Episode 361 – Against Market Monetarism and NGDP Targeting
Guest: Joseph Salerno
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WOODS: I have been wanting to talk about market monetarism for some time. We did an episode on Modern Monetary Theory, which is entirely different, but it's related in the sense that there seem to be a number of new approaches to monetary theory in the wake of the 2008 crisis. You've identified in particular, if not an article, then a podcast interview we might want to respond to later in in just a few minutes. Before we do that, I want to talk about this incredible honor that you had bestowed on you at the recent Austrian Economics Research Conference. It really, to my mind, is one of the greatest honors a scholar can have, and that is you were presented with a Festschrift. Can you tell me what a Festschrift is and tell us the details about this particular one?

SALERNO: A Festschrift is a volume of essays by the students of a professor who is being honored by this volume. So my summer fellows, in particular Professor Dave Howden and Per Bylund got together and began about two years ago to get papers together from people who have been Mises summer fellows over the last 10 years. And these are original papers. They are not fluff pieces. They are not pieces that sing my praises without any substance. These are papers in the Rothbard/Mises tradition of Austrian economics, and I am very proud to be so honored.

WOODS: Joe, when I look at the names of the contributors to this book, and by the way, I am going to link to this book. You can read it online for free, and is it called something like the *New Generation of Austrian Economics*? What's the title?

SALERNO: Yeah, the full title is *The Next Generation of Austrian Economics: Essays in Honor of Joseph T. Salerno*.

WOODS: Yeah, and it's just a beauty. I'll link to it. People can read it for free. The show notes page for today would be tomwoods.com/361. When I was looking at the contributors to this volume, and I saw Xavier Mera's on there. I saw Per and Dave. I saw Philipp Bagus is there, Matt Machaj is there and Matt McCaffrey. I thought, really these are the best young Austrians I can think of. They really are the next generation of Austrian economics. These are the sharpest ones, the ones doing the most interesting research, the ones I know if I go to with a question, I am going to get a really, really good answer.

I’ll tell you, by the way, Joe, maybe you have never heard this story, but Dave Howden, whom I consider to be one of the best young Austrians—e has been a guest on this show before—told me that, you know, just when I feel like I’ve really, really mastered Austrian economics, I walk into Joe’s office, and he starts talking to me about stuff that I realize I haven't read or I don’t know about and he seems to know like the back of his hand, and I walk out slightly dejected.

Before we move on, what are some of the research areas that these younger guys are working on that they are highlighting in the Festschrift, building on your own work?

SALERNO: For example, Per Bylund is working on an Austrian approach to the theory of the firm, and I have done some things on entrepreneurship that would lead along those lines. Philipp Bagus is talking about the quality of money, monetary regimes, and I have done quite a bit on talking about the sound money tradition and how the gold standard fits in. Whereas our current fiat money standard, of course, does not fit in. He’s taken it a step further by focusing on quality rather than the quantity of money.

WOODS: Yeah, that’s interesting work.

SALERNO: Yeah, absolutely, and Matt McCaffrey, by the way, who I do want to point out, has done a lot of good work already on entrepreneurship both on the history of entrepreneurship, what we might call political entrepreneurship, how people act entrepreneurially in government while they are ripping you off, and on the incentives and alertness approaches to entrepreneurship. So these are just some of the things.

WOODS: He is professor at the University of Manchester in the U.K. All of these figures we’re talking about have begun successful careers in academia. So that also is useful to remind us that an interest in Austrian economics, scholarly work in Austrian economics, does not have to be the kiss of death professionally. It doesn't mean you have to do your dissertation on it necessarily, but it’s not as though people are being investigated for possible interest in Austrian economics and then blacklisted forever. It’s sort of looked upon as okay.

SALERNO: Yeah, absolutely, it’s in the mainstream now, and especially in some other business disciplines where entrepreneurship is such a big part—marketing and management. McCaffrey is in the entrepreneurship program at the University of Manchester, and they are much more amenable to the Austrian approach than mainstream economics. Though I want to say even mainstream economists do not look down on Austrian economists in most universities.

WOODS: All right, let’s switch gears now and talk about NGDP targeting, and then we’ll talk about this Larry White excerpt that you sent me. First of all, explain NGDP targeting, what it is, and what it’s supposed to do.

SALERNO: NGDP stands for Nominal Gross Domestic Product. Now, that is simply a word for the total value of all goods and services produced in a year and in an economy. So it’s basically the total spending. Total value is equal to the total money spent on the product. So what that’s supposed to do is the following: if you target it at zero, which is, for example, what Larry White wants to do—not at zero, but the rate of growth at zero—if you want to keep total spending constant, and that is Larry White's program, then what happens is you allow prices of goods that are increasing if there's technological progress, there are more goods, and the total spending stays the same, well then, those prices will fall, and that's fine from a Misesian perspective. But they go further. When you keep the total spending constant, that means that if people for any reason, for example, they are a little bit more worried about the future, so they want to hold more cash in relation to their income. So when people begin to build what the economists call cash balances, they reduce the amount of spending they do, and here is the rub: At that point, Larry White and others who want to focus on this target, they want the Fed to step in, and they advise the Fed to step in and increase the money supply to just offset the increase in the demand for money, which takes money out of circulation. So they want to keep that circulation constant. As people who believe in Austrian business cycle theory will tell you, though, any creation of money always go through credit markets. That pushes interest rates down below their natural level, and that brings about the series of events that we know as the Austrian business cycle theory. So we think that is not a good policy, and it's a dangerous policy.

WOODS: Is Larry White what you would call a market monetarist? He would probably identify with the Austrian School more than George Selgin would.

SALERNO: That's true. Larry has said that he is an economist who values the Austrian tradition. He doesn't quite say he's an Austrian economist anymore, but in the case of Larry White, I wouldn't say he's a market monetarist. His first-best solution to our monetary problems is free banking. He does want to dismantle the Fed, and he wants to deregulate the financial system—all well and good. But he has a second-best position, which he spends a lot of time promoting, unfortunately, and that is advising the Fed about how to keep the economy stable. It's one thing to say the Fed shouldn't inflate, but to actually develop or formulate sort of a full-on program such as targeting NGDP I think is something that really shifts attention from the fact that the Fed is the source of the problem. They should not be considered part of the solution.

WOODS: Joe, if people do, for whatever reason—uncertainty—they increase their cash balances, I don't understand why that isn't something that entrepreneurs should also be forced to anticipate, too. They are not just anticipating where their supply prices are going to go and where their product prices are going to go. They have to anticipate consumer behavior. And one of those behaviors is the desire to build up cash balances. Why does this one phenomenon supposedly throw the entire economy into turmoil? What a delicate little flower the economy must be if it can't deal with an increase in cash balances.

SALERNO: Well, two words, Tom: sticky prices. It seems that the people who are in favor of this targeting, including Larry White, have swallowed what I might call the Keynesian poison, and that is they say, well, prices can't adjust right away. So all of a sudden, entrepreneurs become dolts when it comes to prices. Indeed, the price can't adjust as fast as entrepreneurs want them to. Think about restaurants. They have menus, yes. And there are costs of changing those menus that the Keynesians always emphasize, but from our point of view, if restaurants believe that the demand is falling off, they can quickly change prices. They have daily luncheon and dinner specials. They have coupons. The same is true with supermarkets. Yes, there are some costs involved, small costs involved with changing price stickers. But once again, they can have coupons. They can have discounts on multiple purchases of a particular type of item. Newspapers, for example: okay, they keep their prices fixed, but they change their advertising fees pretty rapidly. So my point is that all entrepreneurs, smart entrepreneurs, entrepreneurs that make money, anticipate changes in the market and can move prices. They all adopt what I call a pricing technology. In some cases like movie theaters and restaurants, you don't change your prices that frequently. But that's a conscious choice. That's how you maximize profits. But in others, you can change your prices very rapidly in supermarkets and car dealerships where you're never charged sticker prices, end-of-season fire sales and so on. So I think this is just something that unfortunately, this whole idea of sticky prices that some Austrians have latched onto and said, well, the Keynesians are right about this, but we can show them how to get around it without being Keynesians.

WOODS: Let me make sure everybody listening follows along with what the problem is. The problem they are alleging exists is that if demand, if spending drops off because people are increasing their cash balances, this is going to tend to pull prices down, but it sometimes takes prices, they say, a long time to adjust to this phenomenon because of the menu costs and the other obstacles that you mentioned. It takes a while for these new prices to actually appear, and so in the interim you've got discoordination, and you've got inventories piling up, and—

SALERNO: And you're laying off workers. See, this is the thing. You're laying off workers. But that's ridiculous. These decisions to hire and fire aren't taken lightly because there's that little blip up or down in a price. That's something else that they miss.

WOODS: Well, and also they will say that the—I mean, this isn't maybe so big a deal these days with unions not being as powerful as they once were, but they'll say unions have negotiated these long-term contracts that stipulate particular wage rates, and under these conditions with people spending less, we can afford to pay them less. We can't pay these wages, and yet, those wages stay high because they are contractually stipulated. But on the other hand, one way to deal with that is you can let people go and then rehire them at a lower wage, can't you?

SALERNO: Yeah, sure. That's something that can easily be done. But beyond unions, and unions, by the way, have lost a tremendous amount of power. I think only 7% of the private labor force is now unionized as opposed to 25% back in the 1950s, which is all to the good. But other things that Keynesians say is that, well, okay, even if there aren't unions, there is an invisible handshake, meaning that you somehow communicated with your workers not verbally, but somehow communicated with them that you won't cut their wages unless the firm is going bankrupt or something like that, and I think that is just a myth. I don't see it as existing. You worry about the morale of your workers, and there are things that you can do to make wage cuts more palatable, but sometimes they have to take place, and they do take place.

WOODS: If sticky prices cause these various problems—idle factors of production, unemployment—and the claim then is that an expansionary monetary policy could solve this, by in effect helping to push prices in the direction that they think they should go in or help to stabilize prices—does that not seem, and I am sorry to give you this loaded question, but it seems to me that this is an extremely blunt instrument to deal with a series of micro-level adjustments.

SALERNO: Yeah, you're absolutely right. It's a macro instrument, and by the way, you can't really direct the money that you create into those areas where prices are falling for some reason.

WOODS: That's what I'm trying to drive at. Go ahead.

SALERNO: So what you're doing is you're distorting relative prices. If you think they are already distorted, you're distorting them even more. But once again, I want to get back to that point. Look, Walmart, if it really wanted to, could have a monitor at the end of every aisle, and if they wanted to change prices every five minutes, they could do that. People just look up and see that. But consumers don't want that. They want some stability in prices to be able to plan. Walmart understands that. When prices change, they don't fire half their workforce or a substantial part of their workforce. They ride it out. They have entrepreneurial judgments of whether this is temporary or permanent, and this is not a problem. This occurs even when there is no increase in cash balances. There are always blips in the market, ups and downs that over time that will reverse themselves. So we have to trust entrepreneurs. We do in every other area, but for some reason, Austrians like Larry White and others are—and the market monetarists are fearful that somehow entrepreneurship fails when it comes to getting the prices right, and I think that's ridiculous.

WOODS: You're right about prices having the potential to be extremely flexible if an entrepreneur wanted them to be, and sometimes people will talk about movie theaters and say a movie theater could say, look, it's the open night for this big movie, so we're going to jack up the price of the tickets to $20 a ticket, but they would lose so much consumer goodwill that they wouldn't do that. So it's an entrepreneurial choice to keep the prices sticky.

Bob Murphy has looked at it on the other side—looked at wages. He said, we could have perfectly flexible wages, wages that adjusted every five minutes, as you said for prices, but then we would be getting the complaint that wages are too flexible because how can the workers plan? How can they know if they can know if they can make their mortgage payment on a month-to-month basis if their wage is so flexible? So you can't satisfy these people. They are too sticky or they are too flexible. What about, they are the agreed-upon wage on the market? That's something that we accept, as you say, in every other circumstance.

SALERNO: Right. It's a question of bargaining. Let me just give you an example. A deeper problem with the Keynesians and the market monetarists is that they believe spending drives prices, but as William Hutt, the great British economist, who was also an Austrian in his views, said, it's—and very late in life he says, you know, I always thought that spending caused prices to be whatever level they are, but now I realize it's the precise opposite. So in other words, on the market, it's prices that are determined by people bargaining—prices and quantities, and then it's only if they are determined that spending occurs. So just take an example: if you have a babysitter, and you come up with a price of $20 an hour, you agree on a price. She agrees to babysit for four hours, and then the spending comes. The spending happens to come out of that. It's $80. If the price is $25, well, then you may only want her for three hours and then spending results of $75. So spending is not a causal phenomenon—a factor. It doesn't cause anything. It's caused by the interaction of subjective values on the market determining prices. Prices are the thing, and then spending follows afterward, and it has no causal significance.

WOODS: What about this: is this one of the reasons that they argue—the market monetarists or the I don't know if want to say fellow travelers like Larry White—they say also it's not just the sticky prices problem. It's also that we want to stabilize total spending because in an environment of declining total spending, how can entrepreneurs make profits? Is that one of the claims?

SALERNO: Yes, it is, but they would then say—let's say prices are actually falling and spending is falling, but then they would talk about the stickiness of wages. It does really come back—

WOODS: It always comes back to that, okay.

SALERNO: Yes, because there was a Keynesian back in 1946 who wrote a great article. His name was Franco Modigliani. He won the Nobel Prize, and Henry Hazlitt even reprinted that essay in his book *The Critics of Keynesian Economics*. But what he pointed out—he was the first one to point out—the first Keynesian—it all comes down to the assumption of sticky prices.

WOODS: So what we're dealing with, then, is a disagreement regarding the extent of the sticky price problem, the extent of the ability of the market and entrepreneurs to cope with it. Is there a big picture issue in terms of the way the market monetarists—and here I may exclude Larry White, but somebody like a Scott Sumner—look at the economy versus the way the Austrians look at the economy that's at the heart of this?

SALERNO: Yes, and I am glad you asked that question. The big picture is that both the market monetarists, and I would include, I will call them the free bankers, actually believe that there is a real part of the economy where all the action is—where people are actually trading goods against goods and labor against goods and then the monetary part of the economy that somehow the monetary part of the economy is really just a veil and is imposed on the real economy, and if the veil gets stuck in the gear, in the workings of the real economy, then you have problems. Whereas Mises, Rothbard, even going back to Menger, the Austrians believe that, look, money and goods are all valued—ranked, valued on people's value scales. Okay, they are all subjectively appraised, and then when you go into the market, you compare what value you put on money with what value you put on goods. So prices and quantities arise organically, and that's a big difference. We do not see a difference—the Austrians do not—between the monetary and the real. They are integrated. You couldn’t have an economy above a primitive level without money being integrated into that economy.