In Defense of Austrian Business Cycle Theory

Introduction

The business cycle theory expounded in the previous chapter has its roots in Austrian business cycle theory (ABCT). ABCT was originated by Ludwig von Mises and developed further by Friedrich Hayek. The theory I present also incorporates many important truths identified by George Reisman.1 Others have contributed to the development and defense of ABCT as well. In terms of essential characteristics, there are no differences between what I present here and ABCT, so I will refer to them synonymously.

Many criticisms of ABCT have been made over the last several decades by various people. All of them are invalid. The theory provides the only comprehensive and logically consistent explanation of the cycle. It is the only theory that is consistent with all the facts of the cycle. Nonetheless, since many criticisms have been made, they need to be addressed. I will not address all of the criticisms in this chapter. Many of the criticisms are shown to be invalid in other chapters, such as the claim that ABCT does not explain the contraction phase of the cycle (chapter 3) and the claim that the theory is not based in reality (chapters 3 and 5–9).2 In addition, some of the criticisms are devoid of intellectual content or are incoherent and therefore require no response.3

The only criticisms of ABCT I will address in this chapter are those that are not addressed elsewhere in this book and that raise serious questions about the validity of ABCT. One criticism, on whether ABCT is consistent with what contemporary economists call rational expectations, requires significant treatment to show that this, in fact, is not a valid criticism. Others pertain to claims that ABCT is too complex and that ABCT commits errors in regard to its use of interest rates. Still others criticize ABCT for allegedly requiring full employment at the start of the expansion to generate the harmful effects of the cycle. And there are many more. I address the “rational expectations” criticism last, since it requires a more lengthy treatment. I start with the claim that ABCT is overly complex.

Complexity

The charge that ABCT is too complex says that there are simpler theories that explain the same phenomenon (i.e., the boom-bust business cycle). Therefore,
based on the principle of Occam's razor (that in choosing between two competing theories, each of which does an equally good job explaining the same phenomenon, the simpler one should be accepted), ABCT must be rejected. Occam's razor is a valid principle. One does not want to create needless complexity in attempting to understand the world. This will only make it harder to do so, since people will have to retain concepts, ideas, propositions, et cetera that they would otherwise not have to. Each individual has only a limited mental capacity and creating needlessly complex theories goes against the requirements of cognition. The distinctive feature of human beings, the one that raises them above the lower animals, is their conceptual faculty. This faculty makes it possible for humans to retain an enormous amount of information by condensing and classifying knowledge. Creating needlessly complex theories undercuts this process.

Notice the emphasis is on the rejection of needlessly complex theories. A good theory will not be needlessly complex but it will not be overly simplified either. What determines whether a theory has the appropriate level of complexity? The answer: the nature of reality. The nature of the phenomenon being analyzed determines whether a theory explaining it will need to be complex or simple. If a phenomenon is complex (for instance, if it has many parts to explain and understand or deals with abstract issues), it will require a complex theory to explain it. However, if a phenomenon is simple, it will require a simple theory. For example, explaining addition is much simpler than explaining how to solve differential equations. The steps involved in the latter are more complex and the concepts used are more abstract, so one would expect any theory describing the latter to be more complex than a theory describing the former. But this would not make an explanation of how to solve differential equations overly complex because the nature of what is being explained is complex. Occam's razor only applies to two competing theories that explain the same phenomenon. It does not apply to two theories that explain different phenomena.

The business cycle is an enormously complex phenomenon. It is a series of events that occur over many years and can encompass large geographic areas. It can involve millions—even billions—of people, perhaps tens of thousands of different types of goods, millions of businesses, and thousands of industries. It affects consumers and producers, prices, unemployment, interest rates, output, revenues, profits, and many other variables. To be able to understand the causal nature of something that affects so many variables across significant periods of time and widespread geographic areas requires an enormous act of integration. This can only be done at a very abstract level. This is why any valid business cycle theory will be complex. Such a theory must explain, or at least be consistent with, what is occurring throughout the entire economy during the cycle.

The charge of ABCT being too complex would only be valid if there was another theory that did an equally good job explaining the cycle and was less complex. However, there is no such theory. ABCT is the only theory that is consistent with all the facts of the business cycle and explains the cycle in a logical fashion. I have given my explanation of the cycle based on ABCT in chapter 3. I show elsewhere that other theories put forward in an attempt to explain the cycle