**<iframe width="420" height="315" src="http://www.youtube.com/embed/vIz57flWLns" frameborder="0" allowfullscreen></iframe>**

[**http://www.smithsonianmag.com/travel/cannibals.html**](http://www.smithsonianmag.com/travel/cannibals.html)

**Why Don't Entrepreneurs Outsmart the Business Cycle?**

**Mises Daily:** Tuesday, August 28, 2007 by [Brian J. Stanley](http://www.mises.org/daily/author/1005/Brian-J-Stanley)

The credit markets are in some turmoil, and numerous market watchers and commentators are calling for or even (like [Jim Cramer](http://www.youtube.com/watch?v=GY5nfytTQT8)) demanding a rate cut from the Fed. The immediate question for these market watchers, of course, is this: how will the market react to cuts, or to no cuts? But the broader question is, how will the underlying economy react?

The actions of the underlying economy are determined by business owners, entrepreneurs, who make decisions about how to invest funds, whether to expand or contract hiring, etc. So the basic issue, now and always, concerning Fed rate cuts and Fed [intervention](http://www.mises.org/daily/2673) in general is, how do entrepreneurs react to Fed intervention?

The Austrian [Business Cycle](http://www.mises.org/daily/2673) Theory (ABCT) holds, in part, that central bank intervention often causes interest rates to be artificially low, and these artificially low rates mislead entrepreneurs into making investment errors. The result of these errors is the familiar boom and bust cycle.

But other schools of economists disagree. A common argument against the ABCT is that entrepreneurs are too smart to be fooled by Fed intervention. The argument claims that entrepreneurs recognize the Fed actions and ignore the Fed by proceeding as if the [interest rates](http://www.mises.org/daily/2673) were where they would be if they were set by the free market and not by Fed intervention. If this contention is true, the ABCT is wrong in its conclusions about what causes the boom and bust cycle.[[1]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn1)

Do these critics of the ABCT have a point?

To assess the strength of the critics' argument, a brief overview of the basic ABCT is useful.[[2]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn2) In part, the ABCT says that, without central bank involvement, the time preferences of market participants set interest rates; and interest rates reflect the risk level of projects undertaken by entrepreneurs. When the central bank injects money into the system, this artificially lowers interest rates, and entrepreneurs react as if the "natural" interest rate had fallen because of market fundamentals.

The entrepreneurs then undertake projects that weren't profitable at the higher rate. Because long-term projects are normally inherently riskier than short-term projects, the [new](http://www.mises.org/daily/2673) projects are disproportionately long term. These are projects related to the higher stages of production, those far removed from the low-level stages where goods for immediate consumption are produced. Such long-term projects create the infrastructure that allows for increased production in the future, and they are financed by the savings built up by consumers in a previous period when their time preferences were higher and they tended to save more and spend less.[[3]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn3)

But, because the lower rates are the result of the injection of money — a medium of exchange, not [true wealth](http://www.mises.org/daily/2673) — by the central bank, many of these projects shouldn't have been undertaken. A misallocation of resources has occurred. When the central bank eventually raises rates artificially to combat the inevitable inflation that results from the money injection, the malinvestments become apparent, and entrepreneurs must abandon the now-unprofitable projects or sell them to mitigate their losses.[[4]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn4)

The critical argument has some superficial appeal. But it dissolves on closer examination, as numerous Austrian School writers have demonstrated.

**AUSTRIAN RESPONSES**

So the entrepreneurs should just recognize the artificially low rates and the excess liquidity and adjust. Good idea. But precisely how does one do that? For starters, how does one determine what the correct rates should be?

Roger W. Garrison has compared the entrepreneur's situation to that of a person whose radio signal is jammed. "[K]nowing that a signal is jammed is not the same things as knowing what the unjammed signal is," he wrote. He added:

During a monetary expansion the price of iron ore, for instance, may rise by eight percent. This eight percent rise may consist of an increase in the real price of iron ore (due to coincidental changes in the underlying real factors) of two percent plus a money-induced price rise of six percent. Or it may consist of some other combination of real and money-induced changes whose algebraic sum is eight percent.[[5]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn5)

Robert Murphy and Mark Erickson use a similar image to describe the confusion the entrepreneur faces:

[E]ven agents with RE [rational expectations] will be more likely to commit more than a critical number of errors over time, if we add noise to the signal on which they rely for guidance. Yes, the agents will take into account this extra noise when making their decisions, but they cannot completely offset it.[[6]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn6)

As Murphy and Erikson note in the same article, entrepreneurs must not only take into account the current central bank intervention, but the fact that intervention has been occurring for decades. As they point out, those who claim entrepreneurs would anticipate and adjust to the credit loosening "assume — at least with their description of the boom — an initial free market state, and then analyze the impact of a one-shot intervention." This is unrealistic, of course. They continue:

If *this* were really what happened, then yes, it would be surprising if rational businesspeople continually fell for the ruse. However, in reality the government (in each major country) has implemented a permanent intervention in the credit market by the creation of a central bank (or a centralized system of banks). Actors in these economies have no idea what the free market rate of interest would be in the absence of such interference; even if the Fed *raises* rates, the new rate could still be below the "natural rate" of canonical ABCT.

Gene Callahan has also addressed the fact that the "natural" interest rate long ago disappeared in a haze of governmental meddling:

When, exactly, could we point to a time when we saw that rate [the natural rate] on the market? The Fed is always intervening, attempting to establish *some* rate. We might assume that, at least some of the time, the Fed-influenced rate has been close to the market rate, but how do we know at *which* times? … Fed watchers might be able to tell entrepreneurs that the Fed is easing. But is it easing toward the market rate of interest from some level above it, or further past the market rate from some level already below it?[[7]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn7)

Those who expect entrepreneurs to perform such calculations are simply asking too much. As Callahan sums up this point, "The idea that entrepreneurs are committing significant errors by not somehow divining where the rate ought to be is to criticize them for lacking superhuman capacities."

Callahan also notes that, while many business people have certainly gotten more sophisticated in their analysis of the Fed and its actions, the Fed has gotten more sophisticated in its analysis of business people. He writes:

If businessmen feel the Fed will raise rates, and therefore they refrain from hiring, undertaking new projects, making new capital good orders, and so on, then the Fed, watching the statistics collected on new hires, capital good spending, etc., will be *less* likely to raise rates. The Fed will explain that the economic growth seems "under control."

The entrepreneur, then, pursuant to the argument under consideration here, must not only sweep away the fog of years of past interventions, he must also predict what the Fed will do in the future and when it will do it — all while the Fed tries to anticipate what the entrepreneurs will do.

It seems that any entrepreneur who attempts to undertake such investigations would have little time for things such as serving his customers, improving his product and responding to his customers' preferences. These things, after all, are what entrepreneurs do, and it is these day-to-day operational skills that make the capitalist economy efficient and productive.

Garrison addressed this issue when he discussed Hayek's contention that there are two kinds of knowledge in relation to the economy:

Hayek's distinction … between two kinds of knowledge allows us to take account of what market participants can and cannot reasonably be expected to know. The distinction is that between the knowledge of the particular circumstances of time and place (that is, normal market information coupled with various degrees of entrepreneurial insights) and scientific knowledge (that is, an understanding of how the economic system works — knowledge of the structure of the economy). Market participants can reasonably be expected to have the first kind of knowledge, but not the second kind. Given their knowledge of the particular circumstances of time and place, they can be induced by market-determined prices to behave "as if" they understood the structure of the economy. But they cannot be expected to correct for money-induced price distortions on the basis of an actual understanding of the economy’s structure.[[8]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn8)

The critics would respond, no doubt, that many businesses can hire experts to perform the calculations for them. That is certainly true, though it is also true that most businesses — especially small businesses, the majority of businesses in the United States — cannot afford such experts. But, more importantly, even if all companies could obtain expert advice, would this matter? Why should we assume that all, or any significant portion, of these experts would conclude that Fed intervention is a problem to be dealt with? Not all economists are Austrian. Many adamantly reject the ABCT. So how would this mix of conflicting advice somehow allow masses of entrepreneurs, and hence the economy itself, to avoid the ill-effects of Fed intervention? As Garrison concluded:

Some believe that the economy works in the manner envisioned by Keynes or by his many interpreters, some believe that the economy is more accurately depicted by the Classical model, and some believe that the economic relationships identified by the Austrians are essential to the understanding of the economy's structure.…

It would be an amazing feat for market participants [or their consultants] either individually or collectively to single out not only the correct theoretical framework but also the parametric values that are currently applicable.[[9]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn9)

How reasonable is it to assume that vast numbers of entrepreneurs and their economic advisors would understand and accept as accurate the teachings of the Austrian School? Then, as noted throughout, even if they did, could they avoid the problems caused by the intervention? Is this expecting entrepreneurs and their advisors to have "superhuman capacities," as Callahan states?

It seems likely that even if most entrepreneurs accepted the ABCT and tried to avoid being pulled into the cheap-money morass, there would be those who would knowingly borrow at the below-market rates and take the risks associated with the loans. These companies would be those that were undercapitalized, perhaps startups or companies in trouble. In short, they would be the companies that had nothing to lose. And, eventually, they might pull the stronger companies into the fray. For example, Callahan explains the situation this way:

Even if they [companies that are not financially stable] *could* tell that they are witnessing an artificial boom, it might make sense for them to "take a flier" anyway. As it is, they are either not capitalized, or on the verge of failing. If they ride the boom, they will have a couple of years of the high life. And who knows, their business just might make it through! Or, perhaps, they will build a sufficient customer base to be purchased, maybe even enough to retire on. In that case, it might not matter to them if their company ultimately fails.

And, as Callahan also notes, the companies with little to lose that take advantage of the cheap money eventually begin to threaten the more stable, economically informed companies, which are trying to avoid the boom:

Although the most skilled entrepreneurs suspect that the expansion is artificial, most can't afford to shut down their business for the duration of the boom. But if they can't, they must increasingly compete with [the struggling companies who borrowed] for access to the factors of production.

The competition for the factors of production drives up costs for all companies, not only the ones who, intentionally or obliviously, have leapt into the pool of Fed-created capital. So, the stable companies trying to avoid the artificial boom are faced with difficult choices, and many will be forced to participate in the boom, even if they know better.

Of course, in the real world, the entrepreneurs running these firms will not know exactly where interest rates should be, so they will not know how much risk they are undertaking. If, for example, market rates are at 2% and the entrepreneurs think that the natural rate would be at 7%, the entrepreneurs might be more willing to avoid the boom. But they can't know this. All they can know is that they believe the market rates are too low — though, of course, the market rates might actually be the natural rate, in which case the entrepreneurs would be making an error by not undertaking appropriate long-term projects.

The bottom line is, the Fed intervention causes confusion and makes decision-making riskier than it would be in a free-market environment. As the ABCT says, it causes entrepreneurs to make clusters of mistakes.

That opportunity costs are driven artificially low also puts pressure on entrepreneurs to participate in the boom. The prevailing interest rate matters not only because it is the borrowing rate, of course, but because it sets the risk-free rate, or the opportunity cost, for investments. If a company determines that a project will return 5% a year but it can get 5.5% on savings, a relatively risk-free return, normally the company will opt for the safe 5.5% return. But when Fed intervention drives rates below the natural rate, risk-free returns are below where they should be.

For example, say Company XYZ reviews several projects and determines that none will return more then 5% a year. Company XYZ's managers think that, were they in a free market, the natural rate would be 5.5%. (They can't actually determine this, but assume they can for the sake of argument.) So, they want to opt for the risk-free return of 5.5%. But wait. The 5.5% return doesn't exist, because the Fed has driven rates to artificial lows, and the best they can get is, say, 4%.

Here the ABCT critics' admonition to act as if natural rates existed is meaningless advice. The managers can't act as if 5.5% existed and opt for it as their risk-free rate, because it doesn't exist in the real world. The risk-free rate is 4%.

The managers can either take the 4% risk-free return or pursue the 5% return, with our without borrowed money, realizing that they might never complete the project if the boom turns to bust too soon. But the concept of opportunity cost is skewed here, because the available opportunity cost is 4%, though it should be 5.5%. Pursuing the 5% return leads to more risk than is necessary. And, again, the artificially low rates cause entrepreneurs to accept excessive risk, which risk can't be avoided by anticipating and adjusting to the Fed easing.

Note, too, that if Company XYZ has shareholders or investors, the managers (or ultimately, the directors) may be under pressure from them to pursue the 5% return. Unless the shareholders or investors are all students of the Austrian School *and* agree that the natural rate would be 5.5%, they aren't likely to look kindly on a decision by the managers or directors to opt for a 4% risk-free return instead of pursuing a project that will return 5%. So the managers or directors might have to pursue the 5% return to avoid claims of mismanagement or even breach of fiduciary duty. Again, how can these entrepreneurs follow the critics' advice and adjust to and avoid the effects of Fed intervention?

**CONCLUSION**

|  |  |  |  |
| --- | --- | --- | --- |
|

|  |  |
| --- | --- |
| http://images.mises.org/MisesDaily/desoto.jpg | [$45](http://mises.org/store/Money-Bank-Credit-and-Economic-Cycles-P290C0.aspx) |
| "Despite what critics of the ABCT say, entrepreneurs can't easily avoid the effects of Fed intervention." |

 |

Despite what critics of the ABCT say, entrepreneurs can't easily avoid the effects of Fed intervention. It isn't possible to determine what the natural rate should be. Small businesses particularly can't be expected to recognize and react to Fed intervention, and there is no evidence that even large, sophisticated businesses can perform any relevant and meaningfully accurate calculations and forecasts.

Even if it were possible to make these calculations, many struggling entrepreneurs, having little to lose, would participate in the boom, putting competitive pressure on entrepreneurs who would prefer to avoid the boom. Under any reasonable scenario, Fed intervention increases the risk level by making decisions more difficult and forcing entrepreneurs to focus on unknowable, policy-related issues instead of operational and customer preference matters.

Ultimately, the criticism of the ABCT goes to a fundamental disagreement between the Austrian School and other schools of economics: the effectiveness, or lack thereof, of economic models, especially mathematical models.[[10]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_edn10) Those who encourage entrepreneurs to analyze the Fed's actions and adjust their actions accordingly are, in effect, saying that the entrepreneurs should utilize modern economic models to understand and predict economic activity. But, again, there is no evidence that such effective models exist.

In fact, if economic models were truly effective enough to allow entrepreneurs to determine precisely the effects of Fed actions, these super-accurate models would prevent the Fed from making mistakes in the first place and there would be no negative effects to avoid.

Brian J. Stanley is Vice President and General Counsel for The Hefner Company, Inc. Send him mail. Comment on the [blog](http://blog.mises.org/).

**NOTES**

[[1]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref1) For versions of this argument, see Gordon Tullock, "Why the Austrians Are Wrong About Depressions" (available in [PDF](http://mises.org/journals/rae/pdf/rae2_1_4.pdf)) and Bryan Caplan, ["Why I Am Not an Austrian Economist."](http://www.gmu.edu/departments/economics/bcaplan/whyaust.htm)

[[2]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref2) For much more thorough explanations of the ABCT, see Roger W. Garrison, ["The Austrian Theory: A Summary,"](http://mises.org/tradcycl/theorsum.asp) and Ludwig von Mises, ["The Austrian Theory of the Trade Cycle."](http://mises.org/tradcycl/austcycl.asp)

[[3]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref3) For thorough explanations of the production cycle and the relationship among consumption, spending, and wealth creation, see Frank Shostak, ["The Subsistence Fund,"](http://mises.org/daily/1596) and Roger W. Garrison, ["Overconsumption and Forced Saving in the Mises-Hayek Theory of the Business Cycle,"](http://www.auburn.edu/~garriro/strigl.htm) *History of Political Economy*, Vol. 36, No. 2 (Summer 2004).

[[4]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref4) An instructive analysis of central bank intervention, interest rates and the ABCT is Frank Shostak, ["The Myth of the Neutral Interest Rate Policy."](http://mises.org/daily/1743)

[[5]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref5) Roger W. Garrison, ["Hayekian Trade Cycle Theory: A Reappraisal."](http://www.auburn.edu/~garriro/c4refah.htm)

[[6]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref6) Robert P. Murphy and Mark Erickson, "The Rational Expectations Objection to Austrian Business Cycle Theory: Prisoner's Dilemma or Noisy signal?" available in [PDF](http://www.sjsu.edu/depts/economics/faculty/powell/docs/econ206/BusCycle-Murphy.pdf). Rational Expectations is an economic theory that holds, among other things, that business people anticipate and adjust to governmental actions, rendering the actions ineffective.

[[7]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref7) Gene Callahan, ["Times Are Hard: On the Causes of the Business Cycle."](http://mises.org/daily/2121) Italics in original.

[[8]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref8) Garrison, [1986](http://www.auburn.edu/~garriro/c4refah.htm). Garrison is citing Hayek, ["The Use of Knowledge in Society,"](http://www.econlib.org/library/Essays/hykKnw1.html) 1945.

[[9]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref9) Garrison, [1986](http://www.auburn.edu/~garriro/c4refah.htm).

[[10]](http://www.mises.org/daily/2673%22%20%5Cl%20%22_ednref10) Ludwig von Mises, ["The Plight of Business Forecasting."](http://mises.org/efandi/ch23.asp)