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The Austrian business cycle theory [1]

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At the (sadly now closed) Mises Economics Blog, Art Carden has a good short primer [3] on the Austrian business cycle theory:

> ***Calculation:***
> *People appraise and bargain for goods and services in markets. Prices are the coordinators that tell people the most effective ways in which resources can be deployed. Interest rates are determined by the interaction of firms? demands for investable resources and households? willingness to save. Holding investment demand constant, changing interest rates indicate changes in households? preferences for future versus present consumption. A rising interest rate indicates a reduction in the supply of saving (and an increasing demand for present versus future consumption) while a falling interest rate indicates an increase in the supply of saving (and an increasing demand for future versus present consumption).*
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> *Suppose people decide to save more. They will reduce their present consumption in order to save more for future consumption. The prices of goods for immediate consumption will fall, and the prices of investment goods will rise. Wages will fall at the point of immediate consumption, but they will rise for people farther back in the structure of production.*
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> *How do people know what to produce? When I?m 64, I might want birthday greetings, bottles of wine, or both. Enter profits and losses. Profits and losses tell firms whether they are choosing wisely with respect to what they produce. Firms that correctly anticipate what best satisfies households? wants will be rewarded with profits while those that incorrectly anticipate what households want will be punished with losses. This is the essence of ?an economy working right,? to borrow from F.A. Hayek via Garrison.*
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> ***Miscalculation***
> *: When the government manipulates the money supply, the market?s signals are distorted. In Tim Harford?s book The Undercover Economist, he points out that competitive markets produce a ?world of truth? in which prices reflect households? preferences and firms? costs of production. The Austrian theory gives us an example of a way in which prices are systematically lying. Entrepreneurs? and managers? appraisals are incorrect as a result of credit expansion. What looks like equilibrium isn?t, and the gap between real saving and the quantity of investable resources demanded is masked by new money. To use Professor Garrison?s term, the gap is ?papered over.?*
>
> *Things look great during the boom phase of the business cycle because consumption and investment are both increasing. They are increasing to unsustainable levels, though: during the credit expansion, firms initiate investment projects that cannot be realized given household savings. The structure of production is fundamentally distorted as prices, interest rates, and wages do not reflect households? preferences. As credit expansion cannot continue forever without causing hyperinflation, miscalculations that led to malinvestments are eventually revealed.*

Recalculation
: If the economy is left to its own devices, miscalculations will be corrected and malinvestments will be corrected by a process of recalculation. Firms and households fix their mistakes, and resources are reallocated. Prices that are consistent with the economy?s underlying fundamentals of tastes, technology, and resource availability emerge and guide people toward what Arnold Kling has called ?patterns of sustainable specialization and trade.? In other words, physical capital, human capital, and social capital are invested in lines of production that do not compromise a society?s ability to provide for its future wants.

Watching the budget yesterday, it struck me how unreal politics has become. George Osborne proudly mentioned his "credit easing [4]" policy. Roger Garrison (quoted above) might call this "papering over" the gaps in the British economy, and he'd probably be right. It's as if the last ten years never happened.

The rest, which wediscussed in detail [5] yesterday, sounded to me like papering over gaps in a fundamentally cracked economy that still needs to go through that crucial "recalculation" phase. Osborne invoked Adam Smith's canons of taxation, too, and he is supposed to have a great deal of respect for Smith's work. Very well ? at least he's singing from the right hymn sheet, even if the tune's all wrong [6]. It's too much to hope for an Austrian conversion from the Chancellor, but maybe in between his *Theory of Moral Sentiments* reading sessions, he'll find the time to read some Hayek, Mises, Art Carden or Roger Garrison too.

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