TOWARD A GENERAL THEORY OF ERROR CYCLES

JÖRG GUIDO HÜLMSMANN

One of Ludwig von Mises's most important contributions to economic science was the business cycle theory that he first presented in his *Theory of Money and Credit* (1981, ch. 19, esp. pp. 338ff.). This theory has been elaborated by Mises himself and received important additions through the hands of Friedrich A. Hayek and Murray N. Rothbard. Yet in its foundations it remains unshaken as from the day of its first publication.

The purpose of this article is threefold. First, we challenge Mises's theory by arguing that it is not generally and apodictically valid. Therefore, it cannot be part of economic theory which, as Mises himself stated, is a purely logical science of action. Second, we give the outlines of a truly praxeological (and therefore general) theory of error cycles that withstands this specific criticism. And third, Mises's business cycle theory will be restated in the light of the new approach, that is, it will be interpreted as an instance of a more general theory and thus put on more solid grounds.

A CRITIQUE OF AUSTRIAN BUSINESS CYCLE THEORY

Error and Business Cycles

Any business cycle theory is essentially a theory of error. Its aim is to explain the recurrence of the phenomenon that we call crisis; that is, a situation in which the simultaneous economic failure of many people becomes obvious. Thus, business cycle theory not only has to explain the occurrence of error but the recurrence of a cluster of errors as well. This reminder is especially useful since many economists tend to interpret the business cycle as an equilibrium phenomenon. Let us spell out what that means in terms ordinary people use. It means that these writers contend that bankruptcies are planned, that the loss of big and small

---

1See in particular Mises (1928; 1998, pp. 550ff.); Hayek (1929; 1931); and Rothbard (1993, pp. 854ff; 1983, pt. 1).

2See in particular Lucas (1987); Schultz (1975); and also Shmanske (1994).
fortunes was intended from the outset, and that people could conceive of no better employment for their labor and money than throwing it out the window.

It is to the great merit of the Austrian business cycle theory that it explains recurrent errors in investment decisions by a common cause, namely, the monetary organization that prevails in western civilization. The main features of this system are fractional reserve banks and a central bank operating as a lender of last resort. Under these circumstances commercial banks can unexpectedly increase the quantity of money substitutes (today mainly demand deposits) and, by lending this new money out, push the market interest rates below the level they would have otherwise reached. Thus, with the given production capacities more investment projects are begun than can ultimately be sustained. A systematic error has occurred. It is impossible that all projects are successfully carried out, and this must sooner or later be discovered. When this discovery gains widespread attention, the business cycle has reached the crisis phase. The supposedly least profitable projects are now abandoned and production continues on a more solid base. However, the source that brought about the systematic error is still operating. Still, commercial banks can increase the quantity of their money holdings beyond the quantity of money they may dispose of. And still the central bank helps them in cases of "liquidity crises." Therefore, systematic error is likely to occur again.

Error or failure is a permanent condition of human endeavor. It consists of choosing an alternative for action that is less important (less preferred) than another one that could have been executed instead. Austrian business cycle theory does not have to assume that, were it not for inflation, the market participants would not err at all. It can rely entirely on the idea that inflation causes additional errors; that is, more errors than otherwise would have occurred: "Credit expansion in the midst of unemployment will create more distortions and malinvestments, delay recovery from the preceding boom, and make a more grueling recovery necessary in the future" (Rothbard 1983, p. 34). Thus, the Austrian approach gives a realistic account of the trade cycle and provides the only solution that exists to the theoretical problems raised by any business cycle theory.

General Refutation of the Consequentialist Analysis of Error

However, even the present Austrian solution is defective because it relies on a fallacious analysis of error. Ultimately, the traditional Austrian approach consists of giving an explanation of how error comes about. It is what could be called a consequentialist explanation. Error is conceived as the consequence of a preceding event; namely, of a change in the conditions of action. Thus, Austrian business cycle theory explains clusters of errors by changes in the quantity of money. It claims that market participants err because the quantity of money is increased by

---


5 This explanation is manifest in the use of the imaginary construction of the evenly rotating economy for the explicit purpose of analyzing "the problems of entrepreneurship and of profit and loss" (Mises 1998, p. 248). It is also evident in statements like "[changes in valuations] are the source from which entrepreneurial profits and losses stem" (ibid., p. 534) or "new data emerge again and again and divert the trend of prices from the previous goal of their movement toward a different final state" (ibid., p. 547).