Risk and Business Cycles: New and Old Austrian Perspectives. By Tyler Cowen. London: Routledge, 1997

This very ambitious book starts with the high promise of a radically new and superior theory of business cycles, but when it ends the reader cannot resist the conclusion that the promise has gone unfulfilled. Tyler Cowen states his goal quite explicitly. He finds the "traditional" or "old" Austrian theory of business cycles (hereinafter ABC) to be inadequate and outmoded. Nevertheless, Cowen sees merit in certain aspects of ABC, such as capital goods' complementarity and the importance of intertemporal coordination. Therefore, he offers a "new" Austrian approach whose elements include rational expectations, real business cycle theory, and sectoral shifts, and whose organizing motif is the role of risk in entrepreneurial decision-making. This alternative, risk-based theory of business cycles (hereinafter RBBC) is presented by Cowen as a sophisticated and improved version of the "naive" ABC. It is the result of "grafting rational expectations and modern finance theory onto the original Austrian theory" (p. 10). If such a procedure sounds unsavory and unlovely, I can assure the reader that the resulting amalgam is little better.

The book is divided into five chapters. The first is an introduction in which Cowen names the deficiency he is trying to improve upon: "the traditional Austrian approach fails to establish its central contention—the link between positive rates of nominal money growth and excessive capital-intensity" (p. 2). He then defines what he means by investments that are risky. These are "long-term, costly to reverse, high-yielding, and having returns highly sensitive to the arrival of future information" (p. 3). Malinvestments occur when "entrepreneurs earn less than the risk-free (or minimum-risk) rate of return" (p. 7). Cowen further stipulates under what assumptions his RBBC will be developed. They include expectations that are rational in the sense that errors are serially uncorrelated (although he rejects the idea of strictly homogeneous information), constant returns to scale, perfect competition in all sectors, and perfectly flexible wage rates and prices. He even reveals a capsule version of one of the key conclusions to be found in later chapters.

That is, contrary to ABC, inflation does not systematically lead to unsustainable malinvestments and a boom-and-bust cycle. Sometimes monetary policy produces *sustainable* expansions; "the final outcome is never certain in advance" (p. 4).

Chapter 2 is devoted to a discussion of RBBC in real terms, as opposed to nominal or monetary terms. Here Cowen claims that his approach represents a kind of middle ground between ABC, which interprets cycles as driven by

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entrepreneurial errors, and so-called real business cycle theories, which insist that cycles are driven by technology shocks. The common thread, per Cowen, is the reaction to risk on the part of entrepreneurs. The extent to which investment is undertaken can be affected either by exogenous events such as unexpected changes in a central bank's monetary policy or by endogenous events such as credit rationing, shocks to retained earnings, the arrival of new information, or sudden shifts in entrepreneurs' preferences regarding risk exposure. When discussing the latter, he even utilizes Keynes's notion of "animal spirits" (p. 25). The list of possible precipitating factors is quite long. Indeed, when reading this chapter, I got the unsettling impression that to Cowen's mind virtually *anything* can bring about a business cycle.

There are at least two assertions in Chapter 2 that are sure to rankle most Austrians. First, Cowen confirms quite candidly what a reader will quickly come to suspect. That is, RBBC sees business cycles, at least in part, as evidence of *market failure*, not merely as an aberration imposed on an unsuspecting economy by an intrusive central bank. With RBBC, "all business downturns indicate a market failure, even if the government causes the relevant negative shock" (p. 15). Second, focusing on Hayek's work on cycles, he claims that ABC fails to address the issue of "comovement," that is, the observed general expansions or contractions of activity across many sectors of the economy. Apparently Cowen interprets ABC as dealing exclusively with the shifting of resources from consumer goods production to capital goods production, or *vice versa*. Thus he questions how such intersectoral resource movements can lead to the phases of the business cycle.

Chapter 3 elaborates further on this RBBC, primarily in the context of two basic monetary scenarios. The first is an increase in the rate of growth of the monetary base that lowers real interest rates and thus precipitates a typical boom-and-bust cycle. The second is an increase in "monetary uncertainty or volatility" that throws the economy into a recession without first experiencing an expansionary period. According to Cowen, the former occurs unambiguously only if such monetary growth does not also involve an increase in volatility. If it does not, then entrepreneurs will be induced to invest in longer-term, more capital-intensive, and thus allegedly riskier, projects. Since these are highly sensitive to new information, some entrepreneurs' expectations will be foiled as time passes, and these projects will prove unprofitable. Bust follows boom. In the latter scenario, monetary volatility rises, but presumably not the average rate of monetary growth. This discourages investment in longer-term projects, because it increases perceived risk; growth rates decline; and the economy descends into a recession without a preliminary expansion.

What about the very plausible case in which the rate of monetary growth both rises and becomes more unpredictable? In RBBC, the result is indeterminate, because two opposing forces are at work. "The net effect will be uncertain, and long-term investment may either contract or expand" (p. 46).

This chapter also presents Cowen's views on some of the issues surrounding (a) credit rationing, (b) alternatives to discretionary monetary policy, and (c) the non-neutrality of money with respect to capital markets. If creditors respond to changes in monetary policy by varying the quantity of funds loaned, but not necessarily the rate of interest charged, then the basic, positive relation between money and investment probably still holds. *Ceteris paribus,* monetary growth encourages investment and tends to increase the cyclicality of the economy.

Regarding monetary rules, Cowen finds none to be a simple solution to business cycles. He assumes throughout that the key relationship is between the monetary base (rather than some broader monetary aggregate) and business investment. Any regime that includes a central bank allows for the possibility of monetary base manipulation. Thus, he concludes that price-level rules, nominal GNP targeting, nominal interest rate targeting, commodity currencies, and even 100-percent-reserve banking all may fail in a central banking context. Does this then imply that free banking, with gold as the base money, must be the answer? No, according to Cowen, because even though free banking exhibits automatic restrictions on overexpansion of the (inside) money supply, it does "not necessarily stabilize the marginal cost of producing gold" (p. 57).

Although he gives lip service to both Ricardian equivalence and the Modigliani–Miller theorems concerning monetary policies that do not involve fiscal changes (pp. 68–70), Cowen nevertheless agrees with Austrians and other economists who insist that changes in monetary policy are *not* neutral with respect to real economic variables. "[W]e should think of monetary policy as a real sectoral shock, rather than as a purely nominal event" (p. 64). However, when discussing whether long-term interest rates as well as short-term rates will be affected by a given change in monetary conditions, he once again hedges his bets. Everything "depends on expectations" (p. 74) in that investment decisions may hinge on whether the change in short-term rates is expected to be temporary or permanent.

Chapter 4 will probably garner more attention from Austrians than any of the other portions of this book. It is here that Cowen describes, analyzes, and strongly criticizes what he takes to be the traditional Austrian explanation of business cycles. He portrays ABC as an approach that "views investment as the transmission mechanism for the cycle, starts with the assumption of full employment, links the monetary and real sectors of the economy, uses a loanable funds theory of interest, and builds on Wicksellian themes" (p. 76). The representative expositors of ABC he apparently takes to be Mises, Hayek, Rothbard, and Garrison (pp. 10, 76). Although Cowen is critical of several prominent features of ABC, the one feature with which he is most preoccupied is the posited expectations of entrepreneurs.

Cowen argues that ABC assumes both that entrepreneurs mistake monetary inflation for an increase in voluntary savings and that entrepreneurs mistakenly think that the observed decline in real interest rates will prove to be more or less "permanent." He rejects both as implausible. Indeed, he offers eight detailed reasons why he thinks they should be rejected (pp. 80–100). These include the assertions that private savings do not exhibit the volatility implied by ABC, constant nominal money growth may make newly undertaken investments sustainable in the long term, current real interest rates do not provide reliable information about future commodity demand, and lower real interest rates may be the result of a decline in loanable funds *demand* rather than an increase in the *supply* of loanable funds. The two signal extraction problems associated with ABC he then contrasts with a third type in which economic agents fail to distinguish nominal price effects from real price effects. This last type he correctly identifies as being central to the models of certain New Classical theorists such as Robert Lucas (p. 79).

Cowen's assessment is that the "Austrian theory does not follow directly from the ability of inflation to distort market price signals, or from the injection of new inflationary funds into the loanable funds market" (p. 101). His own, risk-based, approach allegedly avoids the implausible assumptions of ABC and thus offers a superior theory at the same time that it exhibits a degree of eclecticism which brings it closer to neo-Keynesians, modern monetarists, and real business cycle theorists (pp. 2, 104).

Chapter 5 is composed entirely of a survey of recent econometric work on various aspects of business cycles and related monetary issues. The chapter does not, contrary to what one might suppose, present Cowen's testing of some formal model of his own creation. The studies that he catalogues are so diverse, and the results so mixed, that they are quite difficult to summarize. However, in very rough form, Cowen finds at least some support for the propositions that (a) money growth does affect real interest rates and brings about intersectoral resource shifts, (b) changes in uncertainty affect aggregate investment, (c) capital-intensive industries often experience greater cyclicality than other industries, and (d) monetary inflation can increase the riskiness of bank loans. Does any of this unambiguously imply the superiority of either ABC or RBBC? No. And amazingly enough, Cowen admits it. "None of these results, however, discriminates decisively in favor of risk-based (or traditional Austrian) theories as opposed to other potential business cycle mechanisms" (p. 149).

A Good Effort Gone Wrong

This book possesses some virtues. The subject of business cycles is certainly important enough to justify a book-length treatment, and I would give Cowen high marks for a brave assault on a difficult topic. His risk-based approach, although I believe it to be fatally flawed, is innovative and challenging. Moreover, unlike most economists, he treats the traditional Austrian theory with seriousness and attempts to grapple with its principal features. In addition, it is clear that Cowen is familiar with a wide range of research on business cycles and on certain related issues in monetary and capital theory.

On the other hand, this work is disfigured by a number of errors and deficiencies. These might be categorized under the two broad headings of (a) problems of content and (b) problems of style or exposition.

Allow me to begin with the content of the book. Most fundamentally, Cowen argues that ABC, though not without some merit, suffers from certain mistakes that his RBBC avoids. Therefore, RBBC is supposedly superior. But does Cowen accurately portray ABC? No, he does not. I will give just a few of the more glaring misstatements to be found in the book (there are more). Cowen repeatedly states that ABC focuses on low real rates of interest that are brought about by positive rates of monetary growth. In fact, ABC focuses *not* merely on historically low rates of interest, but on rates that are *lower than the natural rate* (Mises 1966, pp. 558–59; Rothbard 1970, pp. 862–63; Garrison 1989, p. 22). It is that inconsistency between the rate in the market for loanable funds and the (natural) rate which reflects individuals' time preferences which lies at the heart of ABC.

Moreover, it is not just *any* monetary increase that can precipitate a cycle per ABC, but only that which involves an expansion of credit in the form of new business loans (Rothbard 1978, p. 152). If Cowen had kept this in mind, it might have prevented him from wondering why ABC assumes that a lower market interest rate must be the result of an increase in the supply of funds rather than a decrease in the demand for funds (pp. 85 and 101). Of course, remembering that time preferences have not changed would also help in this regard, but then Cowen dismisses the concept of time preference (along with the natural rate of interest, the Ricardo effect, and forced savings) as worthless (pp. 65, n. 11, 95, 105–8).

Cowen declares that ABC offers no explanation for "comovement," the expansions and contractions of both capital goods and consumer goods. That is simply false. ABC explicitly argues that, as interest rate signals induce entrepreneurs to invest in a more roundabout production process, capital goods production "booms" and persons involved in capital goods industries enjoy higher incomes. Since time preferences have not changed, those increased incomes will predominantly be spent for *consumer goods*; therefore the demand for, and the quantity supplied of, consumer goods will rise. In short, dollar expenditures for both capital goods and consumer goods will rise, though not strictly simultaneously. Eventually, the rising costs of production reveal that many of the projects which have been undertaken are, in truth, unprofitable, and the recession ensues. Incomes fall in capital goods industries, and this spills over into reduced demand for, and quantity supplied of, consumer goods (Mises 1966, pp. 552–54; Rothbard 1970, pp. 854–59). Contrary to Cowen, ABC offers a lucid and temporally sophisticated explanation of why both the general expansion and the general contraction occur.

In addition, Cowen portrays ABC as starting from the assumption of full employment in the economy (p. 76). According to Rothbard, this is a common criticism of ABC, but nevertheless incorrect. Credit expansions always generate cyclical effects "whether or not there are unemployed factors" (Rothbard 1970, p. 866).

Even setting aside the abovementioned misunderstandings of ABC, this book still has problems. Perhaps the most fundamental of them all is the very use of the concept "risk." It is not entirely clear what Cowen has in mind. On the one hand, he wants quite badly to link RBBC to certain features of modern finance theory such as mean-variance analysis and the capital asset pricing model (CAPM).

There, risk refers to the variance of the probability distribution of past returns on some existing asset. It involves historical data and is quantifiable. On the other hand, he insists that his primary concern is with the entrepreneurial choice of whether to invest in new long-term or new short-term projects. In that case, whatever project is selected will represent a unique event, and there are *no historical data* upon which to draw. Strictly speaking, no probabilities can be calculated (Mises 1966, pp. 106–16). Here, the entrepreneur faces *uncertainty* rather than risk. Is it possible that Cowen is unaware of this potentially critical distinction?

It is also troubling that Cowen assumes longer-term projects are necessarily "riskier" than shorter-term projects. He does grant the possibility that the reverse could, in theory, sometimes be the case, but rejects it as "the exception" (p. 23, n. 5). Of course, this assumption is essential to RBBC, because without it there would be no systematic way to connect "risk-taking" to the capital structure. A similar difficulty arises with the possibility that some entrepreneurs may, under some conditions, be "risk-seekers" rather than being unfailingly "risk-averse."

One would even be justified in asking if RBBC really represents a theory of cycles at all. I say that because the text is peppered with statements of the form, "If X increases, Y might either increase or decrease." Perhaps that is why no formal model is offered: Cowen could not unambiguously specify the algebraic signs of the parameters involved.

Finally, the assumption of rational expectations as an integral part of RBBC must be called into question. Cowen admits that this assumption does not accurately describe the real world, but retains it anyway based on the belief that it is "a useful form of discipline" (p. 8). I would have thought that *reality* was the most useful of all forms of discipline; but Cowen prefers to assume rational expectations, because he believes this assumption forces the analyst to specify the "explicit informational asymmetry" that leads to entrepreneurial errors (p. 8). Odd that Cowen later castigates Austrians for being overly specific about the informational asymmetry between entrepreneurs and the central bank regarding those credit expansions which bring about the boom and bust cycle (pp. 80–82).

I will be mercifully brief with my comments about the writing style encountered in this book. Such mercy is motivated by the fact that, with reluctance, I must admit that the writing is rather uniformly awful. Far too much of the book reads like a series of "laundry-lists." There are eight reasons for rejecting ABC, six assumptions of RBBC, eight stylized facts about cycles, thirteen postulates of ABC, seven empirical questions involving cycles, and so forth. The presentation is often clumsy and pedantic; there is no grace or elegance of exposition. Some will say that is excusable in an academic and technical work, but I still prefer economists who can write.

It is difficult to imagine that the audience for this book will be large. Austrians will quarrel with Cowen's basic premise that ABC is decidedly deficient and needs to be replaced. Monetarists, New Classicals, neo-Keynesians, and real business cycle theorists will probably be disappointed by the absence of any formal models. Only the few who are particularly keen to read everything available on business cycles are likely to struggle through this book.

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