Boom and Bust: The Cause
Guest: David Howden
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WOODS: Give us a two-minute basic overview—no nuance, just the absolute basics, vastly oversimplifying it—of Austrian business cycle theory, so then when we go through point by point, people will already have the bird's-eye view.

HOWDEN: Before I go through and tell you what it is, I'll tell you what it's not, because most people who have heard about Austrian business cycle theory commonly associate it with something that it's not.

WOODS: Okay.

HOWDEN: So one story is typically that the Federal Reserve Bank holds interest rates too low for too long and this makes borrowing very cheap, or relatively cheap compared to what it otherwise would be. So businesspeople and consumers and entrepreneurs rush out and go on a borrowing binge and load up with debt, and then they buy too many houses and make too many investments and buy too many cars and consumer goods and things like this. So most people think of Austrian business cycle theory erroneously as a theory of people loading up with debt and then just buying too many goods—overconsuming and overinvesting, in other words. And the reason I want to start it out this way in explaining it is that this is how the Austrian business cycle generally gets sold by people who don't know what it is.

So to give you the correct rendition, it starts out the same, the Fed sets interest rates too low for too long and makes credit too easy for people. But it's not really a theory of too much investment going on; it's a theory of the wrong types of investment going on. And by this we mean that entrepreneurs and businesspeople, when they invest money, have to do it for a certain amount of time. That time period in which they invest is the time during which the investment matures and then starts creating something that consumers can purchase. When interest rates are dropped artificially low, it motivates investors to start pursuing really, really, really long-dated investment projects—too long, really. These are investment projects that aren't going to mature or won't create anything for an extended period of time. This waiting period is just too long for people to wait and too long for companies to keep going without actually having a salable good that will create cash flow for them. The crux of the problem is that businesses make these long-dated investments that don't pay off for a long period of time. It turns out to be too long, so they don't

have any cash flow that comes in in a timely manner and they start becoming illiquid and eventually bankrupt.

WOODS: Dave, Roger Garrison sometimes says that in order to understand how things go wrong it's sometimes useful to try to think about how they can go right. It might be a good idea to start off our full-fledged discussion by describing how the economy functions without this extraneous intervention. What would things look like, imagining we had a free-market economy and interest rates were set just through the voluntary actions of many millions of people and there's no central authority doing it—what would things look like in that case? And then let's unpack what they'd look like with the intervention.

HOWDEN: Here's a nice story to put in your mind to set the stage. Imagine that you are Robinson Crusoe stranded on a desert island with nothing really to speak of—no tools, no nothing. You wake up in the morning and you realize you've got to go and find some food in order to stay alive. So you find a tree that has some berries on it and you start picking the berries off. You can pick enough berries to keep yourself alive, but you're not going to have a very luxurious life. So soon enough you're going to start asking yourself, well, how can I get ahead in this life, it's not very fun living hand to mouth, literally in this case. How can I do something to improve my quality of life? The answer to that lies in increasing your productivity, becoming a better berry picker. The way you become a better berry picker is by investing.

In this case, Robinson Crusoe on the desert island is going to have to come up with some type of investment that's going to make him more productive at picking berries. Just to think of a simple example, this could be taking some time away from picking berries and searching for a stick, or searching for a better bush to pick berries from, or something of that nature. But the only problem is, right now he needs to pick berries continually in order to have enough to eat to stay alive. And the prerequisite for his taking time off from picking these berries is going to be that he needs to save some of the berries as he's picking them and not consume them right away so that then when he takes time off from picking berries to search for a stick to help him take the berries off the tree better, he'll have a stockpile of berries to eat to keep him alive during this process.

And now, to make it a little bit more modern, the berries in this example are like savings. He produced something in the past and he needed to save it up, and those savings needed to sustain him while he pursued some sort of "production process." The production process in this case is very simple: it's just searching around to look for a better tool to be a better berry picker. But the point that you can draw from this is that savings are a prerequisite to successfully completing an investment project. If he didn't have a sufficient amount of berries to keep him alive while he went out searching for a stick and he needed too much time to find the stick and he didn't have enough berries to keep himself alive, he would have to abandon that investment project and go back to picking berries to stay alive. So if he doesn't have enough berries stockpiled beforehand, he will not have the sufficient means to successfully pursue the investment project after the fact. Savings is a necessary prerequisite for investment.

If you put this story together and make it a little bit more elaborate in the modern economy, you would think, well, savings is money and loans, and savings is also not consuming, just like it is for Robinson Crusoe—his savings are berries that he hasn't consumed at a prior time. Savings today is having workers produce things and then say, I'm not going to consume them right away; I'm going to produce this car but I'm not going to use it right away; I'm going to produce this food but not eat it right away, and so on and so forth. We need these savings to sustain us later on while the economy as a whole, as an abstract concept, consumes these long-dated investment projects.

That's how things go right. The investment is successful when savings match the investment, or are sufficient to complete the investment you partake in. You could ask yourself how would things go wrong. It's pretty hard to see how things would go wrong in Robinson Crusoe's scenario. He picks berries and he takes time off and searches for a stick to be a better berry picker; there's not much room for error there.

But in the modern economy, where savings is defined as money that you're going to loan to entrepreneurs and businessmen, you could think of lots of room for error, and the place where the error comes from is through the very process of creating money. That is, the central bank controls the money supply, so in the modern economy, savings is you and I not spending all of our paycheck and loaning it out to entrepreneurs to invest, but it's also the central bank just creating money out of thin air, and then later entrepreneurs have access to this money created out of thin air to complete their investment projects. It seems like it wouldn't be such a problem, because we're just creating money out of thin air, so what could possibly go wrong?

But it goes wrong because it gets these entrepreneurs to start investing in new types of investment projects; these are the ones, as I said, that are too much for the availability of real savings. Investors actually need a real supply of goods that are going into their investment projects, right? We need real physical goods and we need workers to work on the projects. But the fact that the central bank creates money out of thin air and in the process drives interest rates down low, causes investors to start taking on these really long-dated investment projects, and as they start maturing at the same time, they start putting a real drain on the system. They need more goods that should have been saved in order to complete them. And it's this drain on the system that happens as they start progressing and become more mature that causes the economy to grind to a halt. There's just not enough workers available or the right types of workers to complete the investment projects; there's not enough oil to support all of the investment projects; there are not enough cars or trucks to distribute all of the goods that were supposed to be produced. And that's really what is going wrong.

WOODS: I love that explanation, and I think it is very much in line with what I've been saying, which makes me relieved—as a non-economist, I'm glad to know I haven't been selling snake oil to people. But one of the ways I try to explain to people goes more or less as follows. What's going on without the Fed's intervention is that you have a smooth transition: when the general public decides indeed to save more, then consumer goods industries, the lower-order stages of production find that relatively speaking there isn't as much demand for their products, so they will relatively shrink, and resources will thereby be released for the so-called higher-order stages, the longer-term stages of production. So now there's more lumber for those higher-order stages to use, more trucking services, different types of labor available. So while certain parts of the economy contract, relatively speaking, other parts expand. But when the central bank is involved, both are trying to expand at once. People continue to want consumer goods just as they did before, if not more. But now you've got a tug of war going on, because now, instead of a smooth transition from some parts of the economy to other parts of the economy, you've got these higher-order stages, these longer-term investment projects going on that need the resources and they're not available now, because they haven't been released by the contraction of other parts of the economy. So these different parts of the economy are in a tug of war with each other instead of a smooth transition from one to the other. And the tug of war winds up bidding up costs above projections, and then you wind up getting bankruptcies. Am I off on any of this?

HOWDEN: No, I would say that that's pretty accurate. And I would add that you're right: when it's people naturally and voluntarily saving money and then loaning it to businesses and businesses changing their production plans to produce more of one type of good when consumer demands change or to pursue a

different production process to produce a different type of good, it is this fluid, gradual process. People's preferences don't change overnight. Our savings don't jump around in a very volatile manner; it's this smooth, continuous process, and consumers and producers are linked directly because the savings from consumers choosing not to consume is what's funding businesses and their production plans, so we get a consistent and cohesive economy. So when the central bank all of a sudden jumps in, it's like you get this third party with no relation to either consumers or producers, and they start tinkering around with a very blunt tool. The tool that they use is the core interest rate, the federal funds rate in the States. And by lowering that, they're very abruptly changing a whole dynamic on the side of consumers and their demands to save money versus consume, and on producers when they're drafting plans to produce many goods versus few goods or to produce consumer goods versus investment goods or something of that nature. The central bank, by getting in the middle of this, they're bound to fail, but before they even fail they're bound to be disruptive, just because they're fiddling away with a very finely tuned economy which is naturally linked together and naturally functioning fine but they're fiddling around with it with this very blunt tool, which is completely disconnecting the consumers and the producers of the economy away from one another.

WOODS: Now the way you're describing it and the way I think it's classically described, the Austrian business cycle is describing a situation that's self-reversing, that's got to come to an end. If the economy is in effect being expected to do something that's impossible, then it has to stop doing it at some point—it has to stop trying. But it seems to me that the way these booms come to an end is not that the internal logic of Austrian business cycle theory brings them to an end; it's that the central bank simply stops pumping money in, it simply stops pushing interest rates down, and that leads the thing to collapse. But isn't there something to the logic of the theory that says that even if the central bank just kept on doing it and kept on doing it, if the physical resources aren't there to complete these investments, then they can't be completed?

HOWDEN: Yeah, well, here's an example. Pick a country and pick a central bank that doesn't stop printing money at the boom's end. What are some examples? Zimbabwe maybe—there's an example of just continuing to print money as the boom keeps going to try to stop it from ending, but we see how that ends in just complete destruction of the economy. Here's why it necessarily must come to an end, why it couldn't keep going forever. I like your analogy of a tug of war, so think about the tug of war that's going on in the economy right now. On the one hand, with really low interest rates, what are consumers motivated to do? And the easy answer is consume, not save. Nobody wants to save any money if they're not making any interest or if they're not going to make any money from it. So consumers just consume, consume, consume; that's pretty simple and I think that's pretty evident in the most recent boom-bust cycle.

And then if you look at the producers' side of things, with really low interest rates what are they motivated to do? They're motivated to do two things. On the one hand, they want to make money off consumers consuming, so it makes sense that producers are going to start building a bunch of retail stores, commercial investments that are going to be very heavily tilted towards satisfying the consumer experience. So that's retail stores, that's malls, anything that's directly related to selling these final products. And then on the other hand if they're looking at interest rates and they're trying to figure out how long should our investment projects be, should we be doing very long-dated investment projects that will be very nice once they complete—but gosh, they take forever to get to completion, and that's necessary because that's when the cash flow is going to come in from them that's going to bring us to profitability. And when interest rates drop, all of a sudden producers have a real incentive to start producing longer and longer dated investment projects. In essence, they're willing to wait longer for their cash flows to come in from a finished product, induced by these low interest rates.

The tug of war that develops is as follows. Think about the economy as a whole, in a temporal sequence extending out from when a consumer buys a finished product all the way back in time to when that product started being designed, when the research and development went into it or when the mine started digging into the ground to get the ore out and things like that, which could be many years previous to when the final good was actually produced.

Where do you see the investment taking place? You see it right at the moment when the consumer buys the consumers' good because there's so much demand on the part of consumers to buy, buy, buy that you should see all sorts of stores springing up, malls, things everywhere, things of this nature. And when are businesses making their investments? They're making them way back in the production process: research and development, mining, getting natural resources out of the ground, all of these things that will pay off someday but it's going to take a long time.

And where do you not see investment taking place? Nobody is making investments in the middle of these two extremes. And the middle is like infrastructure investments. It's not sexy; it's not incredibly long dated, right? Building a road, it doesn't take that long—well, not building a road, but maintaining a road. It doesn't take that long to pay off but it doesn't pay off right away like producing a new store or a new mall will. You see a total lack of investment in the medium stages of production, and that's what the tug of war is. The end that's biased toward consumers, that does really well and that expands. The end which is biased as far away as possible from consumers, like research and development, that does really well. But everything in the middle, there's no investment going on. So you see your infrastructure completely crumbling; nobody wants to spend money on this because that is the least profitable of all the investment projects during the boom that you could be diverting your money to.

WOODS: Can you flesh that out a little bit more? Because when people think infrastructure, they think those expenditures are politically driven anyway, so entrepreneurs wouldn't be engaged in that. What other types of spending could you have in mind in terms of the middle stages?

HOWDEN: A big one in middle stages is businesses taking care of the depreciation allowance for their capital investments. Your business needs to be a well-oiled machine, to use an analogy. It needs to be maintained every single year. You need to have technicians and mechanics and all sorts of people come in to maintain your capital stock. But these are the types of investments that businesses don't want to do during the capital boom, either.

Let's look at Walmart. Walmart wants to spend money building new physical stores to satisfy the demands of consumers during the boom. Walmart wants to spend money designing better software to help on the logistics side of things and to help on the distribution side of things, because low interest rates are enticing them to make long-dated investments. Designing a new piece of logistics software, if you're Walmart, is not going to pay off for a long period of time. It's something that will be nice someday. But in the meantime, it's just a lot of spending, which is not going to create a sudden cash flow. But Walmart is enticed, is motivated to do this type of investment because the interest rate is so low; it makes sense to do really long-dated investment projects.

But what Walmart is not going to be investing very much in during the boom is just maintaining its facilities, the very basics of filling in the cracks in the sidewalks or maintaining the asphalt in front of the store or replacing the light bulbs in the store when they burn out. Those are facetious examples, but what I mean to say is it's the medium-stage investments that don't really classify as immediately satisfying consumer wants,

and they're also not incredibly long-dated like research and investment. Those are the things that businesses start to neglect: oiling the machines and getting technicians in to maintain them. They just let them depreciate because investing money in those is relatively unprofitable during the boom. And by relative, I mean relative to satisfying consumer wants on one end of the scale or investing in really long-dated investment projects on the other end of the scale.

WOODS: Dave, I have two more questions I want to ask. I know I'm already over the time I said I'd take from you, but I hope I can ask them both.

HOWDEN: Sure.

WOODS: Because if I ask just the first one I'm going to be disappointed because the first one is so common. But I feel like we have to ask it. The expectations question. Why don't businesses learn? Why don't they learn to factor in a Federal Reserve premium into their expectations of how much these projects are going to wind up costing them? That costs are going to rise unexpectedly because it's going to turn out that they're going to be competing for resources, and the competition for resources is going to bid prices up. Why don't they say, "Look, we've been burned before. The Fed gets involved and it looks like a big boom, we engage in these long-term investment projects and it always comes back to bite us. This time, why don't we proceed cautiously, or why don't we at least factor in the possibility that this project that we're going to engage on might wind up being 30 percent more expensive than we expect?" "Why are they so stupid?" is maybe the most common free-market objection. There are other objections that Keynesians might have, but this is maybe the most common objection that people who might otherwise like the free market would have to the Austrian view specifically.

HOWDEN: I would give you two reasons. The first one is, consider the businessperson. He is not concerned exclusively with absolute profits, with just making money and avoiding losses. If that was his only concern, then he'd say, okay, I recognize that there's an Austrian business cycle going on right now, and it's not going to last. I'm just going to sit this one out. I'll let all my competitors take part; they'll all be bankrupted at the end of this whole thing, and I'll take a couple years off. And once the dust settles, then I'll open up my store again and get back into it.

Businesspeople just can't sit it out. You're not just concerned with absolute profits; you need to have relative profits. You need to always compete against your competitors; otherwise, they drive you out of business. So a businessperson can't just say, I know what's going on but I'm not going to take part in this. You have to take part; otherwise you get left in the dust by your competitors, at least while this artificial boom is still going on.

WOODS: In other words, because your competitors are getting the benefits of being able to engage in investment very, very cheaply and you're just sitting on the sidelines?

HOWDEN: Exactly. And they're earning profits, at least during the short run, during the boom when everything is still okay. Your competitors are pulling ahead of you if you sit it out. So you're not really at liberty to just sit it out because you think it's an unsustainable boom.

But here's maybe the key point in this, and this is my second reason. The Austrian business cycle as a theory is a qualitative theory; it says that the artificial boom will inevitably have to come to an end. It doesn't say anything quantitative, so it doesn't say how long the boom is going to last. And businesspeople don't know how long this boom is going to last, either. So to say, "Okay, we're in the midst of an artificial boom; I'm just

going to sit this one out"—the businessperson has no idea how long the boom is going to last, for two years, three years, five years, a decade, whatever, so to say, "Okay, we'll close up shop and we'll stay away from this artificial boom that's going to end badly, and we're going to do so indefinitely because we can't really say ahead of time how long this game is going to keep getting played for"—businesses can't just sit it out like that. To stay in business, they need to keep competing against their competitors and hope for the best. So it's almost like they're forced to participate in the boom; otherwise their competitors are going to pull ahead and then they're out of business anyway.

WOODS: The other question I want to ask you: would you say that the Austrian theory of the business cycle is the only explanation for business cycles? What would you say to somebody who said: this sounds like a plausible story you're telling here, Howden, but I think there are five or six other ways that business cycles could be set in motion. Is there anything wrong with a claim like that?

HOWDEN: There is and there isn't. There are business cycles that exist for particular reasons: wars, famine, drought. Those are typical, very specific reasons why you could have a business cycle. The Austrian business cycle theory is the only one that explains why the economy as a whole is experiencing a general downturn in business conditions. And the reason why the Austrian business cycle theory is the only one capable of doing it is that it's the only business cycle theory that addresses the common denominator that links everything in the economy together: money. Money is the common denominator that defines every single transaction that takes place in the economy. If you want something to generally go wrong, if you want a general downturn that affects all businesses in some way, you need to upset the one thing that links all businesses and transactions together, and that's money. And because money takes such a starring role in the Austrian business cycle, this is why it's really the only theory that explains why you can have general downturns instead of just industry-specific downturns, right? You can have a new technology that springs up in one part of the economy, and maybe it makes another part of the economy redundant, so that specific area will have a downturn. Like the advent of the car caused the horse-carriage industry to go into deep recession. But that's very specific, that's industry specific. The Austrian theory says no, no, no, the whole economy is going to experience booms and busts because it's driven by changes in the money supply, or central bank-driven changes in the money supply. And that is going to cause all industries to succumb to this cycle together.

WOODS: Well, Dave you've been extremely helpful and a good sport staying a little bit long, but let me just conclude by asking you about the book that you've been putting together with Joe Salerno, a hundred-year overview of the record of the Fed with contributions by various economists. When can we expect that book, and what's the title going to be?

HOWDEN: The title, as long as the publisher doesn't change it, is *The Fed at 100*. It's the centennial of the Federal Reserve. Many people probably are aware of this, but I'm surprised there's not more in the press about it. Because after 100 years of existence, the Fed is almost revered in the economy, at least by some people. And it comes from a complete ignorance, I would say, as to what the Fed has actually achieved over the last 100 years, and when you actually look at the track record, you can see that it's actually pretty horrific. So Joe Salerno and I, we've edited a book, and Tom, you have a chapter very graciously written for the book, and we overview the theory which is very clear for Austrian economists of why central banks are so damaging, debilitating to the economy. And then we provide many chapters—or, we don't provide them, other authors have thankfully provided them—illustrating the examples of where the American economy has been disrupted at the hands of the Fed. But we set the record straight, so to speak, after 100 years of existence.

WOODS: Well, it sounds great. I can't wait to be able to sink my teeth into it. I'm only familiar with my own contribution, so don't spoil the surprise! I'll see what awaits me when it comes out. But when it is available, I'd like to have you back on and we'll talk about what's in there.

HOWDEN: That would be perfect. I'll look forward to it, Tom.