Aggregated confusion [1]

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The Keynesian and Austrian schools of economics may differ most starkly in their policy recommendations but, as Steve Horwitz reminds us [3], their differences are based in a fundamentally different view of how economics should be done. Keynesians, wishing to treat economics with the same tools as the natural sciences, aggregate economic activity into broad categories. The Austrian view is that this aggregation conceals the real things that we should be examining:

> *Hayek wrote: ?Mr. Keynes? aggregates conceal the most fundamental mechanisms of change.? That Austrian macroeconomics rests firmly on the microeconomic ?mechanisms of change? that ultimately comprise economic activity remains a crucial reason why that insight can better explain both the mistakes of the boom and the way out of the bust.*
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> *The Austrian insight is relevant to both capital and labor. In standard Keynesian models (as well as most other macroeconomic models), capital is understood as an undifferentiated mass. The Keynesian model also assumes that interest rates do not equilibrate the supply of savings and the demand for investment funds. Thus when people save more, there?s no signal transmitted to investors that they should build more for the future. As a result, the decline in consumption that accompanies the increase in savings causes firms to invest less as their inventories pile up without any offsetting increase in investment elsewhere due to the lower interest rate.*
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> *In the Austrian view investment cannot be treated at this high a level of aggregation. The production process that leads to consumption goods comprises a number of stages, starting with the ?early? stages of research and development and raw materials, and finishing with the ?later? stages, such as wholesaling or inventory management, which are closer to the final consumer purchase. Looking at the structure of production this way enables Austrians to note that when saving increases and causes interest rates to fall, resources will indeed be drawn away from the late-stage investments in inventory, but they will be drawn toward investment in early stages of production, as the interest lower rate makes longer-term production processes involving more stages relatively less costly. Over time, savings promotes those longer-term processes, which are more productive and provide us the capital base for economic growth.*
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> *By disaggregating investment, the Austrian model also reminds us that different kinds of capital goods have to ?fit together? to be productive. This is most clear when central banks try to inflate to generate growth. In this case, the lower interest rates produced by excess money lead to increased investment in those same early stages. However, unlike the first story, where that increased investment is financed by reduced investment in the later stages, inflation also increases consumption as the lower interest rate reduces savings. The credit expansion creates no new resources but leads to more investment at both the very late and very early stages of production. This is the boom of the business cycle.*

We've written on the Austrian theory of the business cycle at length here, but Horwitz's piece is a timely reminder of how deceptive economic aggregates can be. If, as Austrian schoolers believe, business cycles are based on long-run dislocations between investment and consumption, treating investment as a single mass totally ignores the real problems.

The media is obsessed with GDP figures and the like, but, again, these are of extremely dubious value. A growing GDP isn't a good thing if it's being driven by a credit bubble; conversely, a contraction in GDP isn't itself a bad thing if it reflects the liquidation of that credit bubble. It would be nice if the world's economics pundits would take ten minutes to reflect on the Austrian school's insights: only individuals act, and when you aggregate them into a monolithic single unit, those individuals' motivations are lost.

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