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Austrian Business Cycles and Neutral Money [1]

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The proponents of Austrian Business Cycle Theory (ABCT) are often very critical of the diagnosis offered by monetarism: that sharp and substantial contractions in the money supply are the cause of major recessions. Rather, according to ABCT, a recession is a painful medicine curing the disease monetary policy already caused, as Professor Jesús Huerta de Soto, Spain?s leading Austrian economist, explains:

"[Money] is always injected into the economy in a sequential manner and at various specific points?..only certain people will be the first to receive the new monetary units and have the chance to purchase new goods and services at prices not yet affected by monetary growth?.which can only lead to changes in society?s entire structure of relative prices." (*Money, Bank Credit, and Economic Cycles*, p. 533)

The argument here is that money isn?t neutral, that is, changes in it?s quantity affects peoples? behaviour as price changes aren?t uniform. If money were perfectly neutral; doubling the quantity of money would cause all prices and wages to instantly double and people would go about their lives exactly as they would otherwise. When money isn?t neutral the failure of prices to adjust ubiquitously sends the wrong signals to entrepreneurs, creating mal-investment (capital allocated according to misleading price signals) and a following period of correction/recession. That?s ABCT in a nutshell.

So far, so good. However, Austrians like Soto seem to contradict themselves in their criticism of the aforementioned monetarist diagnosis:

"Attributing crises to a monetary contraction is like attributing measles to the fever and rash which accompany it." (*Money, Bank Credit, and Economic Cycles*, p. 527)

According to this criticism, monetarists have confused cause and effect; monetary contractions don?t cause recessions, recessions cause monetary contractions. It?s as if Soto is claiming that any sharp contraction in the money supply, even if we accept the premise that it was caused by the recession, had no further effect on the economy - that any sharp monetary contraction is neutral.

If ABCT aims to explain recessions whilst denying monetarism it must state, then, that money isn?t neutral

and also neutral. Even more problematic is the apparent claim that money is far from neutral on the way up when growing at a fairly steady rate, but neutral on the way down when declining rapidly. Anyone worried about money supply growth prior to the crisis should also be worried about the fact it tanked in 2008. Soto joins Mises, Rothbard, Schlichter, and perhaps Hayek on the list of popular Austrians who are especially critical of monetarism.

On the other hand, some economists who identify as Austrians, such as Professor Steve Horwitz of St Lawrence University, have accepted some broad form of monetarism. Horwitz goes so far as to suggest that ABCT doesn?t explain every recession, and is only a theory of unsustainable boom. This clearly departs from the classical ABCT which did seek to explain all recessions and is very specific in it?s explanation thereof. And though I mostly agree with Horwitz?s interpretation, it can?t be labelled ABCT, because a theory of unsustainable boom is only a theory for half the cycle. So it leaves the question: can we create a version of ABCT which is consistent in its treatment of money throughout the cycle?

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