

## Chapter 8

# Business Cycles

The main problem that a theory of depression must explain is: *why is there a sudden general cluster of business errors?* This is the first question for any cycle theory. Business activity moves along nicely with most business firms making handsome profits. Suddenly, without warning, conditions change and the bulk of business firms are experiencing losses; they are suddenly revealed to have made grievous errors in forecasting ... As a rule only some businessmen suffer losses at any one time; the bulk either break even or earn profits. How, then, do we explain the curious phenomenon of the crisis when almost all entrepreneurs suffer sudden losses? In short, how did all the country's astute businessmen come to make such errors together, and why were they all suddenly revealed at this particular time? This is the great problem of cycle theory ... In the purely free and unhampered market, there will be no cluster of errors, since trained entrepreneurs will not all make errors at the same time. The "boom-bust" cycle is generated by monetary intervention in the market, specifically bank credit expansion to business.

—Murray Rothbard (1963), *America's Great Depression*: 16.

F.A. Hayek earned two doctorates from the University of Vienna (1921 and 1923). After his university studies, Hayek was introduced to Ludwig von Mises through his teacher, Friedrich von Wieser, and their collaboration began. For five years, Hayek worked under Mises at a government office and then, in 1927, they co-founded the Austrian Institute for Business Cycle Research, where their work resulted in the Mises-Hayek theory of the trade cycle.

Building upon Mises's earlier work (*The Theory of Money and Credit*, 1912), which served as the foundation for the Austrian theory of the trade cycle, Hayek worked to refine both the technical understanding of capital coordination and the institutional details of credit policy. He published two books (*Monetary*

*Theory and the Trade Cycle*, 1929; and *Prices and Production*, 1931), which analyzed the effects of credit expansion on the economy's capital structure. Hayek presented this work in a series of lectures at the London School of Economics, where he was received with great acclaim and appointed, in 1932, as the Tooke Professor of Economics Science and Statistics.

Hayek's arrival in London sparked the most fundamental debate in monetary policy in the twentieth century—the Hayek-Keynes debate. John Maynard Keynes had published *A Treatise on Money* in 1930, of which Hayek wrote a lengthy and critical two-part review. The main problem with Keynes's position, Hayek argued, was his failure to understand the role that the interest rate plays in coordinating plans and the capital structure, through time, in a market society. The Mises-Hayek theory of the trade cycle offered an alternative by rendering intelligible the “cluster of errors” that occurs during the bust by focusing on the distortions in relative prices and in the capital structure created by government-induced credit expansions. In this regard, the Mises-Hayek theory of the business cycle is one illustration of the dynamics of interventionism whereby an initial government intervention into the market sets off a chain of unintended and undesirable consequences.

At the core of the Mises-Hayek theory is the idea that money is not neutral. Money would be neutral if a monetary expansion had no effect on real prices. For example, it would be neutral if a doubling of the money supply led to an automatic doubling of all prices and wages such that real wealth would be left unchanged. People's bank accounts would double and so too would prices such that their real purchasing power remained the same. The notion that money is not neutral, in contrast, emphasizes that monetary expansion does not raise all prices and wages instantaneously and in unison. Instead, money works its way through the economic system starting at the point of injection and causing changes in relative prices as it filters through the system. This process benefits the early recipients of the newly printed money at the expense of those later in line.

Those who receive the new money prior to the full adjustment of prices benefit through increased purchasing power that enables them to bid resources away from others who lack the improved purchasing power. Those who are the last to receive the new money suffer from reduced purchasing power because prices have already adjusted upward. The relative price changes caused by the credit expansion influence the process of exchange and production as

entrepreneurs respond to the signals sent by prices as they make and revise their production plans. These production plans, in turn, are what determine the capital structure and, ultimately, what consumer goods are produced.

Perhaps the easiest way to understand the Austrian theory of the business cycle is to contrast a genuine economic expansion, as a result of a change in savings, with an artificial government-caused credit boom. To begin, consider the market for loanable funds resulting from the willingness of people to save at different interest rates (the supply side of the market) and the willingness of entrepreneurs to borrow at different interest rates (the demand side of the market). Together, the supply and demand for loanable funds result in an interest rate that coordinates both sides of the market. This rate is known as the “natural rate of interest” since it is the interest rate that emerges naturally out of the voluntary interactions of suppliers and demanders of loanable funds.

The interest rate is best understood as an intertemporal price that coordinates the allocation of resources through time. It captures people’s “time preference” or willingness to consume now rather than forgoing current consumption in order to save for the future. Market-determined interest rates serve the function of coordinating the market for loanable funds so that entrepreneurs undertake investment opportunities that are consistent with the desire of income earners to save today in order to consume in the future. Moreover, the natural rate of interest determines not only the overall level of investment, but also the allocation of resources within the complex capital structure.

As the time preferences of income earners change, so too does their desire to save. This affects the market interest rate for loanable funds. Assume, for example, that a new medical innovation increases life expectancy. This will lead people to lower their time preference, which means they will have a stronger preference to save for the future as compared to consuming resources in the present. This change in time preference affects the loanable-funds market. The desire to save more will increase the supply of loanable funds; this has two effects.

First, the increase in the supply of loanable funds will lower the interest rate (for a given demand for loanable funds). This fall in the interest rate for loanable funds sends an important signal to entrepreneurs: longer-term projects that were not previously profitable at the higher interest rate are now profitable at the lower interest rate. Second, at the same time, the desire of people to save more for the future leads to a greater availability of resources for businesses to use to pursue these projects. The interest rate for loanable funds facilitates

a revision in intertemporal production plans as entrepreneurs invest in longer, more roundabout, production projects. Notice that under this scenario the market process operates to coordinate heterogeneous and multi-specific capital across time to reflect the genuine time preferences of economic actors. This situation is sustainable because production plans align with underlying consumer preferences, and also because the resources necessary to execute and complete entrepreneurial projects are readily available given that consumers have decided to forgo consumption in the present for consumption in the future.

Contrast this situation with an artificial government-induced credit boom. A central bank decides to increase the supply of loanable funds by creating new money that it injects into the economy. As in the scenario above, this leads to an increase in the overall supply of loanable funds and a decrease in the interest rate. However, there is an important difference. In the scenario above, the increase in the supply of loanable funds, and the concomitant fall in the interest rate, reflects a genuine change in preference on the part of consumers to save more in the present. The injection induced by the central bank, in contrast, does not reflect an actual change in the time preferences of consumers. As in the previous scenario, entrepreneurs respond to the lower rate by borrowing more as previously unprofitable projects are now profitable at the lower interest rate. Production plans are revised accordingly to make more goods and services available to consumers in the future.

The problem is that the new lower interest rate is not an accurate reflection of genuine consumer preferences. That is, people wish to consume and save in the same manner that they did prior to the credit injection by the central bank. In the prior scenario, the (genuine) reduction in the market interest rate was accompanied by the availability of resources—as consumers chose to save by forgoing consumption today—to complete projects undertaken by entrepreneurs at the lower interest rate. In the credit-induced scenario, this does not happen. Since the preferences of consumers have not changed, they do not make additional resources available through savings. In fact, the opposite happens. As the interest rate falls as a result of the central bank's injection of funds, people will respond by saving less and spending more in the present. The result is that the actions of entrepreneurs and those of consumers are at odds.

The resulting distortion in the structure of production cannot be maintained as the monetary expansion works its way through the economy. Consumers continue to draw incomes and assert their true preferences for

savings and consumption. The artificially low interest rate eventually adjusts to reflect the real scarcity of savings, in comparison to producers' perceptions immediately after the credit expansion, as entrepreneurs bid against one another for the scarce resources available. For some entrepreneurs the projects that appeared profitable are now revealed as unprofitable.

The "boom" associated with credit expansion, therefore, leads to the "bust" when economic forces reassert themselves and it becomes clear that investment opportunities that were perceived to be profitable are either unprofitable or cannot be completed. The bust, which is the revelation of the malinvestment caused by the central bank's credit injection, entails a process of capital re-structuring and re-grouping as entrepreneurs take steps to revise production plans so that they align with the genuine consumption and savings preferences of economic actors.

The Mises-Hayek theory of the business cycle has important implications for policy. In contrast to the Austrian focus on distortions in relative prices and the capital structure, many economists attribute busts to deficiency in aggregate demand. From this perspective the appropriate policy response to busts is for government to increase aggregate demand through some mix of monetary and fiscal stimulus. Austrians oppose this policy response to busts because they see these supposed solutions as the root cause of the bust in the first place.

The appropriate response to a bust is to allow entrepreneurs, through the operation of the market process, to reallocate and regroup scarce resources in the capital structure. This process of reallocation takes time and can impose significant costs like business liquidation, unemployment, and idle resources. However, these costs cannot be avoided through further monetary-induced credit because such a response will only cause subsequent distortions to the capital structure. At best such policies can "kick the can down the road" by papering over the consequences of past credit-induced distortions by creating new ones. They cannot, however, solve the fundamental issue, which is a misallocation of scarce resources caused by the initial intervention in the market.

In addition to discussing the policy response to a bust once it occurs, Austrian economists have also explored ways of avoiding the onset of a bust in the first place. These include designing and reforming monetary institutions to limit the possibility of credit expansions that lead to distortions in relative prices and the capital structure. Such proposals fall under the idea of a "monetary constitution," a set of rules and institutional arrangements to limit the ability of

banks to create money. A monetary constitution can take a variety of forms in practice and might include such things as a rule limiting the amount of credit created within a particular time frame, the backing of credit by hard money to limit the ability of banks to print money, or monetary competition which would limit money creation by replacing a centralized monopoly supplier of money with competition among banks.

We began this chapter with a discussion of the development of the Mises-Hayek theory of the business cycle and Hayek's famous debate with John Maynard Keynes in the 1930s. What was the outcome of this debate? Keynes responded to the first part of Hayek's critique of *A Treatise on Money* by critiquing Hayek's book, *Prices and Production*. After the second part of Hayek's critique was published, Keynes chose not to respond. Instead, he turned his attention to completing his next book, *The General Theory of Employment, Interest, and Money*. Hayek, on the other hand, began refining his understanding of capital theory because he was convinced that this was the key point to convey to Keynes and the rest of the economics profession.

The *General Theory* was published in 1936 and Hayek decided not to respond directly. In making this decision, Hayek committed what many defenders of the free market system consider to be one of the major tactical errors of this century. While Keynes's *General Theory* became perhaps the most influential book on economic policy in the twentieth century, Hayek laboured on a project that would become *The Pure Theory of Capital* (1941), which is his most technical and least influential book. In the midst of the Great Depression Keynes was viewed as winning the debate with Hayek, and Keynesian economics came to dominate the professional discourse in macroeconomics.