

A BCT IS NOT ABCT: A REJOINDER TO BRIAN SIMPSON

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Brian Simpson (2017) in responding to my lengthy review of his two volume *Money, Banking, and the Business Cycle*, provides a welcome opportunity to identify the main distinctions between Simpson's business cycle theory and Austrian business cycle theory (ABCT). Simpson's earnest pleas to the contrary, I nevertheless remain unmoved that he advances our understanding of ABCT. In his response, Simpson asserts I made several errors in my initial review. In this response to Simpson, I will narrow the focus by only discussing our differences about the nature of the business cycle, as this is what I understand to be of most fundamental importance.

When attempting to explicate a theory of the business cycle, it is important to identify and distinguish between those components that are necessary features of the cycle and those that are merely incidental. As is well documented in the economic literature, the key necessary factor of the business cycle is malinvestment in the intertemporal production structure. It is important to remember that the business cycle is a *cycle*. ABCT explains that recessions are endogenous market responses to booms generated by exogenous

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monetary inflation (Garrison, 1989, pp. 6–7). The important question to ask is what precisely causes the cluster of entrepreneurial error that results in the bust. After all *something* has to get the cyclical ball rolling.

To identify what this something is, Ludwig von Mises (2006a [1928]) developed what became known as Austrian Business Cycle Theory by bringing together and integrating three lines of economic thought. He incorporated Knut Wicksell's concept of the natural interest rate, Eugen von Böhm-Bawerk's capital theory in which he describes the intertemporal capital structure, and the Currency School theory of the effects of credit expansion via the issuance of fiduciary bank notes. Mises rightly extended the Currency School theory to include demand deposits which serve the same economic function as bank notes.

Mises (1954 [1912], 357–366; 1998 [1949], 535–583) explained that, in our modern monetary economy, bank credit expansion not funded by voluntary savings leads to capital malinvestment resulting in a boom/bust business cycle. Indeed, ABCT as it has been developed by numerous economists understand the cause of the malinvestment that triggers the business cycle to be due to artificially low interest rates (Garrison, 1989; 2001, pp. 69–71; Haberler, 1983 [1932], pp. 14–15; Hayek, 1967 [1935], pp. 54–65, 85–91; 2008 [1933], pp. 60–62, 67–68, 73–75; Huerta de Soto, 2006, pp. 348–360; Macovei, 2015, pp. 416–418; Mises, 1954 [1912], pp. 357–364; 1983, pp. 2–3; 2006a [1928], pp. 109–111; 2006b [1931], pp. 160–163; Rothbard, 1983 [1969], pp. 29–30; 2000, pp. 9–14; 2004 [1962], pp. 996–1004; Salerno, 2012, pp. 15–24; Sieroń, 2016, p. 313; Strigl, 2000 [1934], pp. 111–116). Simpson (2014, vol. I, p. 74) himself recognizes this. The interest rate's essential role in the business cycle is nicely summed up by David Howden (2016, pp. 345–346) who recently notes, "the assertion that artificial reductions to the interest rate cause an unsustainable lengthening in the structure of production is the central tenet of the Austrian theory of the business cycle."

Lending institutions create fiduciary money through credit expansion. Such credit expansion entails lower money interest rates because in order for banks to find willing borrowers, they must make them an offer they cannot refuse. Banks lower the loanable funds rate so there will be people willing to borrow the money the banks are eager to create.

This artificial lowering of the interest rate is the catalyst for the business cycle, because it generates an inflationary boom. Entrepreneurial ambitions expand immediately which increases economic activity. New businesses are started with the necessary capital funds that can be obtained by lower priced credit. In any given economic situation, opportunities for production that can actually be carried out are limited by the supply of capital goods. With credit expansion in the form of fiduciary money, new investment projects appear profitable because the interest rate for loans is now below the natural rate established by market. Note that this assessment by entrepreneurs does not hinge on increased revenues resulting from increased spending. It is the result of decreases in the costs of borrowing due to the artificially lower interest rates. Additionally, because the present value of capital goods is the sum of their future marginal revenue products discounted by the interest rate, a decrease in the monetary rate of interest causes an increase in the prices of capital goods, which in turn results in capital gains before any rise in sales. The lower interest rates, therefore, serve as the incentive for malinvestment *before* a firm's revenues increase by even one dollar.

Businesses use the new money they borrow to bid away factors from other uses. Additional monetary units do not spontaneously create an increase in factors of production, so the stock of producer goods will be stable relative to the increased demand. Consequently, the prices of factors of production will increase.

The first prices to rise are those of raw materials, semi-manufactured goods, other higher order goods, and wage rates. Entrepreneurs will begin attempting to lengthen the structure of production. The prices of producer goods at stages farthest away from consumption increases. Resources begin to be shifted away from lower order uses to higher order uses. As these adjustments take place, the price differentials between products and their factors of production decrease all along the production structure.

This process is reversed as recipients of the new money spend it. The owners of original factors who receive increased money income allocate it according to their prevailing time preferences. Their spending will follow their same consumption/investment ratio. Production, therefore, no longer reflects voluntary time preferences. Businesses have been led to invest in higher stages

of production as if more real savings were available, when in fact they are not. Businesses have overinvested in higher stages of production and underinvested in lower stages of production. ABCT sees the cluster of entrepreneurial error to be constituted in malinvestment, not overinvestment.

As the spending of the new money ripples through the economy, the price differentials between products and their factors of production will be reestablished at their previous larger spread. Prices of lower order goods will increase relative to those of higher order goods. Interest rates will increase to their previous levels. The monetary loan rate will follow the rate established in the production structure. It is even likely that the loan rate will spike up as businesses increase their demand for loans in the hope of saving their enterprises.

At this point, the crisis is revealed, and it becomes apparent that the expansion of business projects cannot all be brought to profitable completion. The new investment at higher stages will have to be liquidated or abandoned. Many new factories remain uncompleted. Other operations already completed shut down. Some still operate because, after writing off losses, they still generate some positive income. Entrepreneurial malinvestment induced by artificially low interest rates facilitating the expansion of credit in the form of fiduciary money sows the seeds of its own destruction. The process culminates in economic recession. Such are the basic outlines of ABCT.

We are now able to cast Simpson's theory in bold relief. Simpson (2014, vol. I, pp. 57–62) does agree with ABCT by citing an increase in the money supply as the cause of the cycle. He also recognizes that such inflation is accompanied by a decrease in interest rates, attributing this to the necessary consequence of central bank open market operations (Simpson 2014, vol. I, pp. 29–32). While alluding to the effects of increased reserves on the loanable funds market, Simpson does not explain the precise role commercial banks have in the process of lowering interest rates.

While Simpson does acknowledge the effect inflation has on market loanable funds interest rates, he argues that the primary cause of the business cycle is faster than expected monetary inflation that results in faster than anticipated increases in spending,

revenues, and return on investment (which he calls profit), because revenues are calculated based on current sales while costs are calculated based on past expenditure on durable capital goods (Simpson, 2014, vol. I, pp. 59–76). He does acknowledge that the artificially low interest rates also encourage increased investment because it lowers the cost of borrowing resulting in malinvestment (Simpson 2014, vol. I, pp. 73–74, 76–78, 80). Simpson (2014, vol. I, p. 74) stresses, however, that

While the effect of interest rates is important, much more emphasis needs to be placed on the rate of profit. This is the more important variable. The rate of profit is the primary reason why businessmen and entrepreneurs invest. The interest rate is secondary....

Finally, Simpson argues that, just as faster than expected monetary inflation causes the boom, when the central bank begins to decrease the money supply or merely increase it at a rate lower than anticipated, the economy will contract.

We are now at the point to provide some comparisons between Simpson's theory of the business cycle and ABCT. In the first place, ABCT sees the problem *primarily* as one of malinvestment, that is, investment in the wrong stages of production. Simpson barely touches on this and relegates it to decidedly secondary status. However, it is at the heart of ABCT.

Caused by artificially low monetary interest rates, malinvestment is *not* dependent on changes in inflationary expectations. The artificially lower interest rates make investment in some projects more attractive even if expectations about future revenues and rate of return on investment remain constant. This is precisely why, contrary to Simpson (2017, p. 261), the *economic* definition of profit is important. Interest is a cost of production. If borrowing costs decrease, projects appear more profitable even if the return on investment remains the same. Entrepreneurs, therefore, have the incentive to begin new or expand existing production projects even before the effects of increased overall spending are manifest throughout the economy.

In ABCT any effects of increased spending on entrepreneurs' return on investment due to calculating costs based on historical spending on durable capital goods are, in fact, of secondary

importance in explaining the malinvestment that is the key to the business cycle. Austrians who have contributed to the development of ABCT do recognize that these effects can occur (Mises, 1998 [1949], pp. 546–547; Huerta de Soto, 2006, pp. 365–366). Such effects, however, are decidedly secondary in terms of importance, logic, and chronology. They can prolong the boom and therefore contribute to its magnitude. They are not, however, the cause of the cycle. The malinvestment that is the source of the boom/bust cycle is triggered by artificially low interest rates and the lending of new fiduciary money that is borrowed and invested *before* any change in macroeconomic expectations.

Additionally, wages and land rents will begin to rise sooner than later, because entrepreneurs who get the new money first must bid factors away from their alternative uses. This necessitates offering higher prices for their services. Production costs also would, therefore, increase sooner rather than later.

I continue to maintain that, as I said in my original review, Simpson's theory seems more akin to New Classical Money Surprise Theory (Ritenour, 2016, p. 386). According to Simpson, the cause of the cycle is a large, unanticipated increase in money supply by the central bank. Such inflation results in increases in spending, prices, and revenues. Higher revenues increase firm rates of return on investment, thereby providing incentives for firms to expand output. The downturn only occurs when the rate of inflation slows, thereby decreasing rates of return below what is expected. Malinvestment in the capital structure is an afterthought at best.

In Simpson's response to my initial review, he rightly exhorts the reader not to reject a theory merely because it is different (Simpson, 2017, 264). No exposition of a theory is correct either merely because it is old and well received or because it is new and previously unknown. An economic theory is correct to the extent that it can explain the issue at hand. Austrian business cycle was developed to explain the nature of the boom/bust cycle in the economy. This theory explains that the business cycle is the result of malinvestment within the intertemporal production structure fostered by monetary interest rates pushed artificially low by credit expansion, not funded voluntary spending. Because Simpson identifies larger than expected return on investment due to large unexpected rates of monetary inflation as the cause of the

cycle, his theory misconstrues ABCT's explanation of the cause of the cycle. I continue to maintain that Simpson may have a business cycle theory, but his is not Austrian business cycle theory.

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