Misconceptions about Austrian Business Cycle Theory: A Comment

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A recent set of articles (see Michael Bordo 1986; Roger Garrison 1986; Herschel Grossman 1986; Gottfried Haberler 1986; Axel Leijonhufvud 1986 and Leland B. Yeager, 1986) reviews the Austrian theory of the business cycle in comparison to other theories. One of the main issues they consider is the neutrality of disturbances in the money supply, and on this point Thomas Humphrey (1984) is cited as refuting the Austrians' claim to be unique in that they consider relative price changes (Yeager 1986, p. 382). Humphrey quotes and summarizes several quantity theorists and Monetarists on the real effects of a monetary disturbance and concludes that rather than being distinct, the Austrian theory is quite similar to that of the Monetarists both in its explanation of how money affects the economy and in its policy implications.

This note contends that beyond the surface similarity of monetary nonneutrality there are significant differences between the Austrian and Monetarist business cycle theories. The theoretical approaches diverge in the use of macroeconomic aggregates. Different concepts of the monetary mechanism result in different implications about what relative price changes occur and their causes, and about the types of unemployment. In the Monetarist view, the economy will return to its original equilibrium structure, while the Austrian view denies that possibility. Humphrey misrepresents the Austrians and the Monetarists by neglecting their differences and claiming their theories are essentially the same.

For Monetarists, the appropriate concepts are macroeconomic aggregates, especially real cash balances, non-cash assets, the price level, investment, employment, and income. Their analysis focuses on long-run changes in these aggregates. Friedman's portfolio adjustment mechanism is the response to an increase in the money supply and a decrease in the yield of cash as an asset, relative to non-cash

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assets, which then leads to increased spending on newly produced goods and services. Similarly, the Phillips Curve analysis focuses on a relation among aggregates for the price level and unemployment. The recession phase of the business cycle is characterized by cyclical unemployment in response to the general rising real wage. Such real effects focus on macroeconomic aggregates and occur within a temporary adjustment period toward the long-run equilibrium.

Many of these same macroeconomic aggregates are not considered meaningful concepts by the Austrians, who are more concerned with relative changes among the components of the aggregates. Hayek, in discussing the phase of the cycle in which income peaks and begins to decline, stresses changes in the types of investment activities undertaken. The composition of investment spending changes from long-term (early stages in the production process which are removed in time from the actual production of final goods) capital projects to short-term (later stage) investments. This change leads to the unemployment of resources complementary to long-term investment projects. While other Austrians suggest a decrease in total investment during a recession as a cause of unemployment, Hayek maintains that unemployment increases independently of changes in the total amount of investment and states

> whether this [decrease in total investment] is or is not the case is not so important as the fact that the demand for resources which are specific to the early stages ... will cease and unemployment will ensue here, while the increased demand in the later stages must exhaust itself in a rise in money wages in these stages without creating additional employment [Hayek 1939, p. 28n; see also Hayek 1969, p. 284].

Overall unemployment in the recession phase of the Austrian business cycle theory is not a relation among aggregates, but is frictional and structural and is in response to changes in relative yields of capital types. Further, the inappropriate investment during the expansion phase of the cycle forever changes the distribution of wealth and income, so that the original equilibrium cannot be reestablished (Mises 1963, p. 555). Nonneutralities occur within the aggregates and have lasting effects.

The theoretic constructs are fundamentally distinct for the two schools of thought and that is evident in their treatments of macroeconomic aggregates and in the importance they place on disequilibrium. Humphrey's article shows a misunderstanding of this in the statement:

> with the possible exception of a singular Austrian concern for the composition (as opposed to level) of real output, there is little

> difference between the two views of the monetary mechanism [Humphrey 1984, p. 14].

Yeager's comments clarify the importance of the difference: that changes in relative prices,

> though crucial to the distinctively Austrian scenario, are mere details in the monetary disequilibrium account of the business cycle. Understandably the monetarists emphasize the centerpiece of their story—a disequilibrium relation between the nominal quantity of money and the general level of prices and wages [Yeager 1986, p. 382].

As the issue of unemployment exemplifies, the two approaches lead to contrasting descriptions, explanations and predictions of business cycle phenomena.

Humphrey correctly chides the Austrians for claiming that Quantity Theorists and Monetarists completely ignore real effects of a monetary disturbance. Even Mises's comments on the quantity theory (Mises 1963, pp. 412-13) appear consistent with the more recent examples given by Humphrey. However, the relative price changes the Austrians and Monetarists describe are not the "exact counterparts" claimed by Humphrey. In the Monetarist theory, institutional rigidities prevent some prices from changing as rapidly as others, resulting in relative price changes and real effects on the levels of aggregates during disequilibrium. Humphrey's review begins with a quote from Alexander del Mar which leaves the impression that the relative price changes are random. His quotes from Irving Fisher and Clark Warburton clearly state that relative price changes are due to some prices adjusting more slowly than others for institutional reasons. Austrian theory has never relied upon this explanation. His reviews of Friedman and Brunner and Meltzer show a role for the interest rate only in changing relative yields between broad aggregates of cash and noncash assets. In contrast, the fundamental cause in Austrian business cycle theory is that a monetary disturbance distorts the yields of various capital types and alters the time structure of investment allocations (Hayek 1969, p. 277 and Mises 1963, p. 555). The two theories analyze different relative price changes which occur for different reasons.

Humphrey's article does establish that Monetarists consider certain relative price changes. While there are similar general phenomena in the two theories, such as the occurrence of relative price changes, the specific phenomena and the processes that generate them are not similar. Concluding that the two theories are "virtually the same" misrepresents both Austrians and Monetarists.

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