

Monetary Policy in a Hayekian Supply Side Model

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ABSTRACT

In this paper standard macroeconomic models are combined with the Hayek-Garrison model of the business cycle in order to demonstrate in which way modern central banks are prone to initiate boom-bust-cycles through monetary policy. It is shown under which conditions such a policy will occur and why central bank authorities tend to be misled by an apparently stable price-level. Without central bank interference, productivity increases due to technological advances, other cost reductions or an increased supply of cheaper labor would bring about temporary deflation. Left to its natural path, rising profits and a higher purchasing power would move the economy towards an expansion and increased expenditures. However, with central bank interventions that are directed at maintaining the so-called price level, the monetary authorities will expand the money supply and transform a productivity-led wealth increase into a debt-driven boom, which produces the foundation for the contraction later on.

The paper challenges the commonly held notion that when the economy achieves high rates of economic growth along with price level stability, monetary policy is at a neutral stance. It is shown that under the conditions of significant productivity gains, modern central banks create a credit-driven boom also when they achieve their inflation target. The model puts active monetary policy at the center of the analysis. It elaborates the sequence that takes place when central banks aim at price level stability in a constellation when productivity gains would require temporary deflation. By expanding the money supply and thereby bringing the monetary interest rate down, central banks transform the productivity-led economic expansion into a debt-driven boom. At the upper turning point of the cycle, the liquidity, which has been accumulated by various rounds of monetary expansion that were initiated in order to fight deflationary tendencies, shows up as open inflation when the productivity gains peter or when negative supply side shocks should occur. It is at this stage, when monetary policy loses control, as its instruments cannot be adequately calibrated in the inflationary phase and later on in the contractive phase.

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