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An Austrian Macroeconomist

An Interview With Roger W. Garrison

AEN: What was it that prompted you to believe that we need a graphical exposition of Austrian macroeconomics?

GARRISON: While I was in graduate school, I was constantly being subjected to the ISLM version of Keynesianism. I vividly remember a discussion I had with my brother, in which I explained how the Keynesians had this extended, interlocking model that dominated the textbooks. The students all learned it and then had a

vested interest in its being right. That bothered me. My brother, himself a graphic designer, asked whether the Austrians had some alternative model, and I had to say no.

So I went to work on one. My first attempt to build a model drew heavily from Mises's *Theory of Money and Credit*. I put it together in 1973, and it was published in 1978. My graphics were three-dimensional: In one plane I represented the Aus-

trian view and in another, orthogonal plane I represented the Keynesian view. This construction allowed me to show the critical connections between the two views. My professor, who was a Marxist-Institutionalist, gave me a high grade—probably based on the labor-theory of value. He then invited me to present it at a professional meeting in Chicago.

AEN: And was the paper well received?

GARRISON: The response from some Austrians was mixed. Murray Rothbard loved it because he saw it as beating the Keynesians at their own game. The main value, he thought, was its polemical value: here is a diagrammatical exposition that competes effectively with the mainstream. Murray invited me to New York to discuss it. There was a small gathering at his apartment and we all went through the paper page-by-page into the wee hours of the morning.

Some other Austrians believed that it was a sacrilege to Mises to try to put his ideas in a graphical framework. But Mises, in *Human Action*, recognizes that we can visualize the interactions of economic forces by drawing curves and even by expressing them in mathematical symbols. He was dismissive of the graphics of his day, saying they were mere byplay—but even at that he allowed for their usefulness in teaching undergraduates! Graphics certainly can be



Roger W. Garrison is professor of economics at Auburn University and author of *Time and Money: The Macroeconomics of Capital Structure* (Routledge, 2001). He has been a leading contributor to the emerging literature on Austrian macro theory, the theory of the business cycle in particular. He is an adjunct scholar of the Mises Institute and has written for the *Quarterly Journal of Austrian Economics* and the *Review of Austrian Economics*. Many of his articles and reviews can be read at <http://www.auburn.edu/~garriso>; he can be reached via email at rgarrison@business.auburn.edu.

useful, I think. Rothbard used them a good bit in *Man, Economy, and State*. Of course, we shouldn't confuse the graphics with the theory itself, as Mises also warned. I like to think of my graphics as a convenient framework on which we can hang a lot of mutually reinforcing ideas.

AEN: Can you give your rendering of the business cycle in a nutshell?

GARRISON: The Austrian theory is sometimes called an overinvestment theory, or, to capture the uniquely Austrian insight, a malinvestment theory. The idea is that during a credit expansion too many resources are allocated to the early stages of production, leaving too few for the late stages. In my graphical exposition, production is actually pushed beyond the production possibilities frontier, which helps to explain what would otherwise be unexplainable: the lag between the initiation of the boom and the subsequent market correction that constitutes the bust. But the intertemporal mismatch between consumption preferences and investment plans, brought about by an artificially low interest rate, is what necessitates the downturn.

Mises talked about the problem of the boom as being one of both overconsumption and malinvestment. That is, it is possible, on a temporary basis, for an economy to operate beyond its production possibilities frontier, producing more consumer

goods and more early-stage capital, but this mix is not sustainable. The theory is not all that complicated, though it does involve a heavy dose of capital theory and envisions more internal dynamics than do most competing views of the business cycle. The contrast between genuine growth and an artificial boom is depicted in my graphics (see Figures 1 and 2).

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AEN: And the advantages of your graphical framework do go beyond exposition and pedagogy.

GARRISON: Yes, but the pedagogy is very important. To have the ability to

explain the theory to students and colleagues shouldn't be underestimated. And I've found that my new framework in *Time and Money* is very teachable at all levels. And it is not at all limited to the issues of the business cycle. But graphics serve another function: they impose certain constraints on your theorizing. This helps answer Paul Krugman's objection that the Austrian theory does not comply with the "adding up" test, by which he means that everything has to fit together. Typically, economists meet the adding up test by some system of equations. Well, graphics can serve the same purpose. They help you get your story straight by keeping track of all the general interdependencies among markets.

AEN: What began, then, as an effort to explain the business cycle turned into a larger project?

GARRISON: My ambition is not just to construct a graphical story of the business cycle, but to provide a full-fledged macroeconomic framework that allows us to look at a large variety

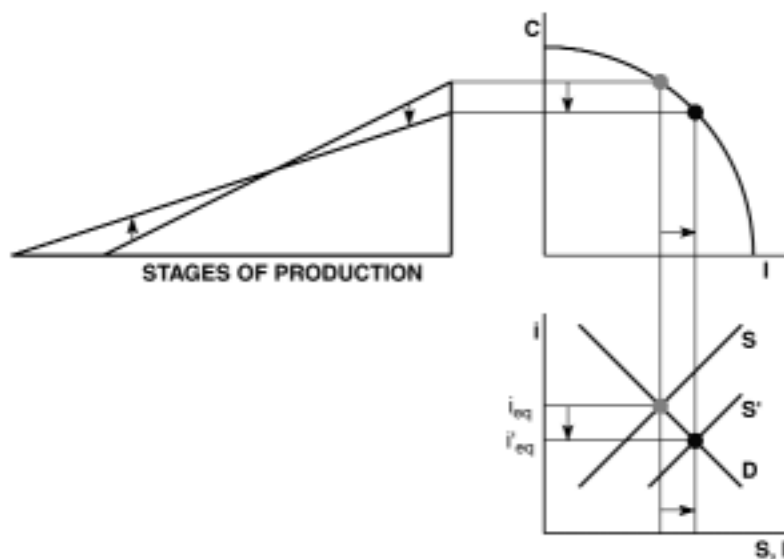


Figure 1. Saving-induced capital restructuring

From Roger W. Garrison, *Time and Money* (Routledge, 2001). Reprinted with permission.

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of theoretical and applied topics. For instance, it deals with the problems of converting from an income tax to a consumption tax: the model shows that the transition alone will create unexpected dilemmas and perversities.

It also illustrates the problem with government spending on infrastructure: government borrowing pushes up interest rates, while the funds borrowed are used to allocate resources to long-term projects. This is a clear instance where government is going against the market—and with results of questionable merit. The graphics also deal with the perversities of deficit spending, showing the improbable conditions that would need to be met in order for Ricardian equivalence actually to hold true. It turns out to be a very unlikely coincidence that people would save more just because the government borrows more. My point is that there are many different applications of Austrian macroeconomics.

AEN: Have you thought about putting your graphics into equations?

GARRISON: Yes, I did that some time ago with my earlier model. I wasn't quite satisfied with the results. What warns against it is that the equations attract undo attention to the possible states of equilibrium and aren't much of a help in discussing the market process, which is what the Austrian theory is really all about. You can't write out a series of equations that give you an equilibrium theory of the business cycle because business cycles involve disequilibria in an essential way.

Now, there may be some worry that the graphics, too, could prove to be a distraction. But so far, readers and students have all told me that my graphics are helpful in getting the story straight and not at all distracting.

AEN: How does your new book fit into the Austrian tradition in particular?

The equations attract undo attention to the possible states of equilibrium and aren't much of a help in discussing the market process, which is what the Austrian theory is really all about.

GARRISON: Well, I hope it will be seen as a follow-up to Hayek's *Prices and Production*. That book, which was based on lectures first delivered in

1931 gave us a key element of an Austrian framework for macroeconomics, namely, the Hayekian triangle. I have tried to avoid getting tangled up in the issues that consumed Hayek in his *Pure Theory of Capital* (1941), even though the overarching goal of my work has been to put capital theory back into macroeconomics.

You could argue that Hayek's *Pure Theory* would be a better starting point. Hayek himself saw this book as an attempt to fill out the thesis of *Prices*. He even said that before we can do much with his triangles, which were only a bare bones representation of the structure of production, we need to provide a thorough account of durable capital and durable consumer goods. And since he eventually abandoned the ambitious project of rewriting *Prices* in the light of the *Pure Theory*, many believe that the 1941 book is the obvious place for someone to pick up the project.

I reject that idea. I propose that we start with Hayek's earlier graphics that, while downplaying detail, capture

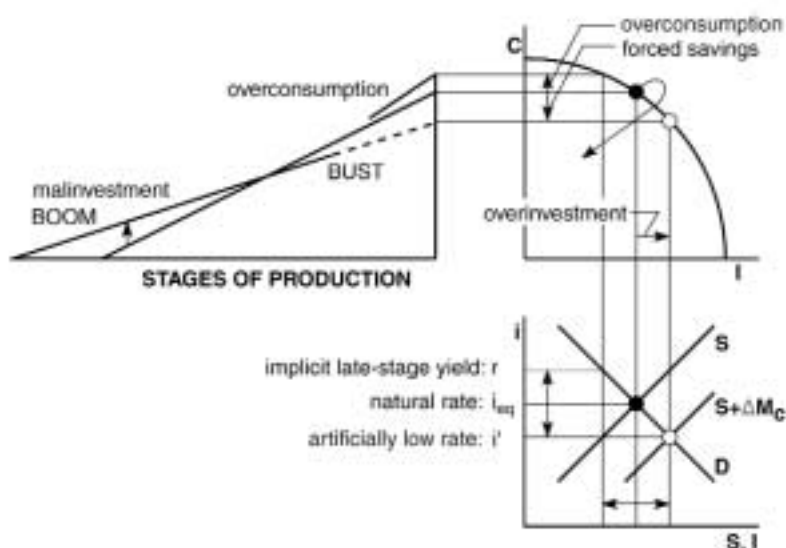


Figure 2. Boom and bust (policy-induced intertemporal disequilibrium)

From Roger W. Garrison, *Time and Money* (Routledge, 2001). Reprinted with permission.

the essential features of the economy's intertemporal capital structure. The Hayekian triangle, which involves just the right level of abstraction, fits nicely as one piece—but a key piece—in an overall macroeconomic framework. For doing Austrian macro, you don't need to complicate it with all the thorny issues of capital theory. You need something much simpler and straightforward.

AEN: You are not, then, attempting to contribute to a capital theory *per se*?

GARRISON: Once we understand that capital is heterogenous, that production takes place in stages, that resources can be allocated among the stages in different ways, you have the core of the theory. Then you can make use of Hayek's triangles to construct a viable framework. Hayek's *Pure Theory* lays out the whole problem we need to address in the first hundred pages: the problem of intertemporal coordination. And dealing with that problem, it turns out, helps keep the theory anchored to real-world issues.

I would say something similar about Israel Kirzner's 1966 book *An Essay on Capital*. It's a good book that delves very deeply into all the complications of capital theory. This is important work; profound stuff. But it is not what we need for understanding how markets keep the macroeconomy on track and how government policy can derail it.

All we need is a model that recognizes the fundamental trade-off between using resources for consumption purposes and using resources for investment purposes. We need to know that some capital is better used in early stages and other capital is better used in late stages. This intertemporal heterogeneity is adequately captured in Hayek's triangles.

Incidentally, Eugen von Böhm-Bawerk was the first Austrian economist to attempt a graphical exposition of multistage production. Instead of using triangles to show the stages, he used concentric rings. Once you figure out what he was doing, you realize that he was doing the same thing that Hayek did. Now,

Austrians are empirical in a different sense: they pay attention to the nitty-gritty of actual historical episodes.



Israel M. Kirzner

Böhm-Bawerk didn't add monetary considerations. There's no theory of the business cycle, not even a hint of it. So his model doesn't get you very far.

AEN: Sometimes Austrians are said to be too theoretical. Do you suppose your more real-world approach is somewhat more marketable to the mainstream?

GARRISON: I would like to think so, but I fear that the more accurate comparison is just the reverse. Most mainstream macroeconomists are not real-world oriented. They are sometimes put off by theorists who insist that we need to examine practical considerations in light of simple theories. They are more interested in the consistency and rigor of their theorizing and the mathematical elegance of their models than they are in questions of application. For that reason, they may see my macro model as pretty low-tech and not worthy of much attention.

But when I talk about business cycles, I am referring to actual business



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cycles that are matters of historical record and to cycles that we will likely experience in the future. Many mainstream theorists, such as “real-business cycle theorists” don’t do that. Austrians are sometimes accused of not being empirical in the sense of not gathering data for testing hypotheses, as has come to be standard fare, but Austrians are empirical in a different sense: they pay attention to the nitty-gritty of actual historical episodes. They are seeking theoretical explanations that dovetail with historical understanding.

In this sense, mainstream macroeconomics is much less empirical. Murray Rothbard used to like to debate the question: “Which is the more dangerous: an historian who doesn’t know any economics or an economist who doesn’t know any history?” I don’t remember which side he finally came down on.

AEN: At the same time, you are very critical of, for example, Friedman for having no theory of causation.

GARRISON: In his “plucking model” of the business cycle he just looks at the Keynesian-based National Income Statistics and describes what he sees as a revealing pattern they follow over time. But this pattern is based upon such a high level of aggregation, it is impossible to make any sense of it without a theory that operates on a lower level of aggregation. That’s what the Austrian theory does. I’ve had correspondence with Friedman on this issue. Not surprisingly, he remains unreceptive to the Austrian view.

That doesn’t mean that we can’t learn from him. James Tobin once said that the best empirical evidence you can muster for your own theory is that which is discovered by your adversary. Now, here’s a prime case of that. Friedman looked at data for a period in the 1970s when real interest

rates were particularly high on the eve of a downturn. That was his empirical observation. His interpretation of the data, given in an interview published in *Barron’s*, was very much an Austrian one: he attributed the high rates just before the actual downturn to “distress borrowing.”

Friedman explained that businessmen regretted having initiated



Murray N. Rothbard

Which is the more dangerous: an historian who doesn’t know any economics or an economist who doesn’t know any history?

investment projects during an earlier period of low interest rates but then found themselves having to borrow more to complete those projects despite the fact that interest rates had risen. That particular sequence of events, of course, is precisely the Austrian theory of the business cycle. Noticing this, I wrote Friedman, asking him if he had worked out this argument more extensively in some

of his published works. He said that he had not, and, moreover, he had only intended that explanation to apply to that particular cycle. All the Austrians are saying is that this phenomenon of “distress borrowing” is more generally applicable and characteristic of credit-driven expansions. Incidentally, taking an empirical—that is, historical—look at distress borrowing would be a great idea for a dissertation topic.

AEN: Why didn’t Friedman recognize his theory as Austrian?

GARRISON: Because Friedman has never seen the significance of Hayek’s *Prices and Production*. In personal conversation he has offered this book along with Dennis Robertson’s *Banking Policy and the Price Level* (1932) as examples of books that are virtually impossible to understand. But if you do understand Hayek, you see that he is explaining how policy can set the market process off on a wrong course and how subsequent “distress borrowing” characterizes the particular phase of the process just before market forces win out over the effects of credit manipulation.

Why does the mainstream have such a difficult time understanding the message? Because they don’t do capital theory. Especially those trained in the Chicago tradition. They all learned from Frank Knight that they didn’t have to pay attention to capital and so they ignore it. They have always considered it irrelevant to macroeconomics.

They think of capital theory as the relationship between stocks and flows. If that is all that capital is, merely a formal dimensional distinction between “the stock of it” and “the flow from it,” then capital doesn’t have much to do with macroeconomics. There’s little scope for disequilibrium.

For a very different set of reasons, Keynes, too, threw capital theory out of macroeconomics. Keynes himself acknowledges this in his 1937 summing-up article. He was proud to have found a way to break macro loose from all the thorny issues of capital theory. When Friedman launched a counterrevolution against Keynes years later, one point he never attacked was the throwing of capital out of macro. That was acceptable to him, due to the influence of Frank Knight.

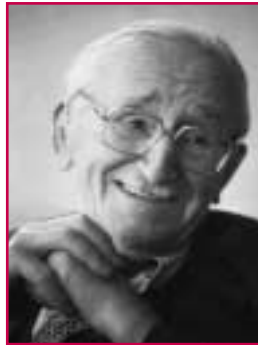
AEN: And that's why you claim that Friedman is himself a Keynesian.

GARRISON: Friedman himself said so, and the reason is that he bought into the Keynesian framework of a macroeconomic theory that made no reference to the structure of capital. In a *New York Times* article last year, Friedman expressed some regrets about setting out monetarist ideas in a Keynesian ISLM framework.¹ He said it was a strategic mistake. Over the years, the differences between Keynesianism and monetarism devolved into a dispute about elasticities and the shapes of curves, and the relative adjustment speeds of prices and wages. Not that Friedman now thinks he would have been better off expressing monetarist ideas in a Hayekian framework. He simply thinks that there is a more fundamental distinction between his views and Keynes's: monetarists believe markets work and the Keynesians believe they don't.

But to demonstrate exactly how markets work is where you need a theory of capital and a structure of capital that takes account of intertemporal patterns of production with resources allocated among the

different stages of production in accordance with the interest rate.

AEN: In support of the Austrian theory and your exposition of it, you cite Lord Robbins's 1933 book *The Great Depression*. What happened to Robbins?



F.A. Hayek

Before you can explain how things can go wrong, you first have to be able to explain how things can ever go right.

GARRISON: His work on the Great Depression is excellent. He sets out the Austrian theory and provides empirical evidence for it. But he eventually became persuaded that Keynesian demand-management policies are the right medicine for a depressed economy. That is, schemes for getting out of the depression should take precedence over concerns about how we got into it. This particular ranking of priorities, of course, is very un-Hayekian. Robbins saw the economywide deflationary forces during the 1930s as "swamping" all considerations of possible vertical maladjustments during the

1920s. He eventually became hostile to the Austrian theory to the point of refusing to autograph his book, and he said in his autobiography that he should never have written it.

This is why it is permissible to speak of a Keynesian Revolution. We see in the *General Theory* the first macro model that had built-in perversities such that the market could not possibly work right. The key perversity is the notion that investment and consumption move in the same direction. If this is so, you can never trade one off against the other in response to an increase in saving. That feature implied almost trivially Keynes's paradox of thrift: if people save more, their saving doesn't allow for more consumption in the future. It causes output and incomes to be decreased in the present. And if government doesn't intervene, incomes and consumption will be reduced in the future, too. There's no other way for the model to work. Policy prescription, then, becomes essential.

All of this is in violation of the methodological precept articulated by Hayek: before you can explain how things can go wrong, you first have to be able to explain how things can ever go right. In the Keynesian macro-model there is simply no way for things to go right. In the Austrian model, a decrease in current consumption allows for an increase in long-term investment which causes the economy to grow more rapidly and produce the goods that people are saving up for.

AEN: How do you employ Keynes's theory in your model?

GARRISON: I use his theoretical framework as a contrast with the Austrian framework, and I do it in a way that is more faithful to the *General Theory* than are most modern renditions of Keynesianism. I feature one aspect of Keynes that tends to get glossed over, especially in discussion

¹M. Weinstein, "Milton Friedman: My Biggest Mistake," *New York Times*, July 4, 1999, sec. 3, p. 2.

of Keynes's theory of the business cycle. He starts with an economy that is plagued by the perversities I've mentioned, but one in which (somehow) the wage rate is at the right level. The labor market clears. But the pattern of business expectations is a house of cards, and hence the economy is prone to collapse. It's "animal spirits" that, according to Keynes, drive the business world. When the spirits are on the wane, investors turn pessimistic. When that happens, the economy sinks into depression, and unemployment becomes widespread.

But contrary to most textbook accounts, Keynes does not lament that the wage rate is sticky downwards. There is nothing wrong with the wage rate in his judgment. It shouldn't be allowed to fall because it is—or would be, could be—the market-clearing wage rate. Axel Leijonhufvud emphasizes this point in his 1968 book *On Keynesian Economics and the Economics of Keynes*: in the Keynesian vision, the wage rate is not stuck too high; it is stuck just right.

In the 1930s, governments did not want wages to fall. Neither did Keynes. He explicitly recommended a fixed-wage policy. I agree with Leijonhufvud here too that Keynes argued like a lawyer, which is to say he made mutually inconsistent arguments all directed to the same conclusion. He argued that wages don't fall, that falling wages have perverse effects, and that wages shouldn't be allowed to fall. His point was to say that wages aren't the problem; the problem, to his mind, was a lack of business confidence and a resulting inadequacy of investment. If government can somehow boost investment, then wages will be correct again. From that point of view, policies pursued during the Great Depression were very much true to Keynes.

AEN: Is it your view that wages are not stickier than prices?

GARRISON: There are a variety of reasons why they could be, some of which are due to government intervention. But the important point is that at the downturn of a business cycle, what is crucial is not an overall change in the wage rate but a relative change among wage rates that will reallocate labor. Labor needs to shift from early stages of production into late stages of production.



Highlighting the differences between Hayek and Keynes helps the students understand the real issues. That is why I like to focus on this debate.

The Austrian macro model shows that you don't need all wages to go down. Some need to go down and some need to go up. Of course, if the cyclical downturn is compounded by a collapse of the money supply, wages generally and prices generally will all be too high. This is Hayek's "secondary contraction." But the problem on

the eve of the bust is not one of wages being too high or too low but one of the pattern of wages across the different stages of production being inconsistent with consumption demand over time.

AEN: For years, you have had your students read *The General Theory*. Why is that?

GARRISON: Here you find the roots of macroeconomics. If you are to understand what macro is all about, you have to understand this book. It also helps students see the fallacies of Keynesianism because they're much more transparent in *The General Theory* than in the cleaned-up textbook versions that came out years later.

There is so much literature on Keynes and the classics, but what is taken as the classical model is a trumped-up invention of the textbook industry. This model, accepted by no actual classical economist, involved capital homogeneity and a constant capital input. It involves a very static presentation of the quantity theory of money. It ignores the stages of production. Setting up this straw man makes Keynesian theory, by comparison, look more sophisticated and enlightened.

But if you go back to Keynes, you find that he used the term "classical" very broadly to include anyone who believed that markets worked, including Hayek. In fact it was Hayek with whom he was doing battle. So highlighting the differences between these two helps the students understand the real issues. That is why I like to focus on this debate. Keynes doesn't look so good in comparison to Hayek.

AEN: Do you think that your use of Keynes as foil to the Austrian view might be considered anachronistic, since Keynes is so out of favor with the mainstream?

GARRISON: The development of Austrian economics missed out on an important phase—the translation of the macro theory into a graphical framework and the creation of what is sometimes called a “positive heuristic.” So, the point isn’t just to provide a contrast but to make a positive restatement of the Austrian theory.

Also, on the level of policy, Keynesianism is far from being out of favor, despite it’s not being on the cutting edge in the mainstream journals. If you keep track of policy matters by reading the *Wall Street Journal*, you find that the newer, allegedly more rigorous theories have virtually no role to play in driving debate. What drives the thinking of policy makers is 1960s-style Keynesian thinking, and we have never had a wholly effective counter to it.

AEN: So how does your book fit into the policy world?

GARRISON: There’s a book by Sheryl Kasper coming out next year called *The Revival of Laissez-Faire in American Macroeconomic Theory*. I look forward to reading it, but I’m not sure the title allows for the kind of revival needed in the Austrian School. Mainstream macroeconomists, at least those who are actually interested in matters of policy, tend to be interventionist. It would be good to see them moving toward a laissez-faire position. Austrian economists tend to be laissez-fairists through and through, but what needs reviving for them is their interest in macroeconomic issues.

We have libraries of books written about micro problems and how markets address them in absence of intervention. But there is far less written about macroeconomic problems and market-based answers. One of the reasons, I believe, is that we haven’t really had a viable macroeco-

omic framework that rivals the interventionist-friendly framework of the mainstream.

AEN: Do you worry that the structure of your model might tempt policy makers to use it for countercyclical purposes?

GARRISON: No, not really, because of the sheer complexity of the capital structure, and the implications about the needed reallocation of labor



We haven’t really had a viable macroeconomic framework that rivals the interventionist-friendly framework of the mainstream.

resources during a downturn. No conceivable proactive macroeconomic policy could orchestrate a recovery.

Now, Lachmann, in his 1956 book *Capital and Its Structure*, sometimes sounds a little like a Keynesian activist because he speculates on

some of these matters. My reading of him, however, is that he was just taking on the Keynesians on their own turf. He said that what is needed is some sort of credit control, by which he meant reducing credit that was extended to long-term production and increasing credit for short-term production. This would have the very effect of reallocating labor resources out of early stages and into late stages. He wasn’t actually advocating that policy makers try to do this. He was just trying to show what a daunting job it would be to use Austrian cycle theory as a basis for a recovery plan.

And Hayek, I think, got a bit off track when he tried to explain just what the central bank would have to do to keep an artificial boom going. Supposedly, the money supply would have to be increased at an increasing rate. Hayek’s so-called “accelerationism” is sometimes seen as anticipating short-run/long-run Phillips curve analysis. But Hayek’s larger point is that accelerating the rate of expansion won’t work. The Fed can print the economy into trouble, but it can’t print it out of trouble. What is needed is some liquidation and reallocation.

AEN: Your taxonomy at the end of your book has tremendous explanatory power. (See Figure 3.)

GARRISON: I originally had that matrix at the front of my book. But then I realized that this was really a pretty good way of summing up. I tried to explain why the debate among Austrians and monetarists and Keynesians has been so protracted. I came up with the answer that debaters are trying to deal with two separate issues at the same time. One issue is whether or not markets work. The other issue is whether, in resolving the first issue, the focus should be on labor or on capital.

That is, what are the key features of the market's mechanisms (those involving capital or those involving labor) for assessing the ability of the market to work in the macroeconomically relevant sense?

In the course of setting up and discussing the 2x2 matrix, I talk about cellmates, rowmates, and columnmates. In my taxonomy, you get Friedman and Keynes focusing on labor markets to the exclusion of capital markets. And you get Keynes and Lachmann assuming—or fearing—that markets don't work well enough to keep the economy out of recession. Hayek, in my view, gets it right: markets work as long as policy activism doesn't distort the interest rate, and our analysis of the intertemporal capital structure shows just how markets work.

The matrix helps us sort out some old issues. For instance, both Milton Friedman and Richard Nixon are on record as saying "We're all Keynesians now." Friedman, though, has complained that he was misinterpreted. When Friedman said it, he meant that both he and Keynes work with the same analytical framework—which focuses on labor markets. But when Nixon said it, he meant that nobody believes markets can be trusted to work things out on their own; hence we need government

supplied stimulants and stabilization policy. My matrix shows Friedman to be Keynes's rowmate and Nixon to be Keynes's cellmate.

AEN: What are the most common myths about Austrian business cycle theory?

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GARRISON: One common myth is that the Austrians believe that all ups and downs in the economy necessarily involve intertemporal disequilibrium that was caused by monetary expansion. This simply isn't true. The theory goes the other way. According to the Austrian theory, artificial booms that are caused by credit expansion are unsustainable.

The theory doesn't try to explain every downturn. One notable episode that didn't directly involve an artificial boom was the downturn in the late 1930s—when the Federal Reserve bone-headedly raised reserve requirements just when the economy was in the process of recovery. That caused a collapse in the money supply and extended the depression for two more years.

AEN: Would you cite Japan as a case of attempting to print itself out of recession?

GARRISON: Yes, I would—also some of the so-called "emerging nations." Many of those booms were caused by artificially cheap credit. And some were caused by artificially secure loans—where the risk is borne not by the borrower but by the lender, and ultimately by the government. Paul Krugman has emphasized this troublesome discrepancy between risk taking and risk bearing, but he doesn't see the strong family resemblance of his own theory to the Austrian theory.

Krugman denigrates the Austrian theory as the "hangover theory," but there is nothing objectionable about the phrase. It's just a way of saying that an artificial stimulation sets the stage for a downturn, which is correct. But he also sees the Austrians as moralizing about the issue, as if the economy *should* have to suffer a painful downturn and depression to atone for its growth binge. The Austrian theory, of course, entails no such simplistic moralizing.

Krugman's alternative theory is a pure money-demand theory. If, for some reason, there is a general, economywide increase in the demand for money, spending decreases. This puts downward pressure on prices, and to the extent that they do not adjust immediately, output falls. He claims this is Keynes's explanation of

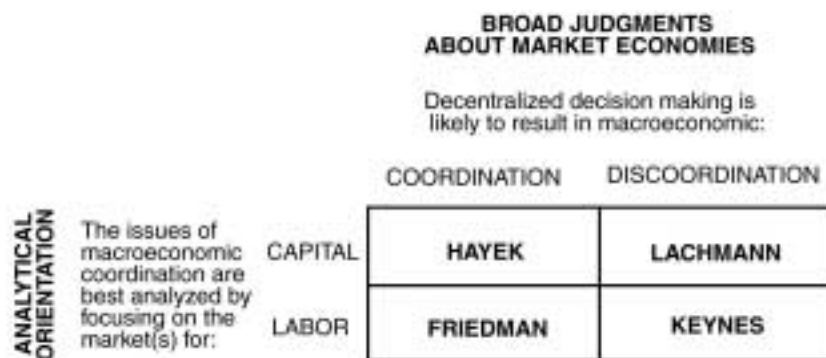


Figure 3. A matrix of frameworks and judgments

From Roger W. Garrison, *Time and Money* (Routledge, 2001). Reprinted with permission.

business cycles, but in fact it is not. Keynes believed that depression was brought on by a collapse in investment demand. He realized that on the heels of collapse, there would be a scramble for liquidity. But he didn't take the increased money demand to be the primary cause.

AEN: Krugman seemed to pick up some anti-Austrian arguments from Gottfried Haberler's later work.

GARRISON: Yes, he says that the Austrians need some sort of symmetry in their boom-and-bust story. The bust involves a reallocation of capital from early stages to late stages and this can involve heavy doses of unemployment. So Haberler asks: why don't you get the same unemployment while capital is reallocated during the boom from late stages to early stages?

The answer is that overall demand is stronger during the boom, precisely because it is being supported by heavy lending from the banking system. This gives a boost to labor demand generally, but demand is especially strong in the early stages of production. Workers are bid out of late stages of production into early stages. When the bust comes, there's an abrupt reduction in demand for labor in the early stages that causes workers to be unemployed. These workers can eventually be reemployed, but that takes time.

A related argument that Krugman gets from Haberler questions the basis for the unemployment in the Austrian theory. Why, Haberler and Krugman ask, should bad investments cause good labor to be unemployed? The answer, of course, follows from the complementarity among the different parts of the capital structure and the shortages—due to malinvestment—of the kinds of capital that are complementary to labor.

AEN: Do you want to address any of Tyler Cowen's arguments in his book criticizing Austrian cycle theory?

GARRISON: Well, Cowen makes long lists of arguments, but let me address one in particular. He claims that according to the Austrians, savings



Gottfried Haberler

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rates must be subject to frequent and dramatic change. Otherwise, entrepreneurs wouldn't take a credit expansion for an increase in saving. This argument confuses pedagogy with historical application. The Austrians make no claim that savings rates are volatile; they need only recognize that saving rates can change and do change. The idea is that the interest rate must reflect even the small and gradual changes if the

economy is not to be set off on an unsustainable growth path.

Austrians, by the way, are neither pro-saving like the supply-siders nor anti-saving like the Keynesians. They are concerned only that investment activities are consistent with the availability of saving, which in turn is consistent with people's time preferences. A similar statement can be made about economic growth generally. There is no reason to be for or against growth as such. What's important is that the economy's growth rate correspond to intertemporal consumption preferences.

AEN: Another objection often raised is that consumer credit markets dramatically change the Austrian story. Is that correct?

GARRISON: It's true that when Hayek first developed the theory, there simply wasn't much in the way of consumer credit. The lion's share of loans went to the business community. This circumstance made for a straightforward application of the theory. But even with a large volume of consumer loans in play, the theory still holds, though the particulars are different. Most consumer loans are for buying consumer durables—appliances, automobiles, and swimming pools. These kinds of goods, though, have many of the characteristics of capital.

Harry Browne once wrote about one of his clients who had splurged on a swimming pool during a period of low interest rates and then later found that he couldn't afford to maintain the pool. Here is an example in which the Austrian business cycle theory plays itself out entirely within the consumer credit market.

AEN: How does the Austrian story fit with the so-called political business cycle?

GARRISON: It's a nice fit: Austrian theory explains the mechanics, but

not the timing of the boom or the length of the period between booms. Early on, Mises accepted Knut Wickse's explanation—that technological factors cause the natural rate of interest to rise and that the banking system only belatedly adjusted the bank rate. But by the 1920s, Mises had come to blame the boom not on technology but on “inflationist ideology” generally.

It wasn't until 1960 that Hayek explained in his *Constitution of Liberty* that the credit-driven boom is politically motivated. He used an

explicit public-choice argument—two years before the publication of Buchanan and Tullock's *Calculus of Consent*—to explain the political benefits of expanding credit before an election.

AEN: How does the internationalization of capital markets affect the model?

GARRISON: With international capital markets in full play, changes in the interest rate are less pronounced. Instead, we get changes in capital

flows, as foreign investors take advantage of even a small increase in the interest rate. So, interest rates aren't quite so high on the eve of the downturn, but capital inflows are large and export markets are weakened. In effect, the access to world capital markets allows the boom to continue longer than it otherwise would.

We should remember, though, that Mises originally devised his business cycle theory by borrowing an idea from the British Currency School. That school had set out the

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self-reversing process strictly in terms of changing patterns of trade between nations. Mises showed that even in a closed economy, there is still a self-reversing process—one that plays itself out as interest rate changes and capital reallocations.

AEN: All the while you have been working on this book, the economy has been on an upswing and conventional macro problems like unemployment and deficits have become less of a problem. Did you ever get discouraged that you are dealing with issues that are no longer relevant?

GARRISON: No, my greater objective is to put together a capital-based macroeconomics that can deal with many different issues in many different circumstances. But I don't believe for a minute, as the profession periodically

seems to believe, that the business cycle is dead. In fact, it's probably fair to say that the popularity of business

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cycle theory is at low ebb on the eve of the bust.

We've heard a lot lately about the "new economy"—the internet, the digital revolution, and just-in-time inventory

management. I don't deny that things have changed, but I doubt the changes somehow add up to perpetual prosperity. Just before the Bush recession in the early 1990s, the unemployment rate was 5.5 percent. Nobody suggested that this rate was unacceptably high. It was seen instead as the "natural rate," the hallmark of macroeconomic health. Are we now to believe that over the period of a single cycle, the natural rate has fallen from 5.5 percent to 4.0 percent?

Macroeconomists—especially Austrian macroeconomists—must be careful about making predictions. But I think that the role of the Federal Reserve in engineering the Clinton expansion is not much in doubt. Is the stage now set for an Austrian-style downturn? Well, let me just predict that if we have one, the value of my book will rise. ■

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Ludwig von Mises Institute
518 West Magnolia Avenue
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