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On Laidler regarding the Austrian business cycle theory

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Abstract The authors welcome criticisms emanating from neoclassical critics of Austrian economics. We congratulate Laidler for transcending the usual modes of macroeconomic analysis to take on praxeological considerations. This paper should be interpreted as a welcome for his efforts in the hope that they will be widely emulated within the profession.

Keywords Business cycle · Macroeconomics · Praxeology · Subjectivism · The structure of production

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1 Introduction[1]

In the 21st century, and the late 20th, it was the rare mainstream macroeconomist[2] who showed any evidence of being aware of, let alone commenting upon, Austrian Business Cycle Theory (ABCT).[3] Thus, when a macroeconomist of the stature of Laidler (2003) appears in print on this topic, it behooves those of us who consider ourselves students of this perspective to take note of this extraordinary occurrence, analyze it, and welcome him to the ranks of those who take seriously praxeology, subjectivism, the structure of production, and other building blocks of the Austrian system. In the next section, we review ABCT. In the section after that we comment upon Laidler (2003). Among the issues discussed here are banking, critique of Mises' objectivity, motives, forced saving, unemployment, public policy, Haberler, and inflation.

2 Review of ABCT

The essence of ABCT can be summarized (Rothbard, 1969) through a series of triangles.[4] The specifications for triangle 1 (Fig. 1) are as follows: pecuniary value is measured on the vertical axis; time appears on the horizontal axis, along which, also, is measured the stages of production in the structure of production.[5] Ultimately, all production is geared by entrepreneurs to produce goods for consumers, as the satisfaction of consumers' wants is the raison d′être for all production. The triangle depicts the production process as commencing at the left and proceeding to the right. Thus the earlier stages of production, located to the left and involving higher orders of capital goods, are more remote in time from the consumers. And, the later stages of production, located to the right and involving lower orders of capital goods, are nearer in time to them. Consumer goods themselves, the ultimate desideratum of all production, are located at the extreme right end; that is, the vertical leg. (It should be noted that capital goods include, importantly, not only fixed capital, but goods in process as well.) Because pecuniary value is measured on the vertical axis, the height of the triangle rises as we move to the right, indicating that each stage of production adds something of value to the process. The angle the hypotenuse of the triangle makes with the base depends on the "social time preference." This angle measures

[1] We were lucky to be assigned by the editor of this journal to a highly competent and very active referee. Rather than thank him for each and every point he suggested to us, which would quickly become tedious since there were so many of them, we have incorporated all into the paper, we content ourselves with thanking him this one time. Needless to say, but we will say it anyway, any remaining errors or infelicities are solely our own responsibility.

[2] Exceptions to this rule include Tullock (1988, 1989), who can be considered a neoclassical economist, although his major work is hardly in the field of macroeconomics. For a rejoinder, see Salerno (1989).

[3] Matters were not at all the same in days bygone. Very much to the contrary, there is a large literature wherein Austrians and their mainstream opponents debated the veracity of the ABCT. See on this Hayek (1931–1932), Keynes (1914), Mises (1951, 1964), and Sraffa (1932). See also http://cepa.newschool.edu/het/profiles/keynes.htm

[4] We are aware of the limitations of the triangle method of presenting ABCT; see on this Barnett and Block (forthcoming), but use it metaphorically as a pedagogic device, for the benefit of those new to ABCT.

[5] See on this Hayek (1935), Rothbard (1975, 1993/1962), Garrison (2001), Lachmann (1956). We follow the practice of Garrison in placing time and the stages of production on the x-axis, and value on the y-axis.

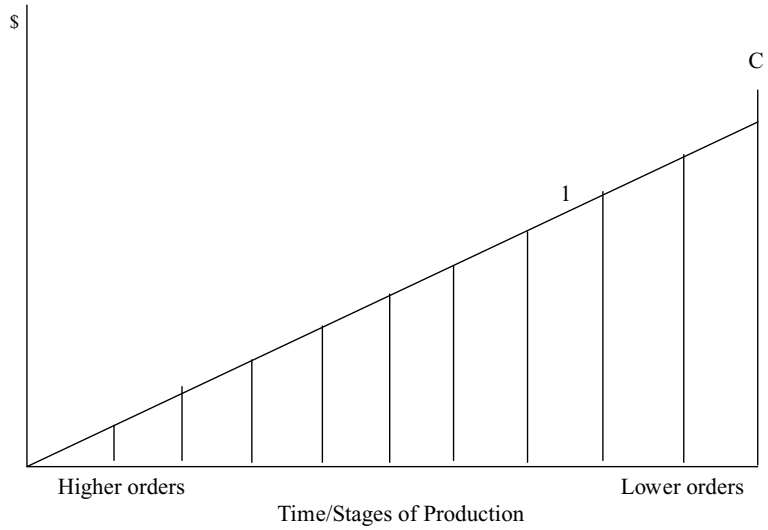

Fig. 1 The structure of production

the ratio between the present discounted values of each of the successive stages in production. An unchanging hypotenuse depicts that the economy is in equilibrium, or constitutes an "evenly rotating economy."[6]

Triangle 1 in Fig. 1 illustrates the term *structure of production* of an economy at a particular point in time. Assume that, for whatever reason, businessmen then misread consumers' time preferences, thinking them to have become more future oriented and adjust production accordingly. The superimposition of triangle 2 in Fig. 2 illustrates the resultant elongation of the term structure of production. Triangle 2 is superimposed on triangle 1 in such a way that the value and time/stages axes of the two triangles are coincident. Some resources have been shifted from uses closer in time to consumers to uses more remote; that is, from the production of consumer goods and lower-order capital goods to higher-order capital goods. The *net* effect is a reallocation of resources from area C to area A. Because entrepreneurs have misread consumers' time preferences, this reallocation is in fact a misallocation: they overinvest (area A) in resources in the higher-order capital goods (basic industry, research and development, construction that will endure for many years, etc.) and underinvest (area C) in the lower-order capital goods and consumer goods. Triangle 1 illustrates the time structure of production that is in accord with the actual (unchanged) time preferences of consumers, whereas triangle 2, is not in accord therewith, illustrating, as it does, the modified structure of production based on entrepreneurs misperceptions of consumers' time preferences.

If this type of mistake is made by but a relatively few entrepreneurs it is of no great moment. For those who commit these errors suffer losses; if they persist, they

[6] This is one of the most serious abstractions from reality involved in using the triangle as a depiction of the economy, for it is a basic tenet of praxeological economics that we can never attain equilibrium. On this see Lachmann (1977, 1986) and Hulsmann (2000).

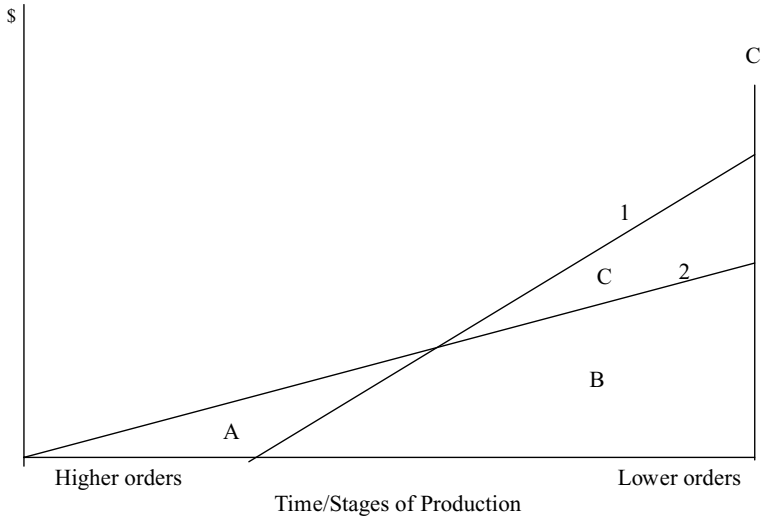

Fig. 2 Contrasting structures of production

risk bankruptcy. The economy quickly devalues investments made in area A, and integrates them into the economy at their new, lower values.[7]

But now, suppose that the government artificially lowers interest rates below their natural rates by lending new money into existence. This injection of newly created money or credit, and manipulation of the interest rate, results in malinvestment, which is systematic, coordinated, and persistent. This economy-wide misperception by a relatively large number of businessmen along these lines is commonly referred to in Austrian circles as a "cluster of error." Depending upon the extant economic institutions, environment, and government policies, these malinvestments (area A) *can* long endure. Instead of being wiped out[8] relatively quickly, they build up over the years.

[7] It should be noted that given consumers' actual (unchanged) time preferences these investments were malinvestments at the time they were made; i.e., entrepreneurs paid too high a price for them given consumers' true time preferences. However, once they generate economic (whether or not accounting, also) losses, their values decrease (whether implicitly and/or explicitly) to bring them into conformity with the actual time preferences of consumers, and, at these new lower values they are no longer malinvestments, but rather plain old investments. For example, an entrepreneur mistakenly buys a piece of equipment that proves to be uneconomic because he misread consumers' time preferences. He then sells it at a loss to a new owner who now integrates it into his structure of production and for whom it proves profitable at the price he paid for it. For the latter, it is a plain old investment, not a malinvestment. The same might be said had the original purchaser, instead of selling it, integrated it into his own structure of production. In effect he sold it a second time, this time to himself, at the lower price, and has suffered a loss (whether recognized on his books, or not); and, in effect, he also bought it a second time, this time from himself, at the lower price, which proves to make it a profitable investment. Therefore the capital goods of which the malinvestment consists are not abandoned, rather they are put into the production process and become part of the structure of production. Even if they are sold for scrap, the scrap becomes plain old investment, in contradistinction to malinvestment, at the price paid for it (unless the buyer of the scrap overestimates its value and pays too high a price for it), and is integrated into the structure of production at its lower value.

[8] That is, sold for a lower price than would otherwise have been obtained, at a loss for the entrepreneurs involved in deciding to set up investment in A.

As long as the government keeps inflating,[9] unwarranted investments in this (A) range of the structure of production can be "viable." Perhaps a better phrase for this is "not yet discovered or demonstrated to be a misallocation of resources."[10] But eventually the rate of increase of price inflation, let alone the price inflation itself, must come to an end, either through the crackup boom associated with hyperinflation, or by the government's ceasing its unwarranted monetary policy. And when it does, investments in area A will no longer be possible to maintain. Their dissolution, financial or in form (e.g., of half built factories that cannot be completed), constitutes the bust phase of the ABCT.

With this very brief introduction to ABCT, we are now ready to consider Laidler (2003) in this light.

3 Laidler

Laidler (2003)[11] is one of the rare publications where a mainstream or neoclassical macroeconomist actually attempts to address ABCT. How does he fare? In a word, reasonably well, albeit not perfectly.

3.1 Government, not banking

He starts off in his abstract with the claim that "Austrian theory . . . stressed the banking system's capacity to generate relative price distortions and forced saving." This is only partially accurate. To be sure, in the view of the praxeological or Austrian school, the genesis of the business cycle is indeed the generation of "relative price distortions and forced saving." But these are not at all created by the "*banking* system." Rather, they stem from *government* mismanagement or, alternatively, they are caused by a banking system alright, but not one as would function under laissez faire capitalism (Hoppe et al., 1998; Rothbard, 1962, 1983, 1990). Rather, a banking system perverted by government through and through. Yes, the state does not create price inflation by dropping money on people homogeneously from helicopters (Rothbard, 1988; Shostak, 2003). Instead, it does so through its creature, the banking system. But this is not *necessary*. That is, a truly free market banking system would *not* be able to create an Austrian business cycle, and an Austrian business cycle *could* come about as a result of government activity totally in the *absence* of a banking system. Thus, contrary to Laidler, a private banking system is neither necessary nor sufficient to engender the ABC.

[9] It must do so at ever-increasing rates. See on this Hayek (1972).

[10] A somewhat apt analogy is to the coyote in the *Roadrunner* cartoons who travels into the air off the top of a mountain. As long as he does not realize he is walking on air, he can keep going. But when he discovers his precarious situation, he falls to the ground.

[11] Laidler's paper is written as if ABCT were frozen in time circa the mid-1930s. (Save for Garrison's, 2001 book, the most recent work by an Austrian that he references is Hayek (1932a). This might seem irrelevant to a paper that is, as the title indicates; about the history-of-thought, nevertheless it purports to be of relevance for current policy issues. One problem, inter alia, this assumption causes pertains to general equilibrium, regarding which, see footnote 41, infra.

However, since the government works through a regulated/controlled banking system, it should be conceded that Laidler's impression of ABCT is not completely incorrect. Rather, the difficulty between him and us stems from the fact that we are using words in a somewhat different manner. This author says "banking." We say, in contrast, "state-regulated/controlled banking." In our view, the problem originates from the government, and would not exist in an economy with free market banking and interest rates. We are, then, here clarifying Laidler, not correcting him. That is, we interpret him sympathetically as really referring to *present* banking institutions, not theoretical nonexistent ones.

3.2 Critique of Mises' objectivity

According to Laidler (2003, 10), the Austrians "[were] exponents of a self-consciously individualist economics that was closely allied to political liberalism, reacted strongly against any presumption that market economies were inherently unstable, and their work should be seen as an attempt to refute this postulate, while reconciling the basic facts of the cycle, including those concerning investment activity, with neo-classical orthodoxy."

Laidler is saying that the Austrian school of economics is not really a value-free enterprise. Every member has a political ax to grind: defense of free enterprise over all other considerations. Even if this were the total absolute truth, it is entirely irrelevant to scientific enquiry. The point is, Austrians might still hit upon the truth, even the truth with a capital "T," despite the fact that they are an "illegitimate" academic organization.

Laidler is obligated to provide evidence—not that some, or even *many*, Austrian economists have been, as ethicists, advocates of the free enterprise system. To support Laidler's charges, he must show that there is some *necessary connection* between the two. And this he cannot do, if only because one is an exercise in normative economics, the other one in positive economics, and the two simply cannot contradict one another, lying as they do in two entirely separate universes of discourse. As it happens, counterexamples can be shown; namely, economists whose credentials as Austrians are impeccable, and yet who are anything but advocates of laissez faire capitalism.[12]

Yet another mistaken notion embedded in this quotation is the claim that Austrians are attempting to reconcile "the basic facts of the cycle, including those concerning investment activity, with neo-classical orthodoxy." But the very *opposite* is the case. The praxeological school is not at all trying to reconcile ABCT with neo-classical orthodoxy. Rather, Austrians are engaged in the process of showing that the former is *correct* and the latter *incorrect*.

Our analysis in this section might be objected to on the following ground: Laidler is criticizing Mises' objectivity, because his scientific analysis was beholden to his political (classical) liberalism. But it is not particularly offensive to Mises (nor should

[12] One case in point is Hayek (1944). For a demonstration of the contention that this book is incompatible with libertarianism, or free enterprise, see Block (1996). Elsewhere, Laidler (2003, 11) castigates the Austrians as "committed liberals," explaining why their research cannot account for the facts of the business cycle.

it be to anyone) to be characterized as a proponent of human liberty; indeed, it is not offensive at all. Calling someone a fascist, if unjustified, is an ad hominem attack. But calling someone a liberal is a compliment, justified or not.

We reject this possible objection. It is indeed an unwarranted attack on Mises to say of him that his economics is little more, or no more, than an implication of his value-laden political beliefs. To say that he is not really a scientist, but rather an ideologue, that he has an ax to grind, allows this process to interfere, nay, override, his economics; that his economics cannot stand on its own, but is dependent upon his political views; that Mises is in effect a political entrepreneur; that he is really guilty of fudging: he knows the economic conclusion he wants to reach based upon his political beliefs (classical liberalism, or free enterprise), and will pervert his supposed economic analysis to reach it. Ordinarily, it cannot be denied that to call someone a classical liberal is not to denigrate him, but it most certainly has this effect in the present context.

Suppose someone said that Milton Friedman's views on the minimum wage or free trade were informed by his political liberalism. To do this would be to undermine this economist's ability to speak as a disinterested scientist. It matters not one whit that many people agree with his defense of classical liberalism. To say this is nevertheless to undermine his critique of minimum wages and protectionism.

3.3 Analysis of ABCT

In the view of Laidler (2003, 11) the Austrian account of the business cycle is based upon a "model inhabited by maximizing agents, initially in general equilibrium, which, when subjected to a certain type of disturbance would move along a time path that for a while led cumulatively away from the initial equilibrium, and then reversed direction only to overshoot that same equilibrium."

However, Austrian economists and "general equilibrium" are not a very good fit; indeed, the praxeological school has explicitly eschewed this concept, at least applying to the real world. However, our criticism of Laidler is independent of any shortcoming of general equilibrium.

Then there is the issue of "overshooting." Laidler and the present authors have different understandings of ABCT. In our view, there is either no "overshooting" at all or, if there is, it is of the same trivial nature as is the entrepreneurial error that does not allow the economy to be perfectly congruent with triangle 1, for example, to be perfectly aligned with the time preferences of its human actors. If the move from triangle 1 to triangle 2 is a matter of entrepreneurial error, it is likely, first, to cancel out; if some businessmen overestimate market time preference, others will make the opposite error and underestimate it.

Since this is a somewhat complicated issue, let us make this same point with the help of an analogy. Suppose that at any one time the proper allocation between the number of socks and the number of spoons in the economy is exactly 1:1. That is, the consumers wish to have an exactly equal supply of these two very different goods. Will the businessmen be able to hit this mark exactly on the bull's eye, and produce a precisely equal number of socks and spoons? Not in any realistic scenario. For remember, this is but a moving target. On the previous day the ratio between these two items was not exactly 1:1, nor will this occur again on the morrow. Then, too, there is that little

matter of coordinating complements and substitutes, the lack of full information,[13] the fact that there are ongoing contracts that prevent the precise pinpointing of this moving target. No, at the precise moment when society wishes equality between these two consumer goods, the business community will either overshoot or undershoot this resource allocation. But this "failure" is an almost completely benign one. First, entrepreneurs are as likely to overshoot (say, offer for sale too many socks and too few spoons) as they are to err in the other direction (e.g., bring to market too many spoons and too few socks). Secondly, the market process tends to grind down these mistakes, for the firms who get caught without a chair when the music stops will tend to lose money. This ongoing process tends to weed out companies that err in either direction (Hazlitt, 1979).

Every misallocation of resources, including every instance of malinvestment, whether part of a cluster of such errors or not, is globally harmful in that it wastes scarce resources. And, every liquidation of such misallocations is globally beneficial. Nevertheless, such mistaken allocations of resources appear profitable from the local perspective of the entrepreneur who has made them, until the market forces him to liquidate these mistakes because of the inevitable losses they cause him.

But now suppose that the government, in its infinite wisdom, pursues a policy that fools entrepreneurs and subsidizes them into the production of twice as many socks as spoons (all during which the public's tastes in this matter have not changed by one iota). Will the business community hit *this* target exactly on the nose? Not a bit of it. However, the identical market process in operation before will continue. Firms will be led by an "invisible hand" to as nearly as possible to this new 2:1 allocation. And now, so as to get back to our business cycle analogy, we may suppose that the government is for some reason forced to pull in its horns, and cease and desist from its mad passionate plan to short-circuit consumer demands. In a word, it stops the policy that initially led to the 2:1 ratio, and allows the market to once more work its "magic." Will firms, in one fell swoop, pounce upon what we shall continue to suppose is the correct 1:1 ratio? This is unlikely in the extreme. Instead, they will *either* overshoot or undershoot this target. But there is no reason to believe that their "aim" will be any worse than that would have ensued, after a reasonable adjustment period takes place, than would it originally have been.[14]

Let us return to Laidler. Based on the foregoing, we can now see there are two very different senses of "overshooting" that he and the present authors are utilizing. On the one hand, there is the overshooting (*or* undershooting) that is an all but necessary component of the market, *all* markets, virtually always. This is the sense in which the economy never reaches an equilibrium state, apart from possible rare temporary accidents. On the other hand there is the ABCT, which is *not* a theory about markets

[13] Austrians by no means subscribe to the perfectly competitive model of neoclassical economics (Kirzner, 1973).

[14] In order for this last statement to be true, we must abstract from the additional pressures placed on the market by this governmental plan to force, or subsidize, or in other ways entice, businessmen to produce in a 2:1 ratio instead of 1:1. For a critique of ABCT on the grounds that firms would "see through" governmental money manipulation, and would thereby refuse to, in effect, lengthen the triangle from 1 to 2 even in the face of inflation, see Wagner (1999). For a rejoinder, based upon the insight that not only does inflation "fool" entrepreneurs into these resource misallocations, but also subsidizes them in this direction, see Block (2001).

overshooting (in any other sense apart from the one we have just discussed, e.g., that equilibrium is a nirvana state.)

Because "overshooting" can used to refer to a wide variety of phenomena, there may be some way it can be useful in explicating ABCT; however, there is no precedent for this in the ABCT literature. Perhaps this is because ABCT probably has not been very high on Laidler's radar screen until recently.

3.4 Motives

According to Laidler (2003, 11–12), "Wicksell had also analyzed the theoretically limiting case of a *pure credit* economy, in which there was no currency, and all transactions were carried out using deposits. Here, if a shortfall of the market from the natural rate of interest led only to price inflation, there would be no mechanism to bring the market rate back into equilibrium with the natural rate, and disequilibrium could apparently persist forever. Mises found the conclusion deeply discomfiting, and in order to meet the challenge it presented, he introduced the process now known as *forced saving* into the Wicksellian framework."

There are difficulties here. Most problematic is this continual attribution to Mises in particular and Austrians in general of ideological or political motives. Praxeologists, it would appear, unlike mainstream neoclassicals of whom Laidler is a prominent example, are motivated in their economic work by side-order ethical considerations. They favor economic freedom, and thus their positive economics is riddled with error from this source. The difficulty is not so much this charge. The problem is that Laidler does not provide evidence that Mises' motivations were impure in this regard. For a member of a school of thought that prides itself on evidence, on not making any claims that cannot be empirically supported, this is more than passing curious.

Second, even if Laidler's charge is completely true, it still leaves open the question as to whether "forced saving" (area A of triangle 2) is an accurate depiction of the economy undergoing a business cycle. It is to this issue we now turn.

3.5 Forced saving and overconsumption[15]

With regard to this concept, Laidler (2003, 12) takes the position that its coherence relies "upon three special assumptions, the first two of which Mises, Hayek and most other exponents of forced saving usually left unstated. The first is that the newly created bank deposits that enter circulation when the natural rate of interest exceeds the market rate do so by way of loans to firms."

[15] It should be noted that confusions and analytical problems often arise from the failure to use words and terms in a scientific manner. In a world in which all consumer goods were totally consumed immediately after they were produced, there would be no distinction between consumption and consumer goods. However, the existence in the real world of durable consumer goods necessitates a distinction being made between these two concepts. Because time enters into Austrian economics in an essential way, this distinction is important for ABCT. On the other hand, as time is basically irrelevant, save as indices for variables in various equations, in virtually all of mainstream economics, this distinction is irrelevant for it. (Additionally, confusion arises, e.g., when the Hayekian triangle is used, when there is a failure to specify whether or not leisure is considered to be a consumer good.

But this claim is false, in that there is no reason, at least in principle, why these ABC-engendering excessive bank loans could not be made directly to individual consumers. The key point of ABCT is that when the market rate of interest is artificially pushed down below that which would otherwise flow from unchanging time preferences, the seeds of later economic destruction are sowed.

As for it being "left unstated," that credit expansion proceeds "by way of loans to firms," Hayek (1935/1931, 11, 54) says, "For, as I shall show later, everything depends on the point where the additional money is injected into circulation (or where money is withdrawn from circulation), and the effects may be quite opposite according as the additional money comes first into the hands of traders and manufacturers or directly into the hands of salaried people employed by the state." And, "It will be sufficient if we investigate only *the case most frequently to be encountered in practice*: the case of an increase in credits granted to producers" (emphasis added). Hayek (1978/1932, 214, n12) maintains, "The only essential assumption I make is that money lent at interest will normally, for the reasons discussed in the text, go to the purchase of producers' goods. It is, however, possible that the loans are made in such a way that they are used to increase the demand for consumers' goods; e.g., when they are made to the government in order to increase the salaries of civil servants." Later Hayek (1978, 212–213) stated, "I do not doubt that in a sense we have today the same kind of phenomenon, but the overexpansion, the undue increase of labour in particular occupations, is not confined to a single, clearly defined block such as the capital-goods industries. It is now spread much more widely, and the distribution is much more difficult to describe." Rothbard (1993, 852) defines "credit expansion" as the creation of new money-substitutes, entering the economy *on the credit market*." While this by no means singles out firms vis-à-vis governments or households, or any other potential borrower, it certainly *includes* firms as a possibility.

Continues Laidler (2003, 12), "The second is that any effects on the general price level that arise from money creation leave the real consumption plans of the general public unaffected." But this, too, is hardly "unstated." To the contrary, Rothbard (1969, 22) avers, "The problem comes as soon as the workers . . . begin to spend the new bank money that they have received in the form of higher wages. For the time-preferences of the public have not *really* gotten lower; the public doesn't *want* to save more than it has. So the workers set about to consume most of their new income, in short to reestablish the old consumer/saving proportions." And moreover (Rothbard, 1993, 856), "The owners of the original factors, with their increased money income, naturally hasten to spend their new money. They allocate this spending between consumption and investment in accordance with their time preferences. Let us assume that the time-preference schedules of the people remain unchanged. This is a proper assumption, since there is no reason to assume that they have changed because of the [price] inflation."

As for the third point, Laidler (2003, 12) states, "Finally, and Hayek would elevate this assumption to a methodological principle, in Austrian analysis any conceptual experiment involving variations in the rate of money creation had to begin with the economy in full general equilibrium at full employment."

Several points in this passage are problematic. First, the phrase "the economy in full general equilibrium at full employment" is a redundancy. Full general equilibrium implies, among many other things, full employment. Second, Austrians are on record

as *opposing* the concept of "full general equilibrium." We most certainly do not clasp this concept to our bosoms, as implied by this critic. Third, it is by no means true that Austrians *necessarily* begin their ABCT with the assumption of "full employment," as is implied by this author. Laidler (2003) is replete with footnotes and citations, but fails to document this charge. Fourth, it is indeed true that most ABCT treatments begin with this assumption, but this is done as a heuristic and simplifying device; it is most certainly not meant as an accurate depiction of the real world. Certainly, Austrians think that monetary/credit expansions undertaken during a recession cause the same types of misallocations as those caused by such expansions at a time of full employment. Fifth any business cycle theory that had to posit "full employment" as its starting point would be all but useless as an analysis of real-world conditions, since in reality there is virtually always at least some unemployment in excess of that which would exist at the free-market rate of unemployment. We do not live in a perfectly competitive world, after all. Sixth, it is simply not true that Hayek elevates the assumption of full employment to a methodological principle. Needless to say, Laidler (2003) fails to document this contention as well. Anyone who knows anything about Austrian economics knows that Hayek is among the least praxeological of all its practitioners.[16] For Hayek to elevate *anything* to the status of an axiom, let alone the assumption of full employment, rings hollow.

ABCT maintains, inter alia, that three things occur during the boom: overconsumption, forced saving, and malinvestment. Different Austrians place different emphasis on these aspects. It should be noted that the first two of these seem to be in contradiction of each other.

Overconsumption implies that consumption increases during the boom, whereas forced saving implies that consumption decreases during the boom. The reconciliation is that leisure, of labor as well as of land and capital, decreases during the boom. This makes possible both additional consumption *and* extra savings. Moreover, as actual saving must equal actual investment, the increased saving resulting from forced saving is the counterpart to the malinvestment. Of course, this implies that the malinvestment takes the form of overinvestment. Most Austrians are quick to correct anyone who claims that ABCT is an overinvestment theory or a theory that involves overinvestment in the boom, advising them that the theory is one of *mal*investment, not overinvestment. In actual point of fact, it is both; or, as we say above, all three: overconsumption, forced saving, and malinvestment.

Let us elaborate on how the circle can be squared, since this is a complicated issue. To be sure, all three aspects are present in the boom. Mises (1996, 575) refers to "the malinvestment and overconsumption of the boom period." Now one possible interpretation is that the malinvestment takes the form either solely of the production of the wrong capital goods; that is, a shift from lower-order to higher-order capital goods, without any change in the quantity of resources devoted to the production of capital goods. But that conflicts with forced saving because if saving increases so must investment. And, that would seem to leave no resources for the increase in the production of consumers goods required by overconsumption. Alternatively, if you consider the same interpretation as above, save that the malinvestment consists,

[16] See the de-homogenization literature on this claim: Block and Garschina (1995), Ebeling (1992), Herbener (1991), Rothbard (1991, 1992), Salerno (1990, 1992, 1995) and Stalebrink (2004).

in addition to a change in the mix of capital goods produced, a decline in the total production thereof, this would provide an explanation for the source of the resources to be used for the increase in production of consumers' goods. However, that would worsen the conflict between the increase in saving and the (now-decreased) investment.

The first key is to realize that the malinvestment takes the form, not only of the changed mix of capital goods, but also of an *increase* in their production. The augmentation in investment constitutes (part of) the malinvestment. And, it is consistent with the rise in saving. In fact, malinvestment and forced saving are, in real terms, different names for the same phenomena (Barnett and Block, 2003, unpublished). But this seems to rule out the necessary increase in production of consumers' goods, as more, not fewer, resources are now being used to produce capital goods.

The second key is to realize that in the boom total production increases as previously idled resources and new resources are brought into use.[17] As the new money that has been lent into existence enters the markets for goods, prices are bid up increasing profits. This induces entrepreneurs to increase production, for which they need to hire additional resources. That involves bidding up the prices thereof, thereby enticing some formerly "idle" people into the workforce and some of the owners of idle nonhuman resources,[18] either to engage them in production themselves or to hire them out to entrepreneurs. It is these newly employed resources that allow the increase in total production that makes possible the simultaneous overconsumption and over- or malinvestment a.k.a. forced saving.[19]

Thus the circle is squared; or, rather, there never was a need to square a circle. It was only a misperception that made us think there was.

3.6 Begin with unemployment

Laidler (2003, 13) now launches a substantive attack on the Austrian edifice: "In particular the assumption that it [ABCT] begins at full employment is critical to the forced saving process. If resources are not fully utilized when firms receive a signal to increase investment, then they can clearly do so without forcing a decrease in consumption."[20] Here, we must posit, Laidler is correct, or at least can be interpreted in such a manner. After all, a successful theory of the business cycle must be able to

[17] It is true that, save for random entrepreneurial mistakes and the systematic errors of the business cycle, all resources are continually being allocated/reallocated to their most highly valued uses. However, for many people this use is leisure or nonmarket production; e.g., students, homemakers, and retired people. From the point of view of production for the market such uses may be considered periods of idleness. The same analysis applies to nonhuman resources.

[18] Such resources can take, for example, the form of plant and equipment already in use that can be used for more shifts or, if out of use, brought back on line.

[19] We have seen that in the boom one relationship involving saving is the identity between forced saving and malinvestment. Another relationship during the boom that involves saving is that between saving and consumption. The key to understanding this is to see that leisure is an element of consumption and that the overconsumption of ABCT is with respect to consumers' goods produced for the market. In fact, the reduction of consumption necessitated by forced saving takes the form of a decline in leisure. Therefore, even in a situation in which there is unemployment; i.e., where unemployment exceeds the free-market rate, an increase in investment still necessitates a decrease in consumption, if in no other way, in the form of decreased leisure.

[20] But see previous note, 19.

use as its starting point not only a situation of full employment, but of unemployment as well.

However, the assumption of full employment is not necessary for ABCT.[21] Apparently, beginning from a point of less than full employment creates a problem for ABCT. The question arises: How, in a situation of full employment, without reducing the production of consumer goods, can firms, in response to an expansion of money/credit, increase investment? We have seen the answer to this question already. It does so at the expense of leisure. Not only can investment increase, but so also can the production of consumers' goods. This additional production is made possible by the existence, even at "full employment" or "full utilization," in the economic sense, of idle resources in the engineering sense. These "idle" resources can be brought into production. This obviously involves misallocation of resources.

The real point to be made here regards the misallocation of resources that results from a money/credit expansion regardless of the employment condition of the economy when that expansion begins. First, it is obvious that if the economy is in a state of full or, a fortiori, overly full, employment when such an expansion commences, the increase in production that occurs necessarily involves a misallocation of resources. Second, a money/credit expansion that begins when unemployment (in excess of that which would exist at the free-market rate) exists *may, and to mainstream economists does*, seem beneficial because it will reduce the amount thereof. What is less obvious than the decline in unemployment, but more important, is that the attendant increase in resource usage is *itself* a misallocation thereof.[22] Although a condition of unemployment necessarily means that there is a misallocation of resources to begin with, a money/credit expansion only *exacerbates* the inconsistency between the structure of production and people's time preferences. It might be argued that this is not so, as any use of previously unemployed resources results in the production of more goods, a good thing in itself. However this is mistaken. An obvious example is the production of redundant buildings and equipment for the governmental bureaucracy.

3.7 Possibilities, Necessities, Garrison's role

Laidler (2003, 14) states, "(The Austrians) took logical *possibilities* implicit in the analysis of forced saving, and treated them as logical *necessities*." There is a difficulty here in that Laidler does not explain w*hy* he perceives the chain of reasoning that constitutes ABCT merely to be possible, and not necessary. Instead, he offers a quote from Garrison, a "sympathetic [to ABCT] modern commentator,"[23] and refers readers to a previous work of his own "for accounts of and references to contemporary

[21] This is not only a simplifying device. The purpose of ABCT is to explain unemployment. It would scarcely do to assume into being at the outset the very thing we are attempting to explain. If we are to fully come to grips with unemployment, we must, among other things, show how it can arise from a situation of full employment. Garrison (2001) argues along similar lines.

[22] In fact, regardless of the initial condition, a money/credit expansion *always* causes a misallocation of resources.

[23] One minor problem is that Garrison is by no means a "modern," e.g., mainstream neoclassical economist, who is merely "sympathetic" to Austrianism. Rather, Garrison is perhaps the preeminent Austrian business cycle theorist of the modern day, who writes solidly within the tradition of Mises, Hayek, and Rothbard.

treatments of forced saving that suggested that an initial excess of investment over saving might generate an equilibrating response on the part of savers."

The quote he offers is: "the Austrian theory is not a theory of depression *per se*, but rather a theory of the unsustainable boom" (Garrison, 2001, 240). But the passage from which this quote is taken is orthogonal to Laidler's claim, neither supporting nor undermining it. In fact, it is irrelevant to the issue of whether ABCT is logically necessary or merely possible. Instead, Garrison very sensibly puts his finger on the essence of ABCT, to wit, that its primary focus, in sharp contradistinction to all other theories of the business cycle, is on the problematic and misallocative boom, not on the cleansing and salutary bust.[24]

The reference to Laidler's previous work is found in his footnote 30. There, he refers to "contemporary treatments of forced saving that suggested that an initial excess of investment over saving might generate an equilibrating response on the part of savers. Among the possibilities that the Austrians did not notice, but were raised by their contemporaries, were that changes in the distribution of income from wages to profits during the upswing might cause an increase in voluntary saving and eliminate disequilibrium between saving and investment." This would be all well and good if the Austrians were concerned with an imbalance between saving and investment. However, this is not at all the case. In contradistinction to Keynesians and other mainstream types for whom savings and investment can diverge, and which divergence is of great import, Austrians do not admit of such a divergence. For them saving is always equal to investment, even if it is forced saving and its attendant malinvestment. Instead, the important issue for ABCT is the mismatch between the structure of production as it actually is, based on the false market (interest-rate) signals perpetrated upon the economy by the polity, and the structure of production as it would be, were it consonant with the time preferences of the participants in the economy. In a word, the malinvestments that distort the actual structure of production must be liquidated, not physically, but financially, so that these same investments, appropriately valued, may take their proper place in a new, adjusted structure of production that is aligned with peoples' time preferences.

3.8 Even Haberler says

Laidler (2003, 14) next considers the relationship between price inflation and the inception of the Austrian business cycle. He is correct when he says that Austrians necessarily argued, and still do, that despite the absence of price inflation, imbalances in the structure of production sufficient to provoke the crash of 1929 and its aftermath

[24] Laidler (2003, 13) states, "Given the Austrians' underlying agenda, however, which was to produce a theory of the cycle that was compatible with a general equilibrium theory strongly tinged with methodological individualism, and could be used to counter socialist critiques of a liberal capitalist society, and given that the great hyper-inflations were a recent memory, one can see how they were let into their over-generalizations." It is as if Laidler is learning a new language, "economic Austrianism," but does not yet fully understand the syntax. This sometimes leads him into misinterpretations. For example, although in the 1920s and 1930s Hayek was indeed trying to develop "a theory of the cycle that was compatible with a general equilibrium theory," it is questionable at best whether he thought in terms of general equilibrium later in his career. Certainly, Mises never thought of business cycles in those terms, nor could one find any modern Austrian who does.

had accumulated. Laidler does not explicitly reject this position. Rather, he (Laidler, 2003, 15) approvingly quotes Haberler (1937) who states *not* that the ABCT is incorrect unless it results in a general inflation, but only that "the reasoning [of ABCT] is not . . . altogether convincing (1937, p. 52)" and "the present theory does not prove. (p. 51)" that, when the economy is growing because of increases in productivity, a credit expansion that does not generate a price inflation[25] will create sufficient imbalances in the structure of production to generate a crash and subsequent depression. However, because Laidler only quotes Haberler's conclusions, and not his reasoning, we cannot discern Laidler's own reasons for accepting these conclusions, as he implies he does.[26]

This is not the time or the place to embark upon a full explication of how ABCT can apply to the case of an inflation coupled with stable prices leading to an unsustainable distortion of the structure of production. Suffice it to say that, at least for the Austrians, what matters for ABCT is not the *level of nominal* prices,[27] however measured, but rather the *structure of relative* prices. Whether or not a bout of government inflation raises prices on average is of no moment. As long as it causes market interest rates to fall below their natural levels, as it does, a business cycle will result: the structure of relative prices will be systematically distorted inducing an unsustainable warping of the structure of formation.[28]

3.9 Policy prescriptions

What are the policy prescriptions on the basis of which Laidler rejects ABCT? Before we answer that, we must give an overview of the differences between Austrians and the mainstream on the business cycle. These are summarized in Table 1.

If the terms *good* and *bad* offend against anyone's normative vs. positive sensibilities, they can substitute for them, respectively, the words *salutary* and *problematic*, or, perhaps, better yet, "solve or prevent the business cycle" and "create the business cycle." It is undoubtedly this difference in assessment of the boom and bust phases that leads to their very different public policy prescriptions.

[25] This may sound awkward to the mainstream ear. This stems from the fact that the neoclassical economist defines inflation as generally rising prices, while this is by no means the Austrian definition. Although many Austrians, when not speaking technically, use the word "inflation" as the mainstream does, when speaking technically, they define inflation as an increase in the stock of money. (Some maintain that inflation refers only to an increase in the stock of fiat money though there is some disagreement as to exactly which assets constitute this stock; e.g. some include all circulating media.) Then, for Austrians, whether or not (money) inflation leads to price inflation depends upon what is going on with the other factors; e.g., productivity changes, that also affect prices.

[26] Laidler (2003, 15) also reiterates the claim that Austrians err by maintaining that the outcomes of certain chains of thought are logically necessary, when in fact they are merely logically possible, implying, obviously, that the relevant chains of reasoning are faulty. This issue is dealt with in section 2 – 7, supra.

[27] This is not to deny that various mainstream theories include a role for the "real" wage and "the interest rate," but rather to maintain that whereas the entire structure of relative prices in an economy, and changes therein, are of the essence of ABCT, such is not the case for neoclassical economics. (This shortcoming at such theories is more than passing odd in that relative prices are elements of the core of mainstream microeconomics.)

[28] Of course, the extent, both in terms of magnitude and duration, of the distortions and warping depend upon the extent of the deviations of actual from free-market interest rates, in turn dependent on the magnitude and duration of the initiating money/credit expansion.

Table 1 Austrian and mainstream positions on the phases of business cycles

	Austrians	The mainstream
Boom	Bad	Good
Bust	Good	Bad

At first blush, the Austrian position that the boom is bad and the bust good, seems to be confused. However, this apparent confusion vanishes once we understand that for them it is the boom phase, during which unsustainable investments; that is, malinvestments, are made, which is the source of the problem. And, similarly, it is during the recession or depression phase when these malinvestments are written off, and the misallocated resources redirected toward their appropriate uses. Because of the fact that time has necessarily passed: (1) time preferences (as well as other preferences) may have shifted; and (2) the structure of alternatives consumers face will almost certainly have shifted—this latter, if for no other reason than the durability of the malinvestments. Consequently, the structure of production that would accord with consumers' preferences post boom is different from the analogous structure ex ante. It is the former, not the latter, that incorporates the appropriate uses post boom, and toward which the revaluations during the bust direct the reallocations.

Laidler's treatment of policy issues is strictly in the context of the Great Depression. He (2003, 15) describes the tenets of Austrian policies during that period as

> The central policy problem was to prevent crises happening in the first place. This was to be accomplished by avoiding net credit creation by the banking system, or if the velocity of circulation could not be relied upon to remain stable, by varying credit creation so as to stabilize the rate of flow of money expenditure.
>
> Where prevention had failed, as they thought it was very likely to do, the Austrians further, and crucially, argued that expansionary monetary policy, and/or fiscal measures designed to increase investment and consumption expenditures, would make matters worse rather than better, and were to be avoided. [footnote omitted]

Although Laidler apparently thinks such policies incorrect, quoting Robbins' 1971 repudiation[29] of his earlier adherence to these positions, we cannot perceive his reason(s), as neither does he provide them, nor can they be inferred from the Robbins quote, as it provides no reasons for his recantation. Moreover, Laidler does not note differences between the policies Austrians advocated then and later. For example, Rothbard (1969, 26) advocated "cutting the government budget" during the bust to decrease the "social consumption/investment" ratio and thereby improve it.[30] Nor

[29] According to Robbins, "to treat what developed subsequently in the way which I then thought valid was as unsuitable as denying blankets and stimulants to a drunk who has fallen into an icy pond, on the grounds that his original problem was overheating." But this analogy is a misapplied one. There was no icy pond. There was, however, a drunk, as per Robbins. And the last thing medically called for was a further addition of the very stimulant that got the person into trouble in the first place.

[30] "The government must do nothing to encourage consumption, and it must not increase its own expenditures, for this will further increase the social consumption/investment ratio. In fact, cutting the government budget will improve the ratio. What the economy needs is not more consumption spending but more saving in order to validate some of the excessive investments in the boom" Rothbard (1969, 26).

do Austrians today advocate stabilizing the rate of flow of money expenditures by offsetting decreases in circulation velocity with increases in money/credit.[31]

Moreover, Laidler (2003, 15) states, "in the early 1930s, the Austrians urged governments to remain passive and allow the passage of time to unwind the imbalances in the capital market that they thought lay at the root of the depression." He (2003, 15–16) implies that the Austrians were wrong and, by lending credibility to the "real-bills" doctrine, and its many adherents at the Fed and among bankers, were, at least in part, responsible for the "indecisiveness of Fed policy during the Great Depression."

Laidler (2003, abstract) labels these as "nihilistic policy prescriptions," but it is not at all clear that this appellation is accurate. Certainly, it is very much incompatible with recommendations emanating from mainstream macroeconomic sources, but this is due, not to any "nihilism," but rather to ABCT being a completely different theory of the business cycle.

Instead of "nihilism," the "activist" policy of Hoover and Roosevelt had several planks: prop up failing businesses, prevent wages from falling, and pass the Smoot Hawley tariff.[32] But Laidler does not discuss the recent literature (Hall and Ferguson, 1998; Smiley, 2002; Vedder and Gallaway, 1993) that considers the many and various governmental interventions (i.e., the activist policies of Hoover and Roosevelt) that increased the role of government in the economy. These are what so distinguished the depression that began in 1929 from such previous busts that it is named The *Great* Depression.

Let us now conclude the paper. We have been throwing not a few brickbats at Laidler's (2003) attempt to wrestle with ABCT. But we must conclude our reaction to him by acknowledging that his (2003, 12–13) depiction of this process is not an altogether erroneous one. He (2003, 13) quite accurately summarizes his treatment by stating "In short, forced saving is the outcome of a coordination failure with respect to the inter-temporal allocation of resources. It occurs because a relative price is set at a disequilibrium value... ."[33] Further, his interest in Austrian economics in general, and in ABCT in particular, is to be greatly welcomed. May this be only the first of his publications on that subject. Nor should it be assumed that we see errors in Laidler's treatment because we are Austrians and he is not. Austrianism is a vibrant, living school of thought; its members are continually criticizing each other's work. In criticizing Laidler, we should be, then, interpreted as welcoming him to this critical tradition.

[31] It is true that Selgin (1997) favored a dynamic version of such a policy, but by the time he did so, he no longer counted himself an Austrian.

[32] In contrast, Friedman and Schwartz (1965) advocated monetary increases, or, at least, to not allow the stock of money to fall. This is not "nihilistic," for Laidler, presumably, because it better accords with his own business cycle analysis.

[33] Laidler ends this sentence with the words: "by the banking system." We can sympathetically interpret this not in terms of an entirely capitalist free market banking system, but one which is under state control.

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