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Some criticisms of Austrian Business Cycle and Their Rebuttal

Austrian idea: Artificially low interest rates create artificial boom, distort capital structure.

Krugman's criticism

Krugman's criticism: As a matter of simple arithmetic, total spending in the economy is necessarily equal to total income (every sale is also a purchase, and vice versa). So if people decide to spend less on investment goods, doesn't that mean that they must be deciding to spend more on consumption goods – implying that an investment slump should always be accompanied by a corresponding consumption boom? And if so why should there be a rise in unemployment?

Elaboration: We can stipulate that certain producers (such as builders) expanded too aggressively in a boom, and then they suddenly discover that their customers no longer want to buy their products (urban office buildings, let's say). But, Krugman explains, people in the economy have to spend their income somewhere. If the income isn't going towards $10 million office buildings, it must be getting channeled into movie tickets, or electric generators, or copies of Peter Schiff's book. So it's not at all obvious, Krugman concludes, why massive unemployment should accompany the onset of the "hangover" from the credit binge. The jobs destroyed in the "higher-order" (in Austrian jargon) stages ought to be offset by newly created jobs in the lower-order stages.

- For Krugman, his argument relies on a static conception of income and spending. Just using that accounting tautology – without indexing for time – Krugman could also argue that real income can never change in an economy, even if the government announced that the most productive 10% of workers in every firm would be shot. (After all, total income would still equal total spending.)
  - Justin's Comment: Right. Shooting the 10% most productive employees would decrease total income. All other things being equal, total income should be less after the decimation than before. But in both cases (before and after decimation) you could say Total Spending = Total Income.
- The elementary flaw in Krugman's objection is that he is ignoring the time structure of production. When workers get laid off in the industries that produce investment goods, they can't simply switch over to cranking out TVs and steak dinners. This is because the production of TVs and steak dinners relies on capital goods that must have already been produced. In our sushi economy, the unemployed islanders couldn't jump into sushi rolling, because there weren't yet enough fish being produced. And they couldn't jump into fish production, because there weren't enough boats and nets to make their efforts worthwhile. And finally, they couldn't jump into boat and net production, because there were already enough islanders working in that area to restore the fleet and collection of nets back to their long-run sustainable level.
- Justin's Question: This is a more basic issue than what the essay is dealing with, but: how does saving fit into the idea that Total Spending = Total Income?

These points are extensively illustrated in Sushi economy example, the details of which I'm leaving out of this map

Cowen's criticism

Cowen's criticism: Why should the boom be a boom in the first place? The shift toward investment goods, and thus away from consumption goods production, should mean falling real wages, not rising real wages. In other words, the Austrian theory doesn't generate the very high degree of comovement found in the data. [note: by comovement I think he means that both wages and investment increase at the same time during a boom.]

Elaboration: Cowen wants to know why people should feel rich during the Fed-induced boom, as the Austrians allege. In fact, because workers and materials are shifted into producing higher-order goods like tractor trailers and orange cones for road crews, the fact of scarcity implies that there should be fewer consumption goods (TVs, steak dinners, sports cars) being cranked out when the boom first sets in. If fewer consumption goods are being produced, then per capita real income has to fall, which again is the opposite of what the Austrians claim.

- As for Cowen, he seems to be assuming that "real income" is equivalent to "real consumption." I don't know what to say except, "No it isn't." If a worker gets a job in a silver mine and gets paid in ounces of silver that he stores in his basement, he can have very high "real wages" even if his consumption is very low.
  - Justin's Comment: I think that this silver mine example isn't the greatest in this context. I don't know but I guess Cowen wouldn't dispute that you can consume less than you produce. The fact that you can overconsume beyond the amount of consumption goods produced by depleting capital is a subtle point (which Murphy makes at great length in the rest of the article).
  - Justin's Question: How exactly does Cowen assume that "real income" is equal to "real consumption"? I understand his point as being more about Austrian theory being inconsistent with some data.
- let's assume that he meant to say that ABCT makes us expect real consumption (not income) to fall during the boom period. Cowen's point is that this doesn't match with the data. During the boom, we see increased investment in new (and more "roundabout" in Austrian lingo) projects, and we see workers getting paid more and hence buying more consumer goods. But shouldn't this be impossible, Cowen asks, if, as the Austrians claim, during the boom, resources are pulled away from consumption goods (like iPhones) and instead are devoted to the production of investment goods (like tractor trailers)?
  - Cowen is right that a sustainable lengthening of the capital structure initially requires a reduction in consumption; what happens is investors abstain and plow their savings into the new projects. But during a central-bank-induced boom, there hasn't been real savings to fund the new investments. That's why the boom is unsustainable, but it also explains why consumption increases at the same time. It's true that this is impossible in the long run, but in the short run it is possible to increase investment in new projects, and to increase consumption at the same time. What you do is neglect maintenance on critical intermediate goods, just as our islanders were able to pull off the feat for a few months. A modern economy is very complex, and it can take a few years for an unsustainable structure to become recognized as such.
    - Justin's Comment: Basically, deferring maintenance is a form of seed-corn-eating. It lets you have both new investment and consumption at the same time. But then at the end you've got a backlog of maintenance to catch up on.

Elaboration: Austrian story is that during the artificial boom, workers' labor and other resources get channeled into investment projects that aren't compatible with the overall level of real savings. Sooner or later, reality rears its ugly head, and the unsustainable projects have to be abandoned before completion. Entrepreneurs realize they were horribly mistaken during the boom, everybody feels poorer and slashes consumption, and many workers get thrown out of jobs until the production structure can be reconfigured in light of the revelation.