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| Bryan Caplan  | PERMANENT LINK | JANUARY 2, 2008**What's Wrong With Austrian Business Cycle Theory**[Bryan Caplan](http://econlog.econlib.org/authorbcaplan.html) | [PRINT](http://econlog.econlib.org/cgi-bin/printblog.pl) EMAIL [ShareSHARE](http://www.addthis.com/bookmark.php?v=250&username=econlib)  |
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A lot, but Tyler's written [a very fine postcard version](http://www.marginalrevolution.com/marginalrevolution/2008/01/the-return-of-h.html):The Austrian story is that "the government distorted price signals to the market." Are those two accounts really so different? Do we need metaphysics to resolve that question? Take the classic "thin skull" case in the law. Austrians won't describe it this way, but they are postulating a very thin skull for markets and then blaming government for the disaster which results from government's glancing blow to that skull.This is basically just a pithier version of what I said ten years ago in ["Why I Am Not an Austrian Economist"](http://www.gmu.edu/departments/economics/bcaplan/whyaust.htm):What I deny is that the artificially stimulated investments have any tendency to become malinvestments. Supposedly, since the central bank's inflation cannot continue indefinitely, it is eventually necessary to let interest rates rise back to the natural rate, which then reveals the underlying unprofitability of the artificially stimulated investments. The objection is simple: Given that interest rates are artificially and unsustainably low, why would any businessman make his profitability calculations based on the assumption that the [low interest rates](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html) will prevail indefinitely? No, what would happen is that entrepreneurs would realize that interest rates are only temporarily low, and take this into account.[...]Why does Rothbard think businessmen are so incompetent at forecasting government policy? He credits them with entrepreneurial foresight about all market-generated conditions, but curiously finds them unable to forecast government policy, or even to avoid falling prey to [simple accounting](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html) illusions generated by inflation and deflation... Particularly in interventionist economies, it would seem that natural selection would weed out businesspeople with such a gigantic blind spot. Admittedly, some Austrians have tried to answer this charge by positing some sort of Prisoners' Dilemma, but this doesn't work either:It should be noted that other Austrians, particularly Roger Garrison, attempt to handle the expectational objection. Garrison astutely notes that "[M]acroeconomic irrationality does not imply individual irrationality. An individual can rationally choose to initiate or perpetuate a chain letter... Similarly, it is possible for the individual to profit by his participation in a market process that is - and is known by that individual to be - an ill-fated process."[50] This is definitely a possible scenario. But does it make sense in this particular case? It does not. Naturally, entrepreneurs will not turn down lower interest rates. Rather, the rational response to artificially low interest rates is to (a) make investments which will be profitable even though interest rates will later rise, and (b) refrain from making investments which would be profitable only on the assumption that interest rates will not later rise. If entrepreneurs followed this rule, then there would be no tendency for policy reversals to produce malinvestments.If my long self-quotations are putting you to sleep, let me end with a fortune cookie:The roots of the business cycle lie not in praxeology, but [in psychology](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html).**Comments and Sharing**CATEGORIES: [Macroeconomics](http://econlog.econlib.org/archives/macroeconomics/) Follow [Bryan Caplan on Twitter](http://twitter.com/bryan_caplan) COMMENTS (22 to date)[Latest Comment](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32028)Horatio writes: People aren't rational. The average Joe investing in real estate in 2004 did not know how to forecast changes in government policies. He got caught up in the rush. In a free market, he would still be vulnerable to his [psychology](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html), but interest rates would not be vulnerable to government meddling. I expect human psychology to be better adapted to free markets than fettered markets. You are on the right track, but the government certainly has a role in generating malinvestments.The investment banks asking for a handout should have known better. They probably did and figured they could get the government to bail them out.Posted [January 2, 2008 6:33 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32007)RobbL writes: So, Horatio, head they win and tails you lose? Investment bank CEOs have it both ways. They either deserve their enormous salaries because they bet right in the market or because they bet that the government will clean up after their disasters....How is it working out this time around? not so good. Of course it is early times yet for this particular greed fest.Posted [January 2, 2008 6:51 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32008)arrow writes: One could also argue that the Austrian Business Cycle Theory can be made consistent by relaxing the optimistic assumptions about entrepreneurial foresight. Some Austrians may be reluctant to do this but the recent housing bubble seems to provide support for this.BTW, I have always wondered what Bryan Caplan's position on the gold standard is.Posted [January 2, 2008 7:47 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32009)Austro-libertarian writes: Bryan in case you haven't already reviewed these arguments, here is an engaging presentation of why Entrepreneurs are unable to avoid being fooled by interest rate manipulation. I think it answers your core objection nicely. http://www.mises.org/story/2673Posted [January 2, 2008 9:06 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32010)Stephen Smith writes: People aren't rational. The average Joe investing in real estate in 2004 did not know how to forecast changes in government policies.People who bought real estate in Florida in 2004 clearly weren't acting rationally, but I think it's a bit of a stretch to declare from that that "people aren't rational." Rationality depends on continuity, and government policy is a huge impediment to continuity. The investments of ordinary consumers are often driven more by inflation than anything else -- if the money supply were constant in either its totality or even in its per capita amount (or only increased by very small amounts, as would gold under a system of free banking), prices would be always going down, and one's purchasing power would in fact be rising throughout time rather than falling. So many investments (especially things like savings accounts and low-interest instruments that are as good as a 100% guarantee) wouldn't even be made without the constant inflation of our money supply, and you'd have to be crazy to say that this doesn't screw with our natural proclivities for rational thought. It's like setting someone's house on fire and then when they fall to their death out the window in a useless attempt to save themselves calling them "irrational." They shouldn't have (and, ceteris paribus, without you setting the house on fire/without the government sticking its hands in just about everything without any expectation of profit, WOULDN'T have) been put in that situation to begin with.Posted [January 2, 2008 9:24 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32011)[Steve Miller](http://www.stevecmiller.com) writes: "Rather, the rational response to artificially low interest rates is to (a) make investments which will be profitable even though interest rates will later rise, and (b) refrain from making investments which would be profitable only on the assumption that interest rates will not later rise."That's still consistent with ABCT and Garrison's story. As you say, his argument is that bunch of individually rational investments are macro-irrational. "Human capital" example: rates are low today so I get a student loan locked in at 5% permanently. Even if rates go up, my borrowing was rational, given my expected future earnings. Further, I discount my expected future earnings because I realize many others will behave similarly (this requires a very strong assumption of substantive rationality, but I'll go along with it). The end result is I have more education than otherwise, and at the low rates it was worth it, and the same goes for everyone else who made the same decision. The macro result? My wages are higher, *but even those who didn't invest in education have their wages pushed down by those of us who did* (remember question #10 from your assigned homework #4 in Labor Econ? -[**link**](http://www.gmu.edu/departments/economics/bcaplan/e321/hw4.htm) - the total earnings actually fall, and only partly from a reduction in the college "premium"). The structure of production in labor markets has changed. A reduction in the interest rate leads more people to rationally get college degrees (a long-term project), and this causes total earnings to fall. Very Austrian, and very Caplanian.Posted [January 2, 2008 11:15 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32012)Matt writes: Talking about the business cycle, especially as to its potential causes.Arnold's model of the simple business agent that can estimate and counteract business cycles is incomplete. The market for monetization of debt is a highly correlated market when the monetary authority is a singular monopoly. So, the simple business agent is guaranteed to see any monetary effects after the larger agents more correlated with the monopoly bank.So, if one looks at a standard wealth distribution, then one sees a differential phase shift from right to left, from the position of the central bank. Differential changes in fed policy take time to reveal themselves to agents farther to the left.When the bank phases it cycles with the federal legislature, then one can get undamped oscillations because the federal legislature sits even further to the right of the monopoly bank.The problem with predictive correction is that the fed, of necessity, works closely with the data gathering function of its highly correlated regional banks. By the time we see a fed policy shift, most of the economic agents to the right of us have already priced the change in. Why does this produce change in time? All markets (all mammalian herds) operate to acheive a standard normal distribution in value over a fixed time \* space window. Hence, when a highly correlated (monopoly generally) change occurs in X, the herd corrects in time. In essence, the herd acts as if it has a gaussian kernel in variables time, space; the time constant of this kernel is determined by the evolutionary herding constant.The psychology, and math; then is quite simple. We all predict prices, we all estimate the movement of the herd, we all feel comfortable with a fixed, constant amount of variance in herd position.When we cause a phase shift in X, the herd corrects in t. This, getting us back to the fundamental causes of growth, or efficiency improvement. It is the ability of the human (or mammal) to shift value in time more efficiently to make the spread of the herd more Guassian over the terrain. Beavers have a different constant then squirrels and apes.Wealth is a measure of power, so units must be kept in mind. For the cow herd, the units of wealth are cow\_kisses\*unit of grass. Which is to say that evolution tries to get the maximum number of cows kissing with the most amount of grass per cow over a fixed time\*space window, so as to approximate the steady state carrying conditions of the terrain, and the resultant with be gaussian distribution in wealth.If we go back to the herd of cows in a box canyon, we can see this effect. The bull is in the center, wealth will be Gaussian; and solving for the herd shape would likely lead to a Bessel function, very mathematical indeed. The herd will vibrate like a drum, each concentric ring of cows altering the amount of grass each has and the number of cow interactions over time.The reason evolution uses the Gaussian distribution is that that distribution can hold the most variation in the smallest space. Evolution seeks to maximize biological work.One can actually construct the spectral shape of the inflation cycle, and determine its characteristic time period with a simple model of inflation expectations as that described above. Brad Delong has done this. The cause of cow herd vibrations are the highly correlated interaction of the bull in the center and the groups of other male in the ring just outward. This interaction results from the monopoly position of the bull and groups of market fixers in the next ring outward. The bull and adjacent cows are right at the center of the market and cannot achieve the comfort zone for variation in grass\*cow\_kisses. They form incomplete markets in the center.So, the ultimate quantum effect in cow herds, again, comes a normal expectation of fixed uncertainty, and drive built into cows, they are disturbed when thing are too uniform, or too chaotic. This is an integral theory of economics, while the utility theory would be a differential theory of economics. They should match in any correctly framed mathematical framework.Posted [January 3, 2008 5:16 AM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32013)eddy writes: "Given that interest rates are artificially and unsustainably low, why would any businessman make his profitability calculations based on the assumption that the low interest rates will prevail indefinitely? No, what would happen is that entrepreneurs would realize that interest rates are only temporarily low, and take this into account."The entrepeneur responds to low int. rates in the same way as the Pavlov dog. Once the bull cycle has started (in housing, capital goods, etc) it is inmaterial "if the int. rates are temporarily low".EVEN if you believe int. rates are going to reset much higher, you are much better going into the game and then "flip" the hot potato (house, firm etc) into some other moron. I can say this certainly becausea)I have succesfully flipped some properties.b) I believe in the Austrian school a thought the r.e. boom was unsustainable.Posted [January 3, 2008 6:24 AM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32014)8 writes: If the Fed cut interest rates to 1% tomorrow, what industry will end up with overinvestment in 2011?When the economy contracts, will it lose all the gains caused by lower interest rates or will those losses be concentrated in certain industries? And will the losses wipe out all the gains, or just some of the gains, such that an early investor will still come out ahead?Posted [January 3, 2008 11:08 AM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32015)ted writes: Horatio:rationality does not mean stupid.Its the idea of basing actions off of reason vs off of emotion. When determining rationality, take into account the knowledge of the individual at the time of the decision.A lot of people make that same mistake.Posted [January 3, 2008 12:24 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32016)TDL writes: To add on to ted's statement; entrepreneurs have to act and they can only act with the information that they have at the moment.Regards,TDLPosted [January 3, 2008 1:44 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32017)Wojtek writes: Going back to Bryan's first comment:"What I deny is that the artificially stimulated investments have any tendency to become malinvestments"I fail to see how you could deny this. I submit that this is precisely what happens. But not because investors suddenly become reckless, but because in a high interest rate market, people who call themselves "investors" are actually known by the moniker "non-credit-worthy failures". It's not the mentality that changes, but the cross-section of people who "invest". They may not survive the downturns, but their certainly compete with sound investments in the short-run.Posted [January 3, 2008 3:29 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32018)[liberty](http://economicliberty.net) writes: I may be misunderstanding Austrian economic arguments by my assumption, but you say:"Supposedly, since the central bank's inflation cannot continue indefinitely, it is eventually necessary to let interest rates rise back to the natural rate, which then reveals the underlying unprofitability of the artificially stimulated investments." with regard to :The Austrian story is that "the government distorted price signals to the market."And then argue that people are too smart to be hoodwinked by artificially low rates. OK. But what about distorted price signals that may never change - but then do. Can't they cause business cycles? For example, government subsidies in health care or agriculture or housing or oil or profit caps ... those price distortions may last forever. An investor would reasonably expect them to last indefinitely. But then some kind of policy shift, or lack of action (so that inflation combined with changes in other markets cause a reduction in real value) begins to take effect. Expectations and reactions could be quite irrational at that point with many different possible policy responses... Just an idea.Posted [January 3, 2008 5:03 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32019)jm writes: *"... Given that interest rates are artificially and unsustainably low, why would any businessman make his profitability calculations based on the assumption that the low interest rates will prevail indefinitely? No, what would happen is that entrepreneurs would realize that interest rates are only temporarily low, and take this into account."*The above is is a truly bizarre statement.Time and again during the real estate bubble years, articles appeared in the press by big-name economists averring that it was completely appropriate for home prices to rise as interest rates fell, because the same monthly payment would support a higher price. Clearly, either none of those big-name economists was able to foresee the possibility that mortgage interest rates might eventually rise once more, or else they were unable to comprehend the consequences to the "homeower" of having made a highly leveraged investment on an interest-rate sensitive asset.Perhaps since I am writing to economists here, I will need to point out that for the same reason falling interest rates reduce the monthly payment needed to purchase a home at a given price, rising interest rates raise the payment, often requiring that it be sold at a lower price, such that if the owner ever has to sell for any of those myriad reasons that so often force sales -- job transfer, illness, job loss, divorce, etcetera etcetera -- he or she will go away with reduced or zero equity, and perhaps be unable to buy again for many years, so that the wise price to pay for a home is determined not by the monthly payment at the time of purchase, but rather by some rather more complex function that takes such risks into account.Since typical businessmen are presumably not all that much more intelligent than the typical big-name economists quoted in the national press, it's hard to see why we should expect them to not to make the same errors.Posted [January 3, 2008 9:37 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32020)jm writes: Further to the above, even those entrepreneurs able to perceive that interest rates will not remain low indefinitely will in many cases be making profitability calculations based not on the assumption that the low interest rates will prevail indefinitely, but rather on the assumption that less intelligent actors in the system -- consumers, politicians, economists, etc -- will be unable to perceive that, and will exploit "plausible deniability" to promote malinvestment in ways profitable to themselves though unprofitable (perhaps highly unprofitable) to society as a whole. I seem to recall having read about some instances of this recently.Posted [January 3, 2008 11:39 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32021)SheetWise writes: *The objection is simple: Given that interest rates are artificially and unsustainably low, why would any businessman make his profitability calculations based on the assumption that the low interest rates will prevail indefinitely?*I wouldn't. I would make my calculations based upon the assumption that some other fool will allow them to prevail for me -- for the next 30 years.*No, what would happen is that entrepreneurs would realize that interest rates are only temporarily low, and take this into account.*Damn right we would. We'd take a 60 year mortgage on low rent housing, if it was offered.*The roots of the business cycle lie not in praxeology, but in psychology.*The roots of praxeology are greed, in psychology they're ignorance.I am a son, a person, and a father. There are things I owe to my children, myself, and my parents -- chief among them, is to be honest. Greed is honest.As for ignorance -- It doesn't matter how many generations pretend that they can retire on the earnings of their children, it's not true and it's dishonest. The rules can be changed to make the lie come true -- but it's still a lie. And it's a cyclical lie.I prefer honesty.Posted [January 3, 2008 11:55 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32022)Gary Rogers writes: How can a government that is spending 2.8 trillion dollars a year not be distorting market signals. It struck me yesterday when I read John Edwards editorial in the Wall Street Journal that his point about the middle class not being able to afford health care, mortgages or higher education is true, not because of the class inequalities that Mr. Edwards professes, but because these are the areas the government subsidizes the most. The more the government subsidizes the more prices go up and the middle class is priced out of the market, that is unless the government steps in to provide more help as Mr. Edwards proposes.As for businessmen forecasting that prices had to fall because they cannot continue to increase forever, that is 20/20 hindsight. Housing prices rose continuously for 40 years and I think it is too much to expect anyone to know beforehand that after 40 years the time for an adjustment has finally come. In fact, I would be surprised if enterprising people did not follow the money into these markets. Although some people are going to get burned, a lot more saw their rising home equity as their only hedge against inflation.So here is where we are today. The government has been spending more than they take in since the 1980's, which does distort market signals. It also would be inflationary except that the Fed sold bonds to pull money out of the supply. This keeps inflation under control, but causes more distortion because the bonds were purchased by foreign entities with dollars obtained from selling to us and a higher saving rate than we have. This pulls dollars out of the money supply, but they are the dollars that should be purchasing our exports. It is very much like paying some of the bills each month by putting them on the credit card. It works well as long as you are under your credit limit, but it cannot go on forever.Just like when a family goes into debt, going into debt is easy and fun. Paying back what you owe can be slow and painful. My questions are, how long can we continue to borrow? What is our credit limit? How tolerant will our lenders be when the time comes to pay up? We are fortunate to owe the money in dollars so we can inflate some of the debt away, but when you are the debtor you are not in the drivers seat. I am still afraid that when this time comes, the sub-prime mess will take on a new perspective.Posted [January 4, 2008 2:10 AM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32023)[liberty](http://economicliberty.net) writes: "How can a government that is spending 2.8 trillion dollars a year not be distorting market signals. It struck me yesterday when I read John Edwards editorial in the Wall Street Journal that his point about the middle class not being able to afford health care, mortgages or higher education is true, not because of the class inequalities that Mr. Edwards professes, but because these are the areas the government subsidizes the most. The more the government subsidizes the more prices go up and the middle class is priced out of the market, that is unless the government steps in to provide more help as Mr. Edwards proposes."Amen. Well said. And then what happens when government steps in again (and again...) to bail out the folk who have once again been priced out by the effects of government action? I am enticed by your (quite accurate) telling of this story.Posted [January 4, 2008 12:37 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32024)fundamentalist writes: Caplan makes the mistake of limiting the ABCT to just interest rates, thinking that the malinvestment caused by lower rates will become apparent only when interest rates rise. But that is not the ABCT. Hayek in "Pure Theory of Capital" makes it clear that artificial interest rates cause distortions in the real economy that will cause recessions regardless of whether the Fed raises interest rates later. The main problem that artificially low interest rates cause is a distortion of the relationship between capital goods production and consumer goods production. Low interest rates stimulate investment in capital goods, but the increased employment causes increased spending on consumer goods. Since production of consumer goods hasn't increased, prices and nominal profits rise. At the same time, the costs of inputs in capital goods production have risen as a result of increased demand and profits fall. Falling profits in capital goods production coupled with rising profits in consumer goods causes investors to shift funds to production of consumer goods and the recession starts. In addition, Bryan seems to repeat the neo-classical mistake of crediting entrepreneurs with near-perfect knowledge. As Hayek points out, the lack of knowledge is one of the main problems. On top of that, the Fed pokes the entrepreneur in the eye by distorting the interest rate signal that entrepreneurs use to make decisions. So blaming the entrepreneur for having poor vision when the Fed blinds him is a little odd.Posted [January 4, 2008 12:59 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32025)Stephen Forde writes: The ABCT is easy to explain in neoclassical terms. I don’t see why Caplan rejects it. The rate of interest is the price paid on money borrowed over a temporal period. Like all market prices it coordinates interaction on the market. When more people save and invest, the price will fall. When the price is lower, more people will borrow consumers and entrepreneurs. When it is lower, fewer people will save. The interest rate coordinates the interaction between consumer spending and entrepreneurial borrowing over time. Consumers don’t spend all their money at once. They save some so they can spend later. The more they prefer future spending to current, the more they will save. When this happens, entrepreneurs are faced with a lower interest rate. Capital costs over a longer planning horizon are lower. Accordingly, the overall rate of investment in capital goods temporally further from the final consumer goods in the structure of production will rise. Obviously, when the government starts messing around with the rate of interest, it’s going to screw things up. It increases the ratio of immediate consumer spending to saving. Consumers will buy more immediate goods and fewer mediate goods. Entrepreneurs will invest more heavily in future production, and less heavily in immediate production. Production and consumption become misaligned. The entrepreneurs will eventually realize that they won’t be able to sell their products at a sufficiently high price to cover their costs. Even if a few entrepreneurs realize what’s going on, how does that help them? The increased investment by competitors is still going to drive up the costs of capital and wage rates. Their profitability will be reduced by this. And furthermore, consumers will increase current spending at the expense of future spending. This will reduce the profitability of any investments the entrepreneur has in future production. Unless fully anticipated ahead of time, anytime the government bids down the interest rate with monetary expansion, entrepreneurs will experience losses or lower profits than otherwise. I’d like to hear Caplan’s full explanation of the business cycle. It’s not on his website.Posted [January 5, 2008 12:52 AM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32026)George P writes: Mr. Caplan writes:Given this, I conclude that while self-labeled Austrian economists have some valid contributions to make to economics, these are simply not distinctive enough to sustain a school of thoughtAre you kidding? Clearly, if you ever studied Austrian economics you were not paying attention. This criticism can be leveled at the neo-classical school which appears to be a constant repair job at its own shortcomings. The Austrian school is the only tradition which attempts a broad unified theory of economics. You may disagree with it on a number of grounds but to say it is not of sufficient substance to constiture a school of thought is simply false.There are so many items here which are either mistatements or misunderstandings of Austrian theory that it is difficult to take the author's claim that he has studied Austrian economics seriously.For instance, at one point he writes: There is however a more serious flaw in Rothbard's welfare economics - a flaw which again flows from his behaviorist insistence that only preferences demonstrated in action are real.But Rothbard never claimed that un-expressed preferences were not real but that they were not praxeologically significant. If I have an unexpressed preference for a million dollar house, it does not impact the housing market one bit until I actually express it by buying the house. The fact that everybody around me knows that I have this desire makes it "real" but so what?Posted [January 22, 2008 6:43 PM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32027)[rhys](http://conservativeamericanblog.com) writes: What I deny is that the artificially stimulated investments have any tendency to become malinvestments. Supposedly, since the central bank's inflation cannot continue indefinitely, it is eventually necessary to let interest rates rise back to the natural rate, which then reveals the underlying unprofitability of the artificially stimulated investments. The objection is simple: Given that interest rates are artificially and unsustainably low, why would any businessman make his profitability calculations based on the assumption that the low interest rates will prevail indefinitely? No, what would happen is that entrepreneurs would realize that interest rates are only temporarily low, and take this into account.If an artificially low and unsustainable interest rate stimulates investment, it is due to the fact that the rate is artificially low and unsustainable. Since the length of time that an artificial rate will exist is indeterminate, then investors are taking a chance that they will either conclude the deal before the rate returns to normal or that their capital projects won't require low interest rates before the artificial rate moves higher. In either case, the point of dropping the interest rate to an artificially low, unsustainable level is exactly to spur investment that is itself unsustainable at the natural rate of interest. So, to claim that an artificially low, unsustainable rate of interest will not cause the formation of capital projects that will be unviable at an indeterminate date in the future is to admit that there is no reason to drop the interest rate to an artificially low, unsustainable level in the first place.Posted [January 24, 2008 1:55 AM](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#32028)Comments for this entry have been closed[Read comments](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html#comments)[Return to top](http://econlog.econlib.org/archives/2008/01/whats_wrong_wit_6.html)  |
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