One of the paradoxes of the recovery is that just when maximum freedom and incentives are necessary to accelerate the reshuffling process of recovery, politicians are tempted to increase regulation, to tax and interfere and to put obstacles in the way of recovery. The most evident is the suggestion that the broadest backs are best able to bear the burden in the recession and as a result to increase marginal rates of tax and tax returns absolutely. The effect is actually to ensure that recovery takes longer and that the least well-off suffer most and longest. In a business environment where risks have previously been under-estimated, it makes no sense to reduce returns by raising taxation. Businesspeople having had their hopes frustrated in the artificial optimism of the boom are far less likely to seek out new business opportunities when risks are increased and returns diminished because of increased taxation.

One reason that economists have given for the very slow recovery from the depression of the United States in the 1930s was the fierce anti-business rhetoric and actions of the Roosevelt Administration. Not only were rates of taxation greatly increased but new powers were given to trade unions to fix wage rates and price cutting by business was discouraged and in some cases forbidden by law. It is difficult to imagine a recipe more likely to perpetuate a recession.
**Unfix wages**

If prices must be free to indicate where resources should be moved, so also must wages be free to give the same sort of signals to workers. There are two important facets to the role of wages. First it is highly likely that on average, wages will have to fall if employment is to be maintained, as the economy is likely to be less productive than it was thought to be. If the economy is less productive then it is likely that average wage rates will fall. It follows that unless the minimum wage is reduced, it is likely to lead to higher rates of unemployment.

But much more damaging than the inflexibility of the minimum wage is the role of trade unions. In many industries they have significant powers and the ability to set wages above the clearing rate. This reduces demand for workers in the affected businesses and increases the supply elsewhere. In other words, trade unionists benefit themselves at the expense of non-unionised workers. But this is not the only damage that wage fixing does. In the recovery phase of the cycle, it is vital that resources and labour move from the sectors and business which expanded unsustainably, towards emerging new businesses. This means that to make this happen as rapidly as possible the prices of labour and other resources must be able to fall where they are no longer needed and to increase where there are new opportunities. If trade unions keep wages up in an important sector, it will have serious ill-effects. First, it will tend to make those industries even less profitable than they would be otherwise, and they will contract more than is necessary. Second, by preserving employment in failing industries where they have power they will frustrate the movement of labour to new industries where it would be more productive.

**Interest rates and more savings**

Austrian economists identify natural corrective forces that can bring the economy back to more stable pattern of development. These forces include a return to higher interest rates, which will encourage increased savings. Savings, insist Austrians, are important because the resources released from consumption can be used to complete the unfinished structures which were begun in the boom. Increased savings are thus one of the essential keys to rapid recovery.

This analysis is quite different from that of conventional economics, which tends to dismiss saving as unimportant or actually harmful. But if the economy is seen as a co-ordinated structure made up of interlocking pieces, the importance of saving
is clear. The productive resources freed by foregone consumption can be used to complete the plans which had to be abandoned at the end of the boom. These resources give the economy the flexibility to adapt more easily to the demanding circumstances of the recession. As we saw above, the threat of a liquidity trap is greatly exaggerated – which means that increased savings are an important factor in economic growth in recession times as much as they are at any other time. Indeed they are especially important in the recession as the more resources that are available, the more likely it is that the abandoned projects of the boom can be resurrected or adapted to some other purpose.

Fixing balance sheets

One of the consequences of the boom is that businesspeople and consumers had been deceived into thinking that investments were much less risky than was actually the case. With risk premiums reduced by the credit expansion, people developed business plans that made insufficient allowance for the possibility of failure. Go-getting employees were hired, and ‘rainy day’ provisions were run down. Once the crisis forces businesspeople to shed these illusions, their first concern of business is to ensure their businesses’ survival. They will strive to build up their cash reserves, repay debt and operate more cautiously. To many commentators this new-found caution among businesspeople is an ill-effect of the crisis and businesses should be encouraged to be less risk averse. But this would be a mistake: policies that undermined caution were the cause of the problems in the first place.

It takes time

Given the accumulating damage done by the misinformation fed into the economy during the boom years, it must inevitably take time for the economy to return to stability. The paradox is that the recession is part of the recovery process. Distortions can only be unwound slowly, and the deeper the distortions the longer it will take to reshuffle the assets (both physical and human) into a sustainable structure. Even with the best will and a full programme of Austrian reforms, it will not be a quick and painless process.

Allowing price signals to work

The key to a rapid recovery is that government steps out of the way so that markets can work to get people and resources back to work. To speed the recovery, the
government needs to undertake a programme of radical pro-business reform. This should include:

- **Reduction in the marginal rates of personal taxation, income, capital gains and inheritance.**

Reductions in the marginal tax rates would operate to increase incentives. High marginal tax rates blunt price signals, but prices are the signalling system which tells businesspeople and consumers what they should do. They are particularly important in the recession when assets, human and physical, need to be re-shuffled into new productive uses.

Taxes on capital gains and inheritances also need to be drastically reduced or abolished. They both discourage savings. The effect of capital gains tax is to reduce the reward for taking on risk. The taxation of inheritances is more insidious as it puts strong disincentives in the way of long-term investment.

- **Dramatic easing of regulations to make it much easier to set up and run new businesses.**

Austrian economists would not be alone in advocating the removal of restrictions on business. Excessive regulation prevents the re-arrangement of businesses, assets and jobs.

- **Abolition of the minimum wage – this acts as a tax on jobs and job creation.**

Insofar as it sets wage rates above market clearing rates, minimum wage legislation can only reduce employment. It should be abolished or reformed.

- **Ending the power of trade unions to fix wages above the market clearing rate.**

Trade unions reduce employment and prevent the movement of workers from contracting to expanding industries. This may not be their intention, but they have the effect of slowing the changes that must be made if the recovery is to be swift.
b) Fixing money

Hayek and the Loose Joint

Austrian economists believe that bank reform is necessary because banks are the cause of economic instability and the hugely damaging boom and bust cycle. In Hayek’s famous phrase, banks are the ‘loose joint’ in the capitalist economic system. Hence Austrian economists focus on the reform of the banking system as means of reducing large scale economic instability.

The problem is caused by the ability of a fractional reserve banking system both to create money and to destroy it. The creation of new money creates the apparent prosperity of the boom – and the resulting recession. That would be bad enough, but the system also has the ability to reduce liquidity just when demand for it increases. This effect of the fractional reserve banking system (FRBS) to create destabilising monetary expansions and contractions can cause economic chaos. FRBSs are the rule throughout the world, but they mean that the world economy is inherently unstable as a result.

It is worth setting out in detail how this is possible. Imagine an umbrella depository in a large office. Employees deposit their umbrellas for safe keeping with the depository, and to prove that they have the right to an umbrella they receive a ticket. The attendant in charge of the depository notices that even when it rains only a few employees with tickets actually claim their umbrellas. He then has the idea that he could lend out a proportion of the umbrellas to non-employees for a small fee. By this simple manoeuvre he has both created an income for himself that he did not have before and he has made the total number of umbrella tickets and umbrellas in use greater than the total number of actual umbrellas.

Now notice what happens when there is a thunderstorm. The employees with tickets rush to redeem them and the attendant becomes worried that his scheme will be discovered. If every employee demanded their umbrella, there would not be enough to go round. So he texts all those non-employee borrowers to return their umbrellas at once so that he can meet the legitimate claims of the ticket holders. As the borrowers return the umbrellas loaned to them, the total of umbrellas and unredeemed umbrella tickets declines towards the total of actual umbrellas in the system and the original one-to-one parity is restored.
This analogy explains precisely how a FRBS can both expand and contract credit. Unfortunately, unlike the umbrella example, the expansion and contraction of credit can cause serious distortions and disruption to the economy. This is because credit expansion affects interest rates, which as a result give misleading information about resources and risks to businesspeople and consumers.

We have seen the evils of credit expansion. It is now worth outlining the evil consequences of credit contraction. It is generally in banks’ interests to expand credit – more loans mean bigger profits. But when the crisis hits, the banks’ depositors may withdraw their money – forcing the troubled banks to call in their loans in order to have on hand the cash they need to repay the depositors. The banks contract their balance sheets, just like the umbrella depository in the thunderstorm. The result is that the money supply, represented by the aggregate deposits of the banking system, declines.

Notoriously in the 1930s, the US Federal Reserve, which had only been established in 1913 and was inexperienced, permitted the money supply to decline by about 30%. This was not a reduction in the rate of expansion, but an actual reduction in the amount of money in the US economy. The result was an unnecessary and destructive period of falling prices. Given the power of trade unions to fix wages, this led to a large increase in unemployment. But it also had another damaging effect. With falling prices, real interest rates rose sharply, pushing interest rates well above the ‘natural rate’. In the same way that interest rates below the natural rates lead businesspeople to make unduly optimistic investments in the belief that there are more resources available for investment than is actually the case, so interest rates above the natural rate mislead them into cutting back on investment because they believe that business prospects are worse than is actually the case. In their book A Monetary History of the United States, Milton Friedman and Anna Schwartz explain how the Federal Reserve permitted this disaster. They argued that the American central bank should have prevented the collapse of large parts of the banking system and the resulting sharp fall in the money supply. Friedman and Schwartz argue that if the Fed had prevented the collapse of the US money supply, the depression would have been much less severe.

*The case for reducing central bank discretion*

The current system for regulating the banks of the industrialised countries is based on the Basel formula for bank regulation and it includes a large element of discretion
for the central bankers. (This should be no surprise, as it was devised by central bankers.) They are supposed to use their best judgement to set interest rates and mould credit conditions to achieve economic stability, low inflation and high rates of employment. The exact weight given to each of these aims depends on the country concerned. But in all cases the central banks have discretion on what to do.

In theory it is clear what their policy should be. When economic conditions are poor and growth is weak they should reduce interest rates, and when a boom starts they should increase interest rates. Thus William McChesney Martin who was Federal Reserve Chairman in the 1950s and 1960s described his role as: “…the fellow who takes away the punch bowl just when the party is getting good.” But in the decade before the crash of 2008 it felt that central bankers, rather than removing the punch bowl, were topping it up from their hip flasks. When things were bad central banks eased interest rates and when things were good they took no action to restrain the boom. This was the era of the infamous ‘Greenspan put’ when the Fed could be relied upon to stimulate the economy at the first sign of weakness but to do nothing to restrain what Federal Reserve Chairman Alan Greenspan famously described as “irrational exuberance”. The result was a policy asymmetry that had catastrophic consequences.

Part of the explanation for this folly is a failure of theory. Following conventional mainstream economics, central bankers did not understand that the booms they might create would cause massive dislocation in the structure of the economy that could only result in a recession. And central bankers are no more immune to boom psychology than anyone else: they were just as much carried away by talk of the New Economy as the most bullish Wall Street analysts.

All this leads Austrian economists to argue that it is very difficult for central bankers not to misuse and even abuse the discretion given them. This why Hayek, for example, argued in favour of monetary systems which reduced as much as possible the discretion of the central bank and relied on an automatic system (such as the gold standard). Likewise, the programme of reform set out later in this paper, The Freiburg Plan, aims at moving towards a system where the discretion of the central banks is reduced and central bankers are no longer so free to spike the economic punch bowl.
What about Quantitative Easing?

Although the central banks of the world can and should be criticised for permitting the boom, at least they learnt the lesson of the 1930s and prevented the collapse of the banking system and a precipitous decline in the money supply. Not only did they move to protect depositors in the initial crisis of 2008, but subsequently the programme of Quantitative Easing has replaced money which had been destroyed by the contraction of banks’ balance sheets. But this is not really a justification of their behaviour. They should have realised the damage that a boom could do and stopped it developing in the first place.

Hayek: Against deflation and for limited QE

Austrian economists (Hayek in particular) have sometimes been criticised for their toleration of deflation in the 1930s. But Hayek rapidly saw the error of this way of thinking and had changed his mind by 1933; and in 1937 he argued strongly that central banks should offset undue expansion or contraction of the money supply.

Hayek would have welcomed Quantitative Easing insofar as it prevented the collapse of the money supply, and deflation. But his support would not have been unqualified. Money creation designed to offset the destruction of money by the banks was indeed desirable. But Hayek would firmly oppose QE as a means of stimulating economic growth. This would just be a return to the economic fallacies against which economists had struggled for centuries. Besides the absurdity of thinking that economic growth can be promoted by simple money printing, there is also the danger of inflation and another boom and bust cycle. This was the danger against which Hayek argued so vehemently in the 1970s.

It follows that the task for the reformer is to design banking institutions that reduce or remove the ability of the banking system to expand and contract credit perversely (with highly unsatisfactory consequences in both cases). Austrian economists have suggested a number of possibilities. Hayek advocated in turn a return to the gold standard, a commodity reserve currency, and finally competition in currency without a central bank operating as lender of last resort. Hayek’s views changed with changing circumstances; and his solutions were always practicable, given the context of the times in which he wrote.

In an economic crisis, the prime role of the central bank should be to ensure that
the banking system does not collapse. If this were to happen it would require a re-pricing of labour and all goods and services in terms of the reduced supply of money. But as George Selgin, a modern Austrian economist, has pointed out, such a wholesale re-pricing will be unnecessary, time-consuming and wasteful. So the central bank should seek to keep money stable as a proportion of national income. And this may mean increasing the money supply to offset either an increase in the demand for money or an actual decline in the quantity of money. Hayek recognised throughout his career what the British economist Sir Ralph Hawtrey called the ‘inherent instability of credit’ – the perverse ability of banks to contract the money supply just as demand for it was increasing. Hayek saw this as a flaw in the capitalist system which needed correction.

*Hayek and piecemeal reform*

Hayek believed in a piecemeal approach to economic and social reform. One huge difficulty in introducing the kinds of reform advocated by Austrian economists was that that they challenge the important role of central banks. Much financial and intellectual capital has been invested in central banks and central banking, so the necessary changes can only be attempted slowly and step by step. They must also be perceived as feasible and not utopian. (Though what counts as utopian can change: writing in 1976 Hayek claimed that his proposal for competition in currency was feasible while he thought the proposed European currency was ‘utopian’.)

*Sound money in one country – The Swiss Problem*

But unless banking reform is general, those who embark on it will face what can be called the ‘Swiss Problem’ – that a country with a sound banking system and a hard currency can become a refuge for investors seeking to avoid default, inflation, instability or a combination of all three. This is flattering for the country in question, but unless it has little foreign trade, the consequences can be very damaging. The attractions of the currency as a ‘safe haven’ could push up its value, devastating its export industries and creating a windfall for importers. In 2011 this happened to Switzerland as the Swiss currency was widely and justifiably seen as a safe haven: massive purchases of Swiss francs by worried investors sent the Swiss franc soaring. The threat this posed to Swiss export industries made the Swiss financial authorities abandon their extreme sound money policy and on September 6th they announced that they were “prepared to buy foreign currency in unlimited quantity” and cut interest rates to keep the currency from rising in the foreign exchange markets.
This ‘Swiss Problem’ is one which any reform of the banking system would have to meet. Of course if such reforms were instituted worldwide by international agreement there would be no problem. But such international agreement would be very hard to reach. It follows that any programme of monetary reform to reduce monetary instability must take account of the Swiss Problem if introduced in one country or currency bloc. Nothing would be worse than to introduce desirable reforms, only for them to be abandoned because they caused serious economic problems for the country that introduced them.

*Sound Money in One Country - The City of London problem*

In other words, one difficulty in putting the case for radical reform of the banking system in the UK is that if the policy were introduced in the UK alone it would risk making the UK, and in particular the City of London, an unattractive place to do business. If this were the case the City and Britain would lose a valuable source of income and employment. If British banks became more liquid and better capitalised than those of other counties, then inevitably some banks and perhaps much banking business might move to other centres where the capital and liquidity rules were not so strict.

One obvious response is that since banking has been the cause of the trouble it might be no bad thing if the Britain made less of its living from banking. And the City’s earnings are not limited to banking: other types of financial business might thrive in an environment where the banks and the currency were known to be ultra secure. Further the ‘Swiss Problem’ might actually operate to mitigate the ‘City Problem’. Funds and activity might move to London because of its new found character as a unique international centre with cautious banks, a hard currency and opportunities created by a liberal regime of competing currencies.

*Bank Reform: Some rejected options*

Before setting out a series of reforms for today, the Freiburg Plan, it is worth reviewing the solutions which have been proposed by Austrian economists over the years. All these have the great virtue of recognising the problems created by fractional reserve banking. To a greater or lesser extent they remove the discretion that central banks have so much abused.
(a) 100% reserve banking

Some Austrians have advocated a move to 100% reserve banking. This proposal (which was also advocated in the 1930s by the Chicago proto-monetarist Henry Simon) is criticised as utopian, given the long-established worldwide dominance of the FRBS. Simon coined the term ‘money bootleggers’ to describe the money-creating ability of fractional reserve banks. The value of the proposal is that it faces up squarely to the problems created by fractional reserve banking and suggests a solution that would completely remove it. Banks would be forced to back all their deposits with cash – so there would be no possibility of default. They would then operate as safe deposits for cash – keeping money safe and issuing receipts in exchange which would serve the same role as the money deposited.

Some Austrian economists claim that fractional reserve banking is fraud: banks without cash in their vaults equivalent to their deposits are as fraudulent as a safe deposit company which rented out the items deposited with it. But people who deposit cash in their banks fully understand that the banks will lend out at least some of the money they deposit – so the charge of fraud seems unconvincing. And fractional reserve banking, despite the problems it creates, has become so well established that it is a part of our economic culture. It would take a revolution to abolish it. Perhaps in the Sixteenth Century, when modern banking first developed, the charge of fraud might have sent economic evolution down a different and better path; but that course was not taken and it is not open to us now. So plans to revert to 100% reserve banking are probably utopian. What is required are reforms that can be adopted now.

But proponents of 100% reserve banking have got one thing completely right: the clear understanding of the damage that fractional reserve banking can do. It has the potential to cause crises of varying magnitude. Sometimes they are just the modest ups and downs of the nineteenth-century trade cycle. But they can also be the catastrophic disasters of the Great Depression of the 1930s and the current Great Recession. Perhaps the world would have been better had fractional reserve banking never been invented – but that is not the world in which we live, and it cannot now be uninvented.

So even if it is utopian to advocate 100% reserve banking, its supporters at least make a good criticism, and show the direction in which reform should point.
(b) Return to the Gold Standard

Many Austrians have advocated a return to the Gold Standard. Carl Menger, the founder of the Austrian school, was author of a report that successfully urged the adoption of the gold standard by the Austro-Hungarian Empire. And the nineteenth-century gold standard was a triumph of civilisation, particularly when combined with global free trade: it was accepted at the time as promoting both monetary stability and international trade and investment. It was the ambition of countries to stabilise their currencies and put their currency on the gold standard. Thus Austro-Hungary went on to gold in 1892 and the Russian Empire in 1897. Though the system was destroyed by the inflation and monetary chaos of the First World War, attempts were made to revive the gold standard under Bank of England governor Montagu Norman in the 1920s. In 1925 Britain returned to gold at the pre-war parity – though this greatly over-valued sterling, forcing Britain to leave again in 1931. Other countries followed.

Hayek argued that the gold standard had three main advantages. First, it provided an international standard, which meant that there was no foreign exchange risk. Gold was essentially the money used all over the world; prices could therefore be compared easily and international trade and investment became straightforward. Second, if the countries on the gold standard kept to the rules, adjustment to trade deficits and surpluses became automatic: surplus countries would be net gold importers, which expanded the credit system, and the reverse would happen in the case of trade deficits. Third, the standard’s chief attraction was that it kept inflation at bay because production was limited by the cost of production.

But the nineteenth-century gold standard was that it grew without conscious design and it might be very difficult to recreate such a structure by intentional reform. And there are other difficulties in returning to the gold standard. Countries would have to decide whether to return to the full gold standard, with gold coin being used in everyday transactions, or to revert to the Gold Exchange Standard that existed between the world wars. In the latter case gold was held by central banks and used by them as backing for currency and to settle international transactions. A full gold standard would subject the world economy to the unpredictable changes in gold production and would give substantial economic power to unstable producer countries. One can imagine a cartel of gold producers and exporters being formed like OPEC, the oil producers’ cartel. Equally, a difficulty with the Gold Exchange Standard is to ensure that the central banks played by the rules did not increase
gold certificates in excess of the gold they held.

But Hayek also realised that the gold standard had a major weakness in addition to what he called the ‘vagaries’ of gold production. A more serious flaw was that production could not respond quickly to increased demand. This meant that if there were increased demand, prices would have to fall. This would mean the sort of wholesale re-pricing of wages and prices that George Selgin, the modern Austrian economist, has argued is both inefficient and unnecessary. And if wages are ‘sticky’ as the result of trade union activity, then unemployment would result. What is needed, Hayek argued, is a commodity that can is be used as currency but which can respond quickly to changes in demand.

A further major difficulty is that it unless it were introduced universally, then gold standard countries would find themselves becoming safe havens with their currencies becoming hugely over-valued – a version of the Swiss Problem described above. In sum, a return to gold would be to a far from an ideal system and it would be difficult to achieve.

(c) A commodity reserve currency

In 1943, in the middle of the Second World War, Hayek proposed a Commodity Reserve Currency (CRC), which he argued would be an updated and improved version of the gold standard. Instead of gold, the currency would be based on a basket of commodities. Hayek argued that a CRC would have the advantage over gold in that an increase in demand for money would bring about a rapid increase in supply. (Hayek was writing at a time when a major reform of the world monetary system was possible and which actually took place at the Breton Woods Conference after the Second World War. The result was to establish the World Bank and the International Monetary Fund and a system of fixed exchange rates.)

A CRC would avoid some of the difficulties of the gold standard, such as dependence on the small number of producer countries, but it would still be difficult to introduce universally. One can imagine a deadlocked international conference trying to decide which commodities to include in the index. And again, if a CRC were adopted by a single country it would run into the same ‘Swiss’ objection as the Gold Standard.
(d) Competition in currency

In two papers published in the 1970s, Hayek advocated competition in currencies as a means of promoting stability. Both papers were published by the Institute of Economic Affairs; Competition in Currency and the Denationalisation of Money respectively in February and August 1976. In the first paper Hayek described his highly original idea as a ‘way to stop inflation’. In the second, the title page quotes Hayek as saying:

‘The cause of waves of unemployment is not “capitalism” but governments denying enterprise the right to produce good money.’

A critic might argue that Hayek’s proposal was designed to counter the inflation and unemployment that were the greatest economic problems of the 1970s. Today, the threat is unemployment as a result of a deep recession. Hayek would respond that unwarranted credit expansion by the banks is the cause of both inflation and unemployment. It follows that competition in currency would work to prevent both a recurrence of the inflation and unemployment of the 1970s and a recurrence of the boom which led to the post 2008 Great Recession.

Hayek argued for two steps that would prevent the banks from causing boom-bust cycles. His first proposal was to remove from central banks their role as lenders of last resort. His second was to repeal legal tender laws (and exchange controls) and to allow banks and other financial institutions to issue currency in competition with each other. Together, these reforms would allow for the provision of money by private enterprise rather than by government monopoly. The removal of the role of the central banks would make the issuing banks extremely cautious in how much they would issue without ‘backing’.

In Hayek’s proposal, issuing banks would guarantee that their notes would be redeemable according to indices of a basket of other currencies, commodities, retail or wholesale prices – separately or in combination. So if a privately issued currency started to weaken against others, the issuing bank would have an incentive to restrict the amount they issued. And without a central acting as a lender of last resort, they would be very cautious, since a run on their currency would easily cause their collapse, were they unable make good on their promises to note holders.

Hayek speculated that because money has always been provided by a government
monopoly, we do not know what sort of money consumers would prefer. It might be that they preferred money stable in terms of consumer prices, but they might prefer money which was stable in terms of producer prices or gold or a basket of commodities. Competition in currency would allow all users of money to decide.

One important consequence of Hayek’s proposal for competition in currency is that the monetary system would lose much of its ability perversely to expand and contract. Fear of default would prevent the issuers of competing currencies from expanding them excessively, meaning that inflation would cease to be endemic. But excessive decreases in the money supply would be avoided too. In other words, competition in currency would prevent both inflation and deflation.

Yet some critics argue that fractional reserve banking is so deeply engrained in us that a central bank acting as lender of last resort would soon emerge. Changing to such a completely new system without a central bank would amount to a revolution in theory and practice which would be very hard to achieve.

c) The Freiburg Plan - Tightening the Loose Joint

What’s wrong with Basel

The banks in the G20 group of industrialised countries are regulated on principles established by the Basel Committee of central bankers. The Committee was founded in 1974 and is based on the Bank for International Settlements. It was launched in response to the economic and financial crisis of the early 1970s, though its work has not had great success: its internationally co-ordinated approach failed completely to prevent (or even foresee) the crisis of 2008. After two rule packages, Basel I and Basel II, a third set of rules, Basel III, is to be implemented between 2013 and 2019. There is little reason to believe that these will be any better at preventing another banking crisis; a policy of more of the same kind of rules seems to represent the triumph of hope, and lack of imagination, over experience. And Austrian economists maintain that such rules largely miss the point anyway.

The Basel proposals focus on the danger that banks might collapse if they hold insufficient capital, and that the failure of large banks could cause systemic economic damage. The rules therefore seek to ensure that banks have enough capital relative to the risks they bear. There are complex formulae to calculate this, but liquidity – the proportion of cash relative to total assets – is given little attention.
Also, the capital requirements are based on historic patterns of volatility, which are of only limited use in preventing a future systemic crisis – slamming shut the stable door after the whole Grand National field has bolted. Not only are historic patterns of risk are extremely unlikely to be repeated in the future; the system of capital weightings seems almost designed to ensure they will not, as it will prompt banks to lend where the Basel capital weightings are lowest.

From an Austrian perspective the major flaw in the Basel regimes, current and proposed, is that they ignore the ability of the banking system to distort the economy. It is claimed that with more capital, banks will be in less danger of collapse, so the chance of another crisis will be diminished. But this is to ignore the damage that banks can do during the boom. Increased amounts of capital will do little to prevent the creation of future booms – and busts. The enhanced capital requirements set down by Basel III appear to be treating a symptom rather than the cause of the disease.

Basel III will increase the capital that banks must have up to 15.5% of their liabilities as capital in the form of equity, bonds and retained earnings. The total includes a ‘buffer’ of 2.5% which can be drawn on in a crisis. Banks have until 2019 to have the extra capital in place. In Britain, Basel III is to be strengthened even further by the requirements of Sir John Vickers’s Independent Commission on Banking, which will increase the capital requirement of UK banks to between 17% and 20% of assets by 2019.

You might well think that if, for every new £100 of loans, banks have to have 15.5% of capital rather than (say) 7%, then lending would be proportionately restrained. But once a boom gets going, capital becomes very freely available and capital requirements lose their ability to restrain lending. It is all too easy to imagine a major economic crisis caused by a well-capitalised fractional reserve banking system. Also, the Basel regime counts retained earnings as part of the banks’ capital requirements. But in a boom, banks’ earnings will be enhanced by artificial (and unsustainable) profits, creating a self-reinforcing process of expansion. The retained earnings of banks would just add petrol to the fire of the boom. It is interesting that in a speech in October 2010, Bank of England Governor Sir Mervyn King admitted that Basel III, by itself, would be insufficient to prevent another crisis.

In short, the Basel focus on bank capital is flawed because capital requirements are ineffective as a means of limiting bank lending. A loan from one bank can even
become the capital of another: Bank A lends money to Business X, which uses the loan to buy equipment from Business Y, which invests the money in Bank B’s new bond or equity issue.

All that increasing the capitalisation of the banks may do is to force them to use private capital for the bailout before the event rather than taxpayer resources after the event. What it does not do is to prevent the need for the bailout in the first place.

Even after the introduction of the full Basel III regime in 2019, banks will still be able to create the sort of boom that caused the Great Recession. And on past form, it is not enough to trust central banks to contain such a boom. Federal Reserve Chairmen Alan Greenspan and Ben Bernanke actually presided over the bubble and did nothing to prevent it growing to its economy-destroying bursting point. Though Greenspan saw the ‘irrational exuberance’ of investors, he failed to increase interest rates on the grounds that he did not want to provoke a recession. And Mervyn King made just the same mistakes. The result was one of the greatest economic disasters in history.

It is clear that we cannot rely on central bankers and the enhanced Basel III regime to prevent booms in the future. What is needed is a regime that forces banks to hold a large proportion of their assets in cash, which reduces their gearing and their ability to expand credit. This regime should be supported by the introduction of competition into the production of money.

The Freiburg Plan

The Freiburg Plan sets out proposals for regulating the banking system. As mentioned earlier, it is named after the university town in southwest Germany, close to the French and Swiss borders, which the Nobel economist Hayek made his home. It is said that Hayek was inspired to write his papers on competition in currency because of the ease with which Swiss, French and German currencies circulated in the region.

The Freiburg Plan can be seen less as a replacement for the Basel regime than as an addition that would make it much more effective in preventing future crises. It could follow the Basel approach of international negotiations and accords, but equally it could be introduced in individual countries and currency blocs to beef up Basel III.
The Freiburg Plan has into two strands. The first sets out a regime for fractional reserve banks, which alone will have access to the lender of last resort facilities of the central bank. These will be subject to rules that require them to hold an increasing fraction of their assets in cash.

The second covers a programme of reform to permit competing currencies. The issuers of the new competing currencies will not be covered by lender of last resort facilities of any kind. They would operate as a competing source of money to that provided by government through the fractional reserve banking system. In other words, they would break the government monopoly of money.

*The Freiburg Plan Part 1: Reducing the Money Multiplier*

In analysing the role of banks in causing booms and busts, Austrian economists have focused on the banks’ cash reserves rather than their capitalisation. This is why some Austrian economists have sought to introduce a system of 100% reserve banking. As we have seen, they have good reason to claim that the fractional cash reserve character of the banking system is the root of the trouble.
The Freiburg Plan would require banks slowly but steadily to increase the proportion of liquid assets in the balance sheets by 1% a year up to a pre-determined limit – say between 30% and 40%. This Freiburg requirement could be integrated into the Basel framework by allowing a limited trade-off with Basel III’s mandated increases in bank capital. It would be a programme of long-run radical reform of the banking system, marking a return to ‘old fashioned’ banking principles.

The Plan could be introduced by a single country, or currency union, without attracting the ‘Swiss problem’, because the increase in the cash reserve would take place only gradually – and would be suspended when economic growth fell below a pre-specified amount. The Plan would thus avoid the folly of strengthening bank balance sheets at a time of recession – which as Professor Tim Congdon has pointed out, makes recovery even harder.

The purpose of the Freiburg Plan’s increase in cash reserves is to reduce the ‘Money Multiplier’. This is the mechanism by which banks with fractional cash reserves can expand their deposits. Thus if the cash reserve ratio is 5% then for every £100 of new cash deposited £95 can be lent out. In turn this £95 will be deposited and £4.75 will be retained and £90.25 lend out. This process is continuous and with each cycle of lending and depositing it creates more deposits and increases the money supply.

Figure 1 above illustrates the extraordinary power of the money multiplier with a low cash reserve ratio. It shows that with a reserve ratio of 3%, as allowed by the Basel rules, £100 injected into the system has the power to increase deposits to £2,219 after only 36 cycles of depositing and lending. It illustrates very clearly that the present cash reserve ratio requires extraordinary determination by the central bank if it is to prevent a boom. A small mistake can cause a vast increase in credit and result in extraordinary financial and economic instability: and as we have seen, there has been no shortage of such mistakes in the past.

But an increase in the bank’s cash reserve ratio can bring about an enormous reduction in the money multiplier. With the reserve ratio at 30%, the same £100 could turn into just £333 (and at 40% £100 would turn into only £200) after 36 cycles of lending and depositing. In the latter two cases the rate of increases slows after seven cycles. But with a 3% Basel ratio the total shows no signs of ceasing to rise after 36 cycles. Figure 1 also shows how, by increasing the reserve ratio to between 30% and 40%, the ability of the banking system to create a bubble is
severely restricted. The thick lines at the bottom of the Figure show the range within which cash reserve ratios would be set by the Freiburg Plan.

An economy can work well with highly conservative banks whose assets include a large proportion of cash. In the 1950s British banks had balance sheets with large concentrations of cash and near cash. This meant that their gearing was low and it was difficult for them to expand their balance sheets and increase the money supply.

Of course an increase in the cash reserve to between 30% and 40% would not prevent the banks from expanding money and credit; but it would make it much more difficult. It would achieve many of the benefits of a 100% reserve banking system without its impracticality.

Under Basel III there is no required cash reserve ratio and banks will only be required to hold cash equivalent to 30 days’ worth of transactions. This puts enormous and unjustified faith in the ability of central banks to prevent another recurrence of ‘irrational exuberance’ and stifle an incipient boom. The Freiburg Plan would make us much less reliant on central banks to prevent booms, bubbles and the inevitable busts. At best, capital requirements on their own can have only limited effect in preventing the banking system from collectively increasing its loans and creating a boom. But if banks have a cash reserve ratio of 30%-40%, the ability of central banks to set off a boom would be greatly limited, no matter how cavalier they might be.

Another consequence of the adoption of the Freiburg Plan would be to reduce the central bank’s role as lender of last resort. As banks edged closer to a 30% or 40% reserve ratio, the role of the central bank as lender of last resort would become less and less important. But the main long-term effect is that the Freiburg Plan would tighten the ‘loose joint’ in the economic system and mark a return to the more secure banking principles of the past. In the 1950s British banks had liquid assets of over 30%. In the 1970s this ratio was reduced sharply, a change which led to the inflation in the UK in the mid-1970s. Since then the ratio has been allowed to fall further to around 3% today, as shown in Table 1:
Table 1: UK Cash and Liquid Asset Reserve Ratios

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
<td>30%</td>
<td>20.5%</td>
<td>15.9%</td>
<td>5.0%</td>
<td>3.1%</td>
<td>ca 3.0%</td>
</tr>
</tbody>
</table>

Source: Radcliffe Report Cmnd. 827

Integrating the Freiburg Plan into the Basel Regime

Freiburg Plan would not replace Basel III, but would supplement it. Under the Basel III / Vickers proposals, UK banks are required to increase their capital to between 17% and 20% of assets by 2019. If at the same time they were required to increase their cash reserves by 1% a year, banks would be forced to become both better capitalised and more liquid at a rapid rate. It is indeed a mistake to require banks to strengthen their balance sheets in a recession; and the addition of a Freiburg obligation to Basel would be even more harmful in such circumstances. But the solution is to allow banks to offset their Basel III against their Freiburg commitments and vice versa. Banks would be allowed to choose in any one year whether they met their Basel or their Freiburg requirement for the year in question. Thus in any one year a bank might have to increase its capital by 1.2% under Basel and its liquidity by 1% under Freiburg. It would be allowed to choose which commitment it met. The process would continue until both been met – with capital of 20% of assets and cash of 35%. And the Basel / Freiburg requirements would be suspended entirely when economic growth was depressed.

The Freiburg Plan would reduce the role of banks as intermediaries between savers and borrowers and the ability of banks to distort the economy; and to a considerable extent they would be limited to providing money services. The full implementation of the Freiburg Plan would take a long time and there may be a risk of another major crisis before it was complete. One possibility would be to speed up the process with annual increases in the cash reserve ratio being linked to growth, so that they would increase from 1.5% a year to 2% or even 2.5% a year in a year when the economy grew rapidly.

Basel, the Freiburg Plan and economic growth

A major objection to the Freiburg Plan (and indeed to Basel III) is that it would reduce economic growth by restricting bank lending. In fact, the extra stability that the Freiburg Plan would bring to the economy would actually improve the prospects for economic growth. With less risk of the economy as whole going wrong, businesses
could afford to be less risk averse in their business plans.

But in any case, bank lending is not the source of economic growth. The source of economic growth is a combination of entrepreneurship and savings. The ability of banks to create money is irrelevant, compared to the whether consumers and businesses create new resources for investment by restricting their current consumption. Banks are only one amongst many conduits for savings and there is no reason why others should not take on their role as intermediaries between savers and investors. The growth of peer to peer (P2P) lending shows just how such new intermediaries might develop.

Certainly, it would take some time for these new non-bank intermediaries between savers and investors to grow. But the slow introduction of both the Basel and the Freiburg capital and liquidity requirements would give them plenty of time to explore the market, to launch, to find their feet and to expand.

**Freiburg and Basel: Belt and braces**

Some still might object that the increase in the reserve ratio is unnecessary as central banks could restrain credit expansion by judicious increases in interest rates when a boom or bubble was looming. The answer is that central banks operating under Basel I and II have signally failed to do this in the past. Even if we allow, against all the evidence, that central banks (fortified by the improvements of Basel III) are reformed characters who will not in future allow the development of booms and bubbles, a policy of ‘belt and braces’ might still be wise, given the extraordinary damage that the ‘loose joint’ in the economy can cause. The most important feature of the Freiburg Plan is that it greatly reduces the discretion of central banks. No longer would they have the power to promote, or to tolerate, the booms and busts that are the bane of capitalism.

**The Freiburg Plan part 2: Competing currencies**

The Freiburg Plan would also require the elimination of legal tender laws and restrictions on the use of competing currencies. Banks, or other major institutions such as very large industrial companies, would be free to issue currencies in competition with state monopoly currencies.

As we have seen, Hayek’s proposal for competition in currency would face practical
difficulties. These are largely because of the dominance of central banks, which is likely to continue for some time. But in the meantime, there remains a strong case for permitting and encouraging the issue of currencies competing with established state monopoly monies: competition has always improved the performance of monopolists. An important proviso would be that the issuers of competing currencies would enjoy no lender of last resort facilities with the central bank. They need to stand or fall on the solidity of their own issuing decisions.

The changes required to form a secure framework for competing currencies would be relatively uncontentious. They would include:

1. Abolition of legal tender laws. If parties agreed then they could use any currency they chose to settle their financial obligations. There would be no presumption in favour of sterling.

2. There must be no tax on ‘profits’ gained in holding cash in a recognised alternate currency compared to the ‘official’ currency.

3. Debts to any government agency and the government itself could be settled in a competing currency other than sterling at the choice of the debtor.

4. Government debt, both Gilts (UK government bonds) and UK Treasury Bills would be issued and denominated in competing currencies. The government would be required to issue a (gradually increasing) proportion of new debt denominated in competing currencies.

5. A regulator, the Office of Currency Regulation (OFCUR), would be established with the task of promoting competition in currency and restraining the central bank supplier of money.

By permitting private companies to compete with the state in issuing currencies, the forces of competition would turn be turned loose on the production of money, which for too long has been subject to government monopoly and central bank abuse.

Particular issuers, including the established monopoly, would be forced to restrict their issue if they did not want to see their currency replaced by other, better monies that were not so liable to depreciate.
Competing currencies would not lead to complications with vending machines and in everyday transactions. Unless the state monopoly money deteriorated very much in quality, it would remain in use for most simple everyday transactions. But competing currencies might well be used initially for accounting purposes in the management of investments or for international transactions. Indeed, large corporations already publish versions of their accounts in a number of different currencies.

Another interesting possibility is that large corporations with strong balance sheets might issue currency as a cheap means of raising additional capital. Thus a large multi-national conglomerate with a very strong balance sheet might issue currency which was redeemable in a mixture of the currencies in which it did most of its business. For example, the large US corporation, General Electric, used its strong balance sheet to operate a large reinsurance business; Warren Buffett’s company, Berkshire Hathaway, operates in a similar way. Buffett’s rationale is that since there is a gap between premiums being received and claims paid, well-run insurance and reinsurance companies have a ‘float’ which costs nothing and can be profitably invested. Similarly, the issuance of a high quality competing currency would provide the issuing company with a costless ‘float’ that could be invested in high yielding assets.

It is significant that in the crisis, sovereign debt has become more risky than the debt of large corporations. The concept of large corporations providing of money and liquidity sounds less strange today than it might have done a few years ago.

Competition in currency would not be a panacea. Central banks may just be an inevitable part of the modern world. Yet their functioning, like that of any monopoly, can be improved by competition. It may not even be necessary that the competition actually exist: the mere threat of competition can have much the same effect as actual competition. But critics of the idea must ask themselves: When was a monopoly not improved by competition or the threat of competition?
Sound money in a free society

No system can be perfect but the Freiburg Plan, combined with Basel III, provides a framework that would lead to a highly conservative, conventional banking system with a much reduced ability to create and destroy money. This would make the economy much more stable. These proposals for a better monetary system are feasible and they could be introduced in easy steps. They would reduce the discretion of the central banks, which has been so much abused.

The proposed liberalisation of the economy would accelerate the recovery and help to reduce unemployment as quickly as possible. Low taxes, light regulation and no wage or price fixing would work their usual, well documented magic on economic growth.

But it would be false to claim that the measures proposed are a panacea. The distortions and the waste created by the boom of the 2000s were enormous. The damage done to the world economy and perhaps the UK in particular has been very great. As a result, the British economy is less productive than it would have been had there been no boom. And it was the boom, not the recession, which was the cause of all our problems. But the boom phase of the cycle is history, and now, inevitably, expectations about incomes, house prices and pensions will have to be scaled back from the heady hopes that prevailed before the crash. None of this will be easy; nor will politicians be popular when they point out this painful fact;
nor will the public welcome the fact that if unemployment is to fall, wages in many industries will have to fall too.

Another uncomfortable conclusion of the Austrian analysis is that because the distortions and dislocations caused by the boom were so great, the process of readjustment will take time. Over-extended industries will have to contract and the resources released will have to be applied to new or existing industries. Workers will lose their jobs with little apparent prospect of re-employment and, if and when they do find work, they may have to accept lower wages.

Economists of all persuasions have lamented the length of time it took the American economy to recover from the Great Depression. Unemployment in 1939 was little different from what it was in 1932. Some economists say this is because there was too little government action, others that there was too much, and of the wrong sort. The argument of this paper is that the latter are most probably right. Still, the chaos caused by the boom was so great that it would have taken a number of years even if government policy had been of the best.

Given that it takes a long time and great trouble to recover from the inevitable recession that follows a boom, there is an overwhelming case for taking steps to prevent booms and bubbles recurring. It is worth paying the price in terms of reduced earnings from banking and in terms of the difficult and painful reforms necessary to reduce the role of banks as intermediaries between savers and investors. Discomfort now will spare us greater pain in the future.

By drawing the sting from the banking system, the Freiburg Plan would make a recurrence of the catastrophe of the Great Recession much less likely. It would also provide much needed insulation of the economy from a repetition of the creeping inflation of the 1960s and the galloping inflation of the 1970s. The current use of Quantitative Easing (QE) to stimulate economic growth rather than to preserve the banking system or to prevent a reduction in the money supply suggests that this may be a serious danger.

The expense, inconvenience and frustrated expectations that would result from an effective reform of the banking industry would be as nothing to the tears and anxiety caused to the unfortunate people whose lives are turned upside down in a crisis and recession – though their troubles stem not from the recession but from the boom that made the recession inevitable. The Freiburg reform of the banking
system will reduce its perverse ability to expand and contract credit just when it can
do most harm. If there were to be a repetition of the horrifying boom and bust cycle
of the 2000s, how long could a free economy and its natural companion, a free and
open society, survive?
Bibliography and further reading


FA Hayek, *Denationalisation of Money* (1976)


Ludwig von Mises, *The Theory of Money and Credit* (1953)

Sir Karl Popper, *The Open Society and its Enemies* (1945)

