



Episode 419: Austrian Business Cycle Theory: Answering the Critics

Guest: David Howden

WOODS: Last time I had you on, we were talking about the Austrian theory of the business cycle, and I'm linking to that on today's show notes page. Can you believe this is episode 419 of my little show?

HOWDEN: Ooh.

WOODS: The show notes page is TomWoods.com/419, so we'll link to that. And of course, we're also going to link to this article, the Bryan Caplan article, "Why I Am Not an Austrian Economist." We'll link to the episode with Jeff Herbener, in which we went through the microeconomics section of that article. I'd like to go through the whole thing bit by bit eventually. So today, we're talking about the business cycle section of that article. I guess it wouldn't hurt and would probably make sense for you to start off giving a brief, probably without much nuance, layman's overview of the Austrian theory of the business cycle, so we can understand Caplan's objections.

HOWDEN: Yeah, sure, well I think the Austrian theory is a theory about the timing of when investments take place and how time intensive those investments should be. So it starts with the simple proposition that the longer – everything else being the same – the longer that you spend on a project, the longer that the investment is, the greater the value that the output has to be. And the reason for this is that the only reason why a consumer would wait for a longer period for an investment to pay off over a shorter period is if the payoff is greater or if the value of the product was greater.

So the Austrian theory takes that little insight and then links it to interest rates – and in particular, market interest rates, which are controlled or influenced by central banks – and says that when market interest rates are reduced artificially or lowered artificially by central banks, it skews the whole profit calculus that entrepreneurs use when they're trying to figure out how long and how valuable should the output of an investment project be in order to meet the demands of consumers.

And when central banks drop this interest rate below what would otherwise be the case, entrepreneurs are lured into partaking in very long-dated, long investment projects – which, if you want a practical example, would be something that's very research intensive, something that needs a long lead time, like medicine

developments and things like this that have many year, many decade investment periods. They're lured into pursuing these types of investments in lieu of much shorter dated or shorter duration investments that would give value or would give output in a much shorter period of time. So an example of that would be maybe constructing a store that sells ice cream or something that's very close in time to the moment when the consumer actually wants to get the value of that good.

So in essence, it's a simple theory, which I think most layman intuitively understand, that when you skew interest rates, entrepreneurs respond by changing the types of investments that they partake in, and they start favoring these extremely long-dated investments that need an extended period of time before they actually pay off.

WOODS: All right, very good. Let's look at this Caplan article. In the business cycle section, he's divided the discussion into two parts. The one part involves the conclusions of the theory, the aspects of the theory that he believes are uncontroversial and correct. And then he goes into the parts that he's not convinced of and he believes are wrong.

So let's start on an ecumenical note and look at where he thinks the Austrians go right. And here, he talks about what Mises and Rothbard have to say about, fundamentally, the causes of unemployment. And the cause of unemployment is real wage rates that are too high, and they need to be adjusted in light of current conditions. And he says that this is a very important insight, but he says, basically at this point, at this stage of our economic knowledge, more or less all economists understand and agree with this proposition, even if they wouldn't state it as bluntly as Rothbard. What do you think about that?

HOWDEN: You know, I think the funniest thing when I read this section, when he talks about real wage rates, is he discusses how Rothbard first gives the overview of this cause of unemployment – excessively high real wages – as early as 1963. And then later in the paragraph, in the exact same paragraph he talks about this, he criticizes the Austrians, because by the late 1990s, the mainstream had basically reached the same conclusion – as if this is a big blow to the Austrians, because they had figured out almost 40 years in advance of the mainstream, what the primary cause of unemployment is. So I think he's a little bit disingenuous in this area, as he does try to be ecumenical and say, hey, we all agree on this, because the Austrians, they came up with the theory first, and then the mainstream, it took them decades to follow suit.

But then, I guess, I have to disagree with Caplan a little bit on this, because he agrees unemployment is caused by excessive real wages. Every economist would agree on this point. But then he criticizes Rothbard and Mises, because they do not accept that using real wages to reduce real wages will fix an unemployment problem, whereas the mainstream in distinction, one of the common cures to a recession or depression that they would advocate for is, there's people who can't get a job, because they're demanding too high a wage, and firms, given the value of the output that they are selling, they can't afford to offer this high wage that workers are demanding.

So a lot of mainstream guys would say, well, all we need to do is give a good dose of price inflation to lift the prices of the output that firms are producing, and then firms will be able to afford to hire all these workers.

So Caplan says, why is it that Rothbard and Mises think that excessive real wages are a cause of unemployment, but that they don't want to accept that inflation is a cure for this? And in reconciling the two statements, the key is that Austrians don't think that – we take our macro data, and we like to disaggregate it. We don't like to think in terms of these big aggregate pieces of data. So it's not that all wages are too high, or that all people, all workers are demanding too high a real wage. It's that, in some areas, wages are too high; in other areas, they could well be too low. And if you just give a good dose of inflation to increase prices everywhere, this exacerbates one half of the problem – that the areas in the economy where real wages were already too high – and it doesn't necessarily solve the problem where real wages were too low.

So Caplan, he glances over this key Austrian insight that the average is not what every single worker faces. And sure, it's true some people are unemployed because of excessively high real wages, but we can't solve this problem just by inflating the general price level, so to speak, so that on average, real wages fall more in line with what's acceptable to businesses.

WOODS: I'm glad you said that, because I was going to follow up by asking you to spell out for us what the connection between excessive real wages and the Austrian theory of the business cycle. And it seems to be that the excessively high real wages in some sectors are a byproduct of the distortion of the patterns and kinds of investment during the boom.

HOWDEN: Yeah, well even – let's take a concrete example. Let's say that the boom is caused, at least in part, by an inflationary policy by the central bank. And this inflationary policy has lifted up real wages in one sector of the economy and not in another. So we have this dis-coordination going on, where part of the economy has an employment problem, and the other part potentially doesn't. And then Caplan goes along with this mainstream line of reasoning, and he says, well, let's just fix this by giving a dose of inflation to the whole economy.

And on the one hand, you should stand back and just think about this and say, well, if the initial problem was inflation causing real wage rates to spiral out of control in one part of the economy and not in another, then how can the cure be another dose of inflation? Isn't this just going to worsen the original problem? And so the key Austrian insight is accepting that we're not all the average, and that the cure – and I don't even want to use the word, the “cure” – but if you want to think in these terms, the cure to the downturn or the recession, there's no panacea where you just magically lift the general price level, increase CPI inflation, and magically expect all wage rates to fall in line to be acceptable, given the prices of the output that firms are selling. The key problem is we need to get some wages in some areas of the economy back in line with what is acceptable, given the output that those industries are producing, and other areas of the economy may well not need any adjustment at all.

WOODS: Let me just clarify here, because it looks as if, in my reading of this, is that Caplan is not endorsing inflation as a cure, so to speak, to unemployment. He lists this proposition: “Using inflation to reduce real wages is at best unreliable, and in any case not a long-term solution to the problem of unemployment.” He says that this proposition has also been by and large been accepted by the mainstream. So I don’t think he’s endorsing inflation as a cure, but are you disputing the extent to which that proposition has been accepted?

HOWDEN: Oh sure. I think he’s trying to – I read Caplan as trying to catch Mises and Rothbard in a catch-22, where, on the one hand, they want to argue that excessively high real wages cause unemployment, and at least in the short term – and that’s where Caplan doesn’t accept the full statement – in the short term, at least, most economists would agree that we can reduce real wages through inflation. We can’t as a long run solution, but in the short run, as a temporary policy, this is something that we can do. And so Caplan takes Mises and Rothbard to task by saying, why wouldn’t you agree with this short-term solution, even though you’d have to say that it would solve your initial problem?

WOODS: Here’s the big issue that the defenders of the Austrian business cycle theory have to answer. It’s the usual expectations objection. And there are numerous ways in which Austrians have tried to respond to it. So tell us, what is the problem of expectations that opponents of the theory raise? And why is this not fatal to the theory?

HOWDEN: Well, the best objection is – and actually Caplan gets to it later on in this article – he says, why are people so dumb? Why can’t people see that there’s inflation going on, and why can’t they adjust their plans accordingly? So in other words, we’re so entrepreneurial – Caplan would agree with this – and Mises and Rothbard have done so much work to focus on the entrepreneurial functions of men, and some of us at least are so good at predicting the future and getting our projects, our tasks in line with the future that we think is going to happen; we’re so good at doing this. And then when it comes to the field of money, Austrians seem to think that people are complete failures at estimating what the rate of inflation is or how this is going to skew future production plans or things like that.

So on the one hand, I would say, let’s be realistic about this; that there’s a big difference between forecasting – let’s see, we’re in the beginning of June, and I think most people are reasonably expecting that the demand for T-shirts is going to skyrocket in July and August when there’s hot weather. Most people are pretty good at this. That type of forecasting is completely different than forecasting political processes that don’t seem to abide by, in many instances, any rhyme or reason and are done completely out of the blue.

And as a good case in point right now, are Janet Yellen and the Fed going to raise interest rates this year or not? And for all of the pages written about this and the ink that’s been spilt, people are really uncertain about what’s going on with interest rates – the price of money in many ways, in a way that we’re not uncertain about what the

price of T-shirts is going to be several months from now or the price of winter coats next winter or anything like this. So I think there is a difference between our entrepreneurial abilities to forecast variables that are intertwined in a political process versus those that are economically determined, according to some rationality.

And on the other hand, I think about this expectational argument, and I would think, even if you knew what was going on – you knew that the Fed was artificially reducing interest rates or you knew that there was an unsustainable boom going on – Caplan and a lot of critics like him would say, well, why are you participating in this boom at all? Why don't you just sit it out?

But try telling a banker, whose job relies on making loans or issuing mortgages, that they've got to sit this boom out, because it's not sustainable. And this banker has to keep shareholders happy and has to keep his boss happy and things like that, and the reality of the situation is he can't respond to his own expectation that the boom is unsustainable and sit this one out, because in the meantime in that period when it is going on, he's got to be making money, and he has to be issuing loans and things of this nature.

So on the one hand, I think we have to recognize how difficult it is to forecast political processes. On the other hand, we need to understand that entrepreneurs, sometimes they have to participate in something they don't want to. Sometimes they're forced to do it; otherwise, they lose their job, or they'll sacrifice profits, and other firms will capture those profits, and they'll lose market share.

WOODS: Is this the same answer you would give to his specific objection: why couldn't entrepreneurs just use the credit markets' long-term interest rates for forecasting profitability, instead of stupidly looking at current short-term rates? Is your argument that, again, when you're dealing with a political process, long-term or short-term rates, it's not much to choose, because there's nobody who can really know what the authorities are going to do?

HOWDEN: Yeah, sure. Well, on the one hand, let's pick on those people who took adjustable rate mortgages during the last housing boom. We know ex post facto that it was a terrible decision to just rely on variable rate mortgages that were subject to increasing rapidly when the bust happened. And again, your average person has no idea what's going on in the inflation process. Some people do for sure; there's – lots of Austrian economists, for example, wrote about this during the boom, about the coming bust. But your average layperson has absolutely no idea about this. So of course, they go to what's cheapest. They take out that variable rate mortgage to take advantage of low interest rates.

But on the other hand, think about the bank who's issuing this mortgage. It takes two to tango, and Caplan and some fellow travelers of his could say, why did the bankers stupidly issue so many variable rate mortgages that were going to blow up and cause losses later on? So imagine that you're a banker during the boom, and you've come to the conclusion that variable rate mortgages are terrible; they're going to trap a lot of

people into mortgage conditions that they can't pay back once interest rates adjust higher. So you as a mortgage broker are only going to offer 20-year fixed rate mortgages. And how many clients do you think you're going to have? How many customers are going to come to you and sign on the dotted line and borrow money? And the answer is probably none or very, very, very few. And so you as a mortgage broker are either going to lose your job, or your firm is going to lose market share, because it's not offering the product that people want.

And that's the crux of the expectation problem. It's that even if you know what's going on, you can't necessarily fight it. You can't fight it, because you don't know how long this game's going to last for, and Caplan actually brings up this point – it's a point Roger Garrison has made, that it's like a chain letter or a Ponzi scheme: you can rationally take part in a Ponzi scheme, thinking that you're just going to get out before it blows up. The only problem is we don't know when it's going to blow up. So some people will get caught, even though they know full well exactly what's going on. And the other problem is there's lots of people who have no idea what's going on, so of course they're going to get caught.

WOODS: All right, let's talk about some further things. I mean, I've sometimes – just to illustrate part of the problem, and I suppose I'm exaggerating a bit, and I'm not being altogether fair to people like Caplan – but I've sometimes said, when they say things like, if you're entrepreneurial, surely you should be able to forecast what's going to happen with interest rates; you should be able to roll with the punches here, because after all, don't we believe entrepreneurs can do all these sorts of forecasting tasks. But what if I said to everybody, all right, here's an economy where we're going to have no prices. But you're entrepreneurs – surely, you can see your way through this, right? That's what you're here for. You'll figure out some way. But in some cases, you can't. Entrepreneurs may be really skilled at some things, but that doesn't mean they can do absolutely everything.

HOWDEN: Yeah, and how many – just to follow on that point – how many articles can you read in a day that are written by highly paid financial professionals discussing what interest rates are even going to do six months out from now, that are completely bogus after the fact? It's incredibly difficult to estimate ahead of time what interest rates are doing.

WOODS: I want to read you a full paragraph from Caplan, and you unpack it. He says, “The Austrian theory also suffers from serious internal inconsistencies. If, as in the Austrian theory, initial consumption/investment preferences ‘re-assert themselves’” – so in other words, after the boom period, we realize that people actually didn't want all these long-term projects; they didn't want these types of investments; they wanted more consumption – “initial consumption/investment preferences ‘re-assert themselves,’ why don't the consumption goods industries enjoy a huge boom during depressions?” – you know, as the desire for consumption reasserts itself.

“After all, if the prices of the capital goods factors are too high, are not the prices of the consumption goods factors too low? Wage workers in capital goods industries are

unhappy when old time preferences re-assert themselves. But wage workers in consumer goods industries should be overjoyed. The Austrian theory predicts a decline in employment in some sectors, but an increase in others; thus, it does nothing to explain why unemployment is high during the ‘bust’ and low during the ‘boom.’” What do you say to that?

HOWDEN: Yeah, I think this is a common critique that people give of the Austrian theory, and in a nutshell it says, the problem during the boom is, there’s been too much investment in capital industries, so in the bust, this is going to disappear, and there should just be a re-shifting into the consumers’ industries. So we should get a boom over there.

But this is only half of the Austrian theory, and it’s an understandable mistake, I think, when some people make it, because this is very much Hayek’s theory of the business cycle. Hayek focuses almost exclusively on what happens in the capital industries, what happens to production plans – or in other words, malinvestment – during the boom. But he doesn’t focus on consumers at all.

And if you want to get a good picture at what consumers are doing during the boom, you have to read Mises, because he has two components to his business cycle. It’s a little bit different. On the one hand, there’s this malinvestment story, exact same as what Hayek has going on. But on the other hand, there’s this overconsumption story, where consumers are consuming too many goods – or too many consumer goods, in the sense that it’s unsustainable – during the boom.

And the reason for this is that when central banks increase the money supply and artificially drop down interest rates, savers respond to this by saving less. And saving is just the flip side to consumption. So if you save less, it means that you’re consuming more. And producers, on their side, they see lower interest rates, and they think that there’s money and capital available to be invested, so they start malinvesting; they start skewing the structure of production.

And there’s two sides to this: so during the boom, people consume too much, and businesses malinvest. And then during the bust, everything has to get back to normal. Well that means that consumption expenditures need to come down, and people need to start saving more. So we should have, in the bust – we need an adjustment in the consumer industries. It’s not going to be a boom in the bust, like Caplan and his fellow travelers think. And then we’ve got the normal recessionary period in the production industries, where capital is restructuring itself and getting back to where it’s most highly valued. Or probably, the structure of production is just shortening as firms take on shorter dated projects.

So in that paragraph that you just read, I think it’s an excellent paragraph in the sense that it does sum up what many people criticize the Austrian theory for, but the mistake that people who think this make is they only focus on half of the theory, this malinvestment story, without realizing that there’s overconsumption; there’s a real consumption boom going on at the same time.

WOODS: Of course you know Joe Salerno wrote an article on this a few years ago, looking once again at Austrian business cycle theory in light of the current predicament, the downturn of 2008. Because a lot of the ways that the — I don't want to say this in a disparaging way, but — Austrian apologetics have proceeded, when you're talking about the business cycle, is to talk about the artificial expansion of capital goods industries, and that this is a particularly outstanding feature of the boom, and that the downturn in capital goods industries, being so severe, is a particularly outstanding feature of the bust. But in this most recent bust, we saw major, major retail chains that had existed for years go completely under. There were major repercussions among consumer goods industries, and this seemed like it was a bit of a challenge to the traditional tale of the Austrian business cycle.

HOWDEN: Yeah, and I think when you look at the last boom, it illustrates the Austrian business cycle perfectly, because it has both of these elements. How much did the consumer goods industry take off over the last 15 or 20 years? How many big box stores sprung up? How much did consumer retail culture expand in the states over the boom? And I don't think there's a single person that would not agree that consumerism, I guess to give it a word, had expanded greatly over that period. And at the same time, businesses had really made investments, on the production side of things, in extremely long-dated investment projects that wouldn't pay off for a long period of time, like high tech, for example.

And what was missing during the boom, the investment that we didn't see — which you can't fault people for not seeing what doesn't exist — but if you'll notice, when you go around — I'm always a little bit surprised in the states, that there's lots of brand new stores there to meet consumer demand. There's all sorts of flashy, abstract technology spending in research and development that's not going to pay off maybe ever, or if it does, it will be a long period of time. And then the intermediary investment projects — like infrastructure spending would be a good example of this — things that pay off in a relatively short period of time, not right away, but we're not talking about decades or many decades, things like repaving the parking lot so it's not full of pot holes, or repaving the highway, or something simple like that — that seemed to be missing during the boom. All the emphasis seemed to be on the extreme ends: the consumer culture in the new stores and the long-dated investment projects, the research and development.

And so this is really what the boom is. And a lot of people think that the Austrian theory just says, no, the boom is all about capital over-investment, entrepreneurs are producing too much capital; they're making too many investments. But that's not it at all. It's that they're making the wrong type of investments. And in particular, they're at the two ends of the spectrum. They're at extremely short-dated investment projects that immediately satisfy consumer demand, like building a new store. And they're at the extreme long end of the investment duration horizon, where they're partaking in research and development that's going to take decades to pay off. And they're not doing the intermediary projects that are going to pay off in a relatively short or even intermediary period of time.

And so then when the bust happened, it was shifting out of these things. When the bust happened, we did see, like you say, big consumer industries in trouble, established stores going under. This is exactly what the Austrian theory predicts, and it's exactly not what Caplan would predict in this article or what some of the fellow travelers of his would predict.

And then we also saw, of course, a lot of blow up and a lot of bankruptcies in long-dated investment industries. A lot of research and development projects went under. A lot of real estate projects, as an example of a long-dated investment project, went under. And we saw a re-shifting back into these intermediary industries, like infrastructure development.

WOODS: Dave, I want to ask you one more thing before I let you go. He says, "Even more striking is the Austrian theory's inability to explain why output declines during a depression; instead, it predicts a short-term increase." He says, "Bohm-Bawerk's capital theory, on which Rothbard wisely built his work, implies that actually the short-run effect of switching to consumer goods production would be a period of greater production, followed by a period in which production is less than it would otherwise have been if longer period products had been used instead." So he says that you can't explain with the Austrian theory why output actually goes down during a depression. How do you respond to that?

HOWDEN: The exact same way as I just said. When the problem with the bust is that it's not just that production plans are upset and they need to start doing shorter production plans that are – like, what Caplan's saying is true: entrepreneurs are going to shorten their production horizon, so we should have a sudden surge in production goods being produced. The only problem is who's going to buy them? Because consumers over-consumed during the boom, and now there's no buyers for these goods?

So to use an example with the housing boom from a couple years back: in the bust, are industries, are businesses going to shorten up their investment horizon and start doing short-dated investment projects – like, let's say, making bricks? That doesn't take very long, to make a brick. And they should start making these, and so we should have this big glut, a big really surge of bricks on the market. But of course, this doesn't happen; we don't get a surge in output. And the reason is there's no consumers willing to buy these goods.

So the two sides of the story have to be cohesive. You need consumers willing to buy the goods that are being produced in order for businesses to actually produce them. And the problem on the bust is that businesses need to get their production plans back in line with consumer preferences, and consumer preferences are not focused on consuming more goods that they've already consumed well too many of during the boom.

WOODS: All right, Dave, I appreciate this. We've gone through fairly systematically this article. Again, we'll link to it at TomWoods.com/419. Where would you refer the

interested layman, let's say, for more information about this question of the Austrian theory of the business cycle?

HOWDEN: I think that the single best article that you could read on this – especially in light of, if you wanted to read them together, this Bryan Caplan piece that we've been discussing – the single best article that you could read is one that Joe Salerno wrote recently, and it was in *Quarterly Journal of Austrian Economics*, and it's called "A Reformulation of Austrian Business Cycle Theory in Light of the Financial Crisis."

WOODS: That's the one I was referring to. Okay.

HOWDEN: And that is – in it, Joe masterfully takes apart all of these people like Caplan who completely misunderstand Austrian business cycle theory, or only understand one half of it, and then draw all these damning conclusions for it. And he really sheds in simple to understand terms exactly what it is the Austrians are saying. Because it is difficult to understand what the Austrians are saying at times. Hayek's not the easiest guy to read; I'll agree with that 100%. But Joe is extremely lucid in this piece, and it's a great article.

WOODS: Well, we'll definitely link to that as well as TomWoods.com/419. Dave, you are a hero in the Austrian world and here on the show. Thanks for your time today.

HOWDEN: Thanks, Tom.