

***Further Considerations of the Austrian Business Cycle
Theory: A Response to Caplan***

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A central bank, engaging in credit inflation is not a rational economic actor, and in fact acts purposefully to allocate resources in a manner incongruous with the satisfaction of human wants.

Introduction

Although I cannot state with certainty what sparked my interest in Economics, I am fairly confident in my recollection that a thin volume entitled “The Choice,” by Russell Roberts is likely what led me on my way. I was intrigued by David Ricardo’s lessons on comparative and absolute advantage, as illustrated by Roberts. From that point on, nearing the completion of a Bachelor’s degree in business, the influence of that book began what would ultimately snowball into my current academic pursuit. Along the way, I found myself reading first Hayek’s “The Road to Serfdom,” and ultimately purchasing an old, used copy of Ludwig von Mises’ *pièce de la résistance*, “Human Action,” which I read with religious fervor. Had I known then that the “Austrian” school of economic thought was but a small, oft neglected stump on the tree of economics I might’ve given up, and followed the road more traveled. But, as they say, ignorance is bliss. So, under the mistaken auspice that “Human Action” was a must-read if I ever desired to

pursue further education in the field of economics, I continued on my way, reading various essays and other writings by past and current scholars of the Austrian school. To draw a poker analogy, by the time I realized that this particular school of thought would not exactly open the doors of Academia, I was fully pot-invested, and so I am committed to seeing the hand through, and fully intent on completing my studies in one manner or another.

Among my earlier readings was an essay written by GMU professor Bryan Caplan, entitled “Why I am not an Austrian Economist,” which to my knowledge has not been published, although he has offered other critiques of the Austrian tradition, such as “The Austrian Search for Realistic Foundations,” published in 1999 in the Southern Economic Journal. Caplan is a respected economist whose contributions to the general libertarian sphere of political economy should not go unnoticed. Among mainstream neo-classical economists, his knowledge of the Austrian theory is certainly ahead of the curve, which knowledge uniquely qualifies him to engage in a wholesale deconstruction of the Austrian schools tenets. Having first read his paper, I was intrigued, but let it sit largely ignored. My education in the Austrian school up till that point having been wholly self-directed, I was in no position to evaluate his criticisms. After more than a year of formal (and continuing my self-directed) study in economic theory, however, I was reminded of Caplan’s essay by a classmate, and decided to give it a second look. Shortly thereafter, but not without the urging of others, I decided to try and tackle some of the “incorrect and controversial” aspects of the Austrian theory.

“Why I’m not an Austrian Economist” raises several challenges to the Austrian method, some of which I believe have been addressed by various scholars, although in my research I was unable to find answers or responses to his commentary on the Austrian theory of the business cycle (hereinafter ABCT). It is precisely the arguments against the ABCT which this paper intends to address.

It should be noted, first and foremost, that Caplan does not entirely disagree with the Austrian teachings. Rather, he feels that the Austrian theory is not entirely complete, and many of the arguments between the self-labeled Austrians and mainstream economists are due to lack of understanding of the theories presented by the opposition. With regard to the ABCT, Caplan credits the now widely-accepted contributions regarding the relationship between involuntary unemployment and excessive real wages, government intervention in the labor market, and that inflation is an unreliable method by which to alleviate such excessive wages (a concession which he later contradicts), which taken together comprise Propositions 1 and 2 (as labeled in the essay) of the ABCT. Any agreement with the Austrians, however, ends abruptly at these elucidations. Caplan argues that some of the most important aspects of the ABCT are at best controversial, and as he intends to demonstrate, incorrect. Surely, destroying the foundation upon which the ABCT is built destroys its credibility as a feasible theory of economic cycles. These features of the theory are summarized in Propositions 3 through 6 as follows:

Proposition 3: Monetary expansion distorts the structure of production in an unsustainable way.

Proposition 4: The ABC explains the “sudden general cluster of business errors.”

Proposition 5: The ABC provides the best explanation for why downturns hit the capital goods sectors especially hard.

Proposition 6: Only the Austrian theory can explain the existence of inflationary depressions.

It must first be noted (and I'm confident Caplan is aware of this), that the ABCT is characterized by bank credit and interest rate manipulation, the injection of loanable funds, not backed by any real increase in the rate of saving. Caplan, and mainstream economic theory “accept that monetary policy tends to reduce interest rates.” What he explicitly denies, however, is the Austrian claim that “artificially stimulated investments have any tendency to become malinvestments.” His contention is that entrepreneurs ought to “realize that interest rates are only temporarily low,” and use this knowledge in making their decisions. Caplan's argument seems to ignore the function of the rate of interest as a *price* and a *signal*, a point which this paper will later address in detail. Additionally, in denouncing the “cluster of errors,” he takes the Rothbardian description of the entrepreneur to task. He concludes with several possible explanations for such widespread downturns, but fails to demonstrate how any of them can reasonably be considered cyclical.

The Structure of Production and Malinvestment

Although inflation can create the illusion of wealth and assist in redistributing the factors of production necessary to satisfy human wants, in order for monetary policy to *not* distort the structure of production, one must accept that printing new money *ex nihilo* is capable of creating real wealth. The argument assumes that merely by lowering the rate of interest, can we stimulate the production of *real* capital. No, what happens is that capital is merely reallocated, bid away from the shorter processes of production and towards those longer processes which only appear profitable in light of the artificially low interest rates. (Mises 239, 348) DeSoto explains that “When credit expansion takes place without the backing of prior increases in savings, no original means of production are freed from stages closest to consumption,” which leads to a “gradual increase in the prices of all factors.” (363)

Unlike other commodities, an abundance of which indicates prosperity, a larger quantity of money does *not* assist in production and only serves to make prices higher than they otherwise would be – but it is incapable of raising all prices at the same time and to the same degree. (Reisman)

The problems begin when we consider that the stock of available economic resources (capital, labor, land) has not changed (Mises 239); some actors are capable, through use of new fiduciary media to purchase

goods and services at prices which have not yet risen, with money that has not been earned. Benefiting from greater purchasing power relative to the market, the recipients of inflationary funds are capable of pulling resources away from products requiring shorter periods of production towards those requiring longer processes. But there has been no change in the demand for consumer goods. Producers of consumer goods must then compete with those of capital goods, bidding further upwards the prices of the factors of production and reducing profitability. The credit expansion has the effect of “artificially raising the supply of present goods which are demanded at a lower interest rate”, but lacking the sufficient quantities of factors of production which have been bid away by the longer structures of production, the unchanged consumer demand manifests itself in higher prices for consumer goods. (DeSoto 355) Factor costs, throughout the general economy have begun to rise, through no action of the final consumers. In fact, the consumer *qua* laborer is simply responding to the higher wages he is eventually paid, which permit him to pay progressively higher prices for consumption, temporarily justifying the new prices. Final prices now appear to be justifiable, although they can never compensate businesses for that period in which their factor costs had increased but before consumers' wages had risen.

Some of the increased intensity of consumer demand is caused by the lower yield, which discourages true savings (foregoing current

consumption in favor of future consumption), and encourages consumption. But increased current consumption can only be obtained by an increase in current output, which in turn is predicated upon the *shortest possible* structures of production, precisely those structures from which resources have been pulled. The newly undertaken processes are necessarily longer and more roundabout, as capital is always first directed towards the shortest possible processes which yield the most immediate satisfaction of human wants. (Mises 400)

Businesses, in essence, are encouraged by the lower interest rates to embark upon longer processes of production, while consumers simultaneously reduce their savings in response to the same interest rates. In “Explaining Malinvestment & Overinvestment,” Sechrest notes that the “economy is being pulled in two directions. Entrepreneurs want more capital goods...at the same time that consumers want more consumer goods.” (5) In order to invest in lines that would satisfy consumers’ demand for more final goods, more resources must be committed to or converted in a manner so as to bring about more final goods; sooner rather than later. It is not clear how the injection of new money can cause these results when the supply of available factor inputs has not changed.

Irrational Expectations

In denouncing the entrepreneurial ability which Rothbard (and most Austrians) hold in high esteem, Caplan accuses the Austrian theory of assuming that entrepreneurs have “strange irrational expectations.” According to Caplan, only a theory based on this assumption can explain the “cluster of errors” characteristic of the ABCT, and such an assumption is ridiculous:

Why does Rothbard think businessmen are so incompetent at forecasting government policy? He credits them with entrepreneurial foresight about all market-generated conditions, but curiously finds them unable to forecast government policy, or even to avoid falling prey to simple accounting illusions generated by inflation and deflation.

The irrational expectations objection is certainly worthy of consideration, and at first glance appeared to be an insurmountable inconsistency. In all of the literature surveyed, no response to Caplan’s accusation was found – in fact, some of the arguments in favor of the ABCT bordered on tautology.

Addressing Roger Garrison’s proposition, that “[M]acroeconomic irrationality does not imply individual irrationality ... it is possible for the individual to profit by his participation in a market process that is – and is known by that individual to be – an ill-fated process,” Caplan argues that although it is a “possible scenario,” it simply does not make sense from an entrepreneur’s point of view. He accepts that entrepreneurs “will not turn down lower interest rates,” but argues that the rational response is to “(a)

make investments which would be profitable only on the assumption that interest rates will later rise, and (b) refrain from making investments which would be profitable only on the assumption that interest rates will not later rise.” This exceptionally simple rule is the solution capable of preventing malinvestment. As has been demonstrated above, however, the recipients of new money are *always* at an advantage to those who do not. Garrison’s position, that “resources can be profitably misallocated so long as they are sold before the bust,” I believe, is satisfactory but may benefit from further clarification. (8)

The first consideration is that inflation ought not, under any circumstances, be considered a market-generated condition. In a market devoid of governmental manipulation (whether through legal means afforded to banks, or monetary policy) the rate of interest is a market generated price or ratio, which equilibrates the supply of and the demand for capital. As interest rates rise, savings is induced, concomitantly, a higher rate reduces the demand for borrowing. In this manner, the interest rate sends important signals to both savers and borrowers. (Garrison 2) Only the amount of money saved (deferred consumption) can be invested in capital, and the rate of interest is determined subjectively by both the investors’ time preference and subjective valuation of future goods and present goods, and the intensity of demand for borrowing by businesses.

Caplan's "rational investment" argument suggests that the investments undertaken after inflation ought to be the very same investments that would've otherwise been undertaken. Under conditions of interest rate manipulation, however, the rate no longer serves as an accurate signal conveying the summary of all available market information to market participants; economic calculation approaches impossibility. Severing the connection between savings and investments has violated consumer sovereignty, and replaced it with the politics of pull – whims and favors. There simply is no way to evaluate how consumers might have acted, what they would have demanded, if only the new supply of loanable funds were backed by real savings and deferred consumption. In the absence of a real market, there is no environment capable of fostering the knowledge and entrepreneurship necessary to make markets work. One cannot simply endeavor to "play market" when the rules of the game are in a state of constant flux. (DiLorenzo) On the assumption that such meaningful, rational calculation is possible, Caplan's argument assumes away the very problem under investigation.

Entrepreneurial profits exist when there are factors of production not being utilized to achieve the highest possible ends towards which the factors can be directed. In this manner, profits send a signal about the way things are being made, and direct people to invest in profitable industries, and to withdraw capital from unprofitable industries. (Salerno) Considering

inflationary interest rate manipulation a form of price support, reveals further problems. Price supports in any market pull resources away from businesses in which they were otherwise profitably employed, and into ventures which are only justified for as long as the price support continues. Such policies induce entrepreneurs to invest in lines that are by no means profitable – lines of business which otherwise would not even offer an illusion of profitability.

In “Money, Bank Credit, & Economic Cycles,” DeSoto argues that inflationary policy backed by government guarantees creates just such a moral hazard, the results of which are not in fact, insurable – they are not risks but rather uncertainty, caused by human action. (386) Given what is widely understood and accepted about price controls, it follows that the results of interest rate manipulation should be similar. Caplan offers no argument that suggests money is not subject to the same moral hazard.

Cluster of Errors

Ironically the ABCT permits for entrepreneurs to follow Caplan's suggestion and invest more conservatively in light of credit expansion, while still allowing for entrepreneurs to commit systemic errors. A number of the able entrepreneurs may in fact become more conservative, as Caplan would have it. These entrepreneurs, in their calculations of inflation and profits may refrain from speculative borrowing, some of which likely would yield profits, if only in the Garrisonian sense, and also a number of ordinary investments that may well have proved profitable, even by Caplan's standards. From the point of view of any individual entrepreneur, there is no reason to believe that any particular loan has been created *ex nihilo*, and no reason to believe that he cannot "beat the bubble." Lured by the profit motive, and a certain degree of entrepreneurial *hubris*, however, even the wisest entrepreneurs may be tempted to participate in an ill-fated process. (DeSoto 422)

A lower rate of interest encourages additional borrowing, and loans are now made affordable to those who otherwise were incapable of borrowing. At least initially, the entrepreneurs who borrow the *ex nihilo* credit are those entrepreneurs who were previously unwilling or incapable of borrowing at the market rate. In this regard, "bad" entrepreneurs,

precisely those who, in a freely functioning market, would not exist as entrepreneurs, are induced to borrow money. Through credit expansion and interest rate manipulation, the previously sub-prime borrower is now able to borrow money at the new manipulated rate, despite the fact that his particular business model, debt ratio, solvency, and demand for his products remain unchanged.

It is these entrepreneurs whose ideas are *not* initially profitable that might be more than tempted, seeing an opportunity (albeit temporary) created by the manipulated, lower interest rates. It is certainly conceivable that inept entrepreneurs will invest in lines of business that were previously unprofitable, and generally, a business is unprofitable because there is insufficient demand to sustain its operations. As the prices of factors of production increase, there is no reason to assume the sort of spontaneous change in consumer demand that would render such unprofitable ventures profitable is likely to occur. Consumer preference has not changed – they still want the same products, the prices of which have been bid upwards. With apologies to J.B. Say, productivity buys productivity, and nothing induces demand like lower prices. Inflation has been shown to increase prices, and merely shuffles productivity between various productive processes. If inflation is intended to stimulate wealth, it fails Say's law on both accounts.

Mises recognized the problems created by the falsification of accounting profits and other datum in “The Theory of Money & Credit,” specifically those relating to monetary depreciation:

If the value of money falls, ordinary bookkeeping, which does not take account of monetary depreciation, shows apparent profits, because it balances against the sums of money received for sales a cost of production calculated in money of a higher value, and because it writes off from book values originally estimated in money of a higher value items of money of a smaller value. (235)

Although a “price theorist can conceptually distinguish between a real price change and a money-induced price change...the market participant cannot.” (Garrison 3) The problems of monetary depreciation are not insignificant when taken alone, but the distortion becomes that much more severe when compounded by the fact that there exists no method for evaluating what consumer preference might be if the loanable funds were savings induced.

It is not reasonable, nor does it follow from ABCT that bad entrepreneurs are expected to exhibit the same degree of foresight, accuracy of prediction, etc., as their more capable counterparts. Rothbard’s treatment of the entrepreneur fully permits for consideration of certain qualitative differences between the specific members of the class of entrepreneurs, and that such class may very well expand beyond the most capable when interest rates are lower than they otherwise would be.

The argument from irrational expectations also suffers from the paradox of prediction. As Garrison notes, "It is true but trivial that if market participants were already in possession of all of the information that the price system conveys, then distortion of price signals could not cause cyclical fluctuations." (5) But if we assume that inflation does have effects, without which assumption it would never be undertaken, then those effects *must* be due to incorrect entrepreneurial foresight; precisely the sort of entrepreneurial error that Caplan argues will not (or ought not) occur. Because monetary expansion is an entirely exogenous process which distorts calculation (Mises 235) and the funds thus created bear no meaningful relationship to the actual consumer demand, accurate prediction is rendered extremely unlikely.

In a market wherein the extent and effects of inflation were precisely predicted, inflation would have no ill effect. It would have no positive effect. In fact, it could not possibly have *any* effect. The prices of all goods and services would rise and fall in immediate proportion to the amount of inflationary currency added to the system. Recipients of new money-substitutes would bid "higher" for goods and services, the prices of which had already risen in accurate anticipation of the inflation. It ought to be clear that if the conditions were such, inflation would be rendered wholly impotent.

Internal Inconsistencies

Because the ABCT predicts “a decline in employment in some sectors [consumer goods] and an increase in others [capital goods]” Caplan considers the theory ambiguous in its explanation of why “unemployment is high during the ‘bust’ and low during the ‘boom.’” Caplan also makes the argument that, due to the re-assertion of consumer preferences, the consumption goods market should “enjoy a huge boom during depressions” because “the prices of consumption goods factors [are] too low.” The critical, and I believe mistaken assumption in this reasoning is that the factors of production for consumption goods are in fact, too low.

This is puzzling insofar as it does not follow explicitly from ABCT, which proposes that capital goods are first bid up by the new loanable funds, but the factors of production thus directed towards production of capital goods are merely the same factors which otherwise would’ve been directed towards consumption goods. In order to remain in business, to weather the storm, as it were, entrepreneurs in consumption goods markets will need to match the wages and prices offered in the market for production of capital goods. It is important to note that this also reduces (and in some cases eliminates) profitability, contributing to the general cluster of errors. Through the trickle-down effects of the monetary expansion, the inter-market competition for the various factors of production goods, and the

consumers' increased demand for current consumption due to low interest yields, it follows from ABCT that the prices of current consumption goods factors should also *increase*.

Employment rises during the “boom” because the newly injected money is spent *before* prices have risen. The actors commanding the new money are able to bid the current price (or higher) when no other actors are capable of doing so. In addition to pulling employees away from other lines of work, this affords certain actors the capability of calling forth previously unemployed laborers, those who would not work at the previously prevailing market wages.

Once the general price-level for consumer goods has begun to outpace the rate of inflation with regards to wages, consumers may find that due to the relatively low amount of “real” savings (discouraged by lower interest yields), they no longer command enough money to obtain the goods and services at the prices now demanded. Faced with insufficient demand and a tightening credit market, businesses rush to liquidity which contributes to idle capital, higher unemployment, and decreased production. When the crisis occurs, only labor markets which are extremely flexible are capable of alleviating unemployment; which must be done by moving labor from those processes furthest from consumption to those processes closer to consumption. (DeSoto 418) High

unemployment during the bust is attributable of course to labor market rigidity, but also to the liquidation of capital as a complementary factor of production – which either ceases being used altogether or is directed instead (less efficiently) towards other lines of business. A particular machine is suited best for a certain function in a certain industry, and although it may be used towards the attainment of other ends, it may do so only with less efficiency. Although an Abrams tank is perfectly capable of being used as a commuter vehicle, it is far better-suited for making things go “boom!” Resources, once devoted to a particular line of business become, to an extent, non-convertible, which is due to capital’s non-homogenous nature. (De Soto 414)

Alternate Theories of Stagflation

According to Caplan, the Austrians claim that the ABCT is “the only theory capable of explaining stagflation – the simultaneous presence of high unemployment and high inflation,” among which he cites natural resource shocks and technology shocks. These theories, however, are not cyclical in the Austrian sense. Whereas ABCT argues that credit inflation cycles continually recur due to an institutional cause, “the privilege granted to bankers” and supported with a government gun, the same cannot be said

about the alternate theories which appropriately describe economic *events*. Even in light of such events, however, there is no reason to presume that the prevailing prices thereafter are not subjectively market-generated. Intervention aside, the market will adjust to and/or correct for natural resource shocks.

Technology shocks are also economic *events*, to be distinguished from the recurring nature of the business cycle. They are manifested in structural changes which do not repeat themselves. A technology shock is the embodiment (albeit a radical one) of market conditions, the results of which were determined through the actions of market participants. Although structural changes often leave a group of dispossessed, the sense of a Schumpeterian *creative destruction* involved in the market discovery process indicates that *real wealth* has been created and society will be better off in the long run. It would be spurious to argue that a universal panacea is a detriment to society, despite the fact that it would render obsolete many current lines of business – hospitals, doctors, health-care, insurance providers, medical equipment, *ad infinitum*. What would happen is that the “obsolete” resources would be directed towards the satisfaction of other human wants, previously insatiable because of the existence of factors that caused the human condition to be less comfortable, the lack of such conditions rendering useless all factors previously best-suited to its alleviation.

The other explanation for stagflation that Caplan suggests is the “rational-expectations explanation: “Workers wake up from their real/nominal wage confusion and demand a raise to compensate for inflation (again, reduces supply, raising prices and reducing output.)” But this theory is incapable of challenging the ABCT, which views credit inflation as the root cause of the compensatory wage raises:

Credit expansion is ultimately what gives rise to unemployment, since it instigates the entire process of widespread discoordination...by allocating original means of production to parts of the productive structure where they do not belong.
(DeSoto 417)

Workers, who demand an augmented salary to compensate for inflation, although they may be contributing to its persistence, have in no way *caused* the inflation to which they are responding. Admittedly, my knowledge of the various theories of stagflation is rudimentary at best, although it should by now be clear that the “rational-expectation explanation” of stagflation fails to account for the initial inflation which sets in motion the eventual demand for worker-compensation.

Caplan ends his essay thusly: “If the ABC has anything to contribute, it must add something further – something both original and true – to this lesson. There is little reason to believe that it can.” The intent of this research was to respond to Caplan’s criticism of the ABCT, and to demonstrate that the ABCT is actually quite capable of accounting for the

systemic cluster of errors, various price phenomena, and widespread malinvestment characteristic of the Austrian cycle theory. Whether this paper has added anything “original and true” to the current body of works regarding the ABCT will remain to be seen, and I hope that this present piece may spark further research into some of the strongest and most common criticisms of the Austrian theory.

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Unless otherwise noted, all quotes and/or paraphrases attributed to Roger Garrison, Joseph Salerno, Thomas DiLorenzo, Jörg-Guido Hülsmann and George Reisman are taken from my lecture notes from the 2006 Mises University conference in Auburn, AL.