Time and Money

The Macroeconomics of Capital Structure

Roger W. Garrison

Foundations of the Market Economy

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Time and Money

Can we accept or find practical use for a macroeconomics

- in which consumption and investment always move together in the short run
- in which these two magnitudes must move in opposition to change the economy's rate of growth, and
- for which the long run emerges as a seamless sequence of short runs?

It is increasingly recognized that the weakness in modern macroeconomic theorizing is the lack of any real coupling of short- and long-run aspects of the market process. In the short run, the investment and consumption magnitudes move in the same direction, either both downward into recession or both upward toward full employment and even beyond in an inflationary spiral. But for a given period and with a given technology, any change in the economy's growth rate must entail consumption and investment magnitudes that move, initially, in opposition to one another.

Roger W. Garrison claims that modern Austrian macroeconomics, which builds on the early writings of F.A. Hayek, can be comprehended as an effort to reinstate the capital-theory core that allows for a real coupling of short- and long-run perspectives. Although the macroeconomic relationships identified are largely complementary to the relationships that have dominated the thinking of macroeconomists for the past half century, *Time and Money* presents a fundamental challenge to modern theorists and practitioners who overdraw the short-run/long-run distinction. The primary focus of this text is the intertemporal structure of capital and the associated set of issues that have long been neglected in the more conventional labor- and money-based macroeconomics. This volume puts forth a persuasive argument that the troubles that characterize modern capital-intensive economies, particularly the episodes of boom and bust, may best be analyzed with the aid of a capital-based macroeconomics.

Roger W. Garrison is Professor of Economics at Auburn University, Alabama, USA.

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To Karen and Jimmy

Preface

My venture into macroeconomics has not been a conventional one. In the mid-1960s, I took a one-semester course in microeconomic and macroeconomic principles in partial fulfillment of the social-studies requirement in an engineering curriculum. The text was the sixth edition (1964) of Samuelson's *Economics*. It was several years later that I returned on my own to reconsider the principles that govern the macroeconomy, having stumbled upon Henry Hazlitt's *Failure of the "New Economics"* (1959). The first few chapters of this critique of Keynes's *General Theory of Employment, Interest and Money* (1936) were enough to persuade me that I could not read Hazlitt's book with profit unless I first read Keynes's. I had no idea at the time what actually lay in store for me.

In his own preface, Keynes does warn the reader that his arguments are aimed at his fellow economists, but he invites interested others to eavesdrop. As it turned out, even the most careful reading of the *General Theory*'s 384 pages and the most intense pondering of its one solitary diagram were not enough to elevate me much beyond the status of eavesdropper. But Keynes made me feel that I was listening in on something important and mysterious. The ideas that investment is governed by "animal spirits" and that the use of savings is constricted by the "fetish of liquidity" do not integrate well with more conventional views of the free-enterprise system. Keynes's notion that the rate of interest could and should be driven to zero seemed puzzling, and his call for a "comprehensive socialization of investment" was cause for concern.

With Keynes's mode of argument – though not the full logic of his system – fresh in my mind, Hazlitt's book was intelligible, but his virtual page-by-page critique came across as the work of an unreceptive and hostile eavesdropper. Keynes's vision of the macroeconomy – in which the market tends toward depression and instability and in which the government assumes the role of stimulating and stabilizing it until social reform can replace it with something better – was never effectively countered. Hazlitt did point to the Austrian economists as the ones offering the most worthy alternative vision. There were a double handful of references to Friedrich A. Hayek's writings and twice that many to those of Ludwig von Mises.

My self-directed study expanded to include Mises's *Theory of Money and Credit* ([1912] 1953), Hayek's *Prices and Production* ([1935] 1967), and, soon enough, Murray Rothbard's *America's Great Depression* ([1963] 1972).

After a diet of Keynes, contra-Keynes, and then Austrian economics, I returned to my old principles text to see how I had failed to come to any understanding at all during my undergraduate experience with macroeconomics. In Samuelson's chapters on the macroeconomy, I found a total gloss of the issues. The fundamental questions of whether, how, and in what institutional settings a market economy can be self-regulating were eclipsed by a strong presumption that self-regulation is not possible and by simplistic exercises showing how in a failure-prone macroeconomy the extent of labor and resource idleness is related to the leakages from – and injections into – the economy's streams of spending.

In the early 1970s I entered the graduate program at the University of Missouri, Kansas City, where I learned the intermediate and (at the time) advanced versions of Keynesianism. Having read and by then reread the *General Theory*, the ISLM framework struck me as a clever pedagogical tool but one that, like Samuelson's gloss, left the heart and soul out of Keynes's vision of the macroeconomy. It was at that time that I first conceived of an Austrian counterpart to ISLM – with a treatment of the fundamental issues of the economy's self-regulating capabilities emerging from a comparison of the two contrasting graphical frameworks.

Initially drafted as a term paper, my "Austrian Macroeconomics: A Diagrammatical Exposition," was presented at a professional meeting in Chicago in 1973. In 1976 I rewrote it for a conference on Austrian Economics sponsored by the Institute for Humane Studies and held at Windsor Castle, after which it appeared in the conference volume titled *New Directions in Austrian Economics* (Spadaro, 1978). This early graphical exposition had a certain limited but enduring success. It was published separately as a monograph by the Institute for Humane Studies and was excerpted extensively in W. Duncan Reekie's *Markets, Entrepreneurs and Liberty: An Austrian View of Capitalism* (1984: 75–83). It continues to appear on Austrian economics reading lists, was the basis for some discussion in a interview published in Snowden *et al.* (1994), and tends to get mentioned in histories of the Austrian School, such as in Vaughn (1994), and in survey articles, such as in Kirzner (1997).

Though largely compatible with the graphical exposition offered in the present volume, this earlier effort was inspired by Mises's original account of boom and bust – an account that was anchored in classical modes of thought:

> The period of production . . . must be of such a length that exactly the whole available subsistence fund is necessary on the one hand and sufficient on the other for paying the wages of the labourers throughout the duration of the productive process.
>
> (Mises, [1912] 1953: 360)

This classical language got translated into graphical expression as the supply and demand for dated labor – with the production period being represented by the time elapsing between the employment of labor and the emergence of consumable output. While this construction served its purpose, it placed undue emphasis on the notion of a period of production and put an undue burden on the reader of interpreting the graphics in the light of the more modern language of Austrian macroeconomics.

Resuming my graduate studies – at the University of Virginia – I dropped the graphical framework but continued to deal with the conflict of visions that separated the Keynesian and Austrian Schools. From my dissertation came two relevant articles, "Intertemporal Coordination and the Invisible Hand: An Austrian Perspective on the Keynesian Vision" (1985a) and "Austrian Capital Theory: The Early Controversies" (1990). Bellante and Garrison (1988), together with the two dozen or so of my singly authored articles that appear in the bibliography, undergird or anticipate to one extent or another the theme of the present volume.

Since 1978, when I joined the faculty at Auburn University, I have taught courses in macroeconomics at the introductory, intermediate, and graduate levels. During the summers I have lectured on business cycle theory and on related issues in teaching seminars sponsored by such organizations as the Institute for Humane Studies, the Ludwig von Mises Institute, and the Foundation for Economic Education. I hit upon the interlocking graphical framework presented in Chapter 3 while teaching intermediate macroeconomics in 1995. Since that time I have used this framework in other courses and have presented it at conferences and teaching seminars with some success. At the very least, it helps in explaining just what the Austrian theory is. But because the interlocking graphics impose a certain discipline on the theorizing, they help in demonstrating the coherence of the Austrian vision. For many students, then, the framework goes beyond exposition to persuasion.

My final understanding of Keynesianism comes substantially from my own reading of Keynes's *General Theory* together with his earlier writings, but it owes much to two of Keynes's interpreters – Allan Meltzer and Axel Leijonhufvud. In 1986 I had the privilege of participating in a Liberty Fund Conference devoted to discussing Allan Meltzer's then-forthcoming book, *Keynes's Monetary Theory: A Different Interpretation* (1988). Though called a "different interpretation," Meltzer had simply taken Keynes at his word where other interpreters had been dismissive of his excesses. The notions of socializing investment to avoid the risks unique to decentralized decision making and driving the interest rate to zero in order that capital be increased until it ceases to be scarce were given their due. Meltzer had put the heart and soul back into Keynesianism. My subsequent review article (1993a) substantially anticipates the treatment of these essential aspects of Keynes's vision in Chapter 9.

Leijonhufvud, who was also a participant at the conference on Meltzer's book, has influenced my own thinking in more subtle – though no less

substantial – ways. Leijonhufvud (1968) is a treasure-trove of Keynes-inspired insights into the workings of the macroeconomy, and Leijonhufvud (1981b) links many of those insights to the writings of Knut Wicksell in a way that the Austrian economists, who themselves owe so much to Wicksell, cannot help but appreciate. Though Leijonhufvud has often been critical of Austrian theory, he sees merit in emphasizing the heterogeneity of capital goods and the subjectivity of entrepreneurial expectations (1981b: 197) and has recently called for renewed attention to the problems of intertemporal coordination (1998: 197–202). I have dealt only tangentially with Leijonhufvud's views of Keynes and the Austrians (Garrison, 1992a: 144–5), including, though, a mild chiding for his reluctance to integrate Austrian capital theory into his own macroeconomics (1992a: 146–7, n. 10). A late rereading of Leijonhufvud (1981b), and the recent appearance of Leijonhufvud (1999), however, revealed that my treatment in Chapter 8 of Keynes's views on macroeconomic stimulation and stabilization is consistent in nearly all important respects to Leijonhufvud's reconstruction of Keynesian theory.

My understanding of Monetarism reflects the influence of Leland Yeager, though in ways he may not appreciate. In fact, had I taken his blunt and frequent condemnations of Austrian business cycle theory to heart, I would never have conceived of writing this book. But as professor and dissertation director at the University of Virginia and as colleague and friend at Auburn University, he has influenced me in many positive ways. For one, Yeager's graduate course in macroeconomics focused intensely on Don Patinkin's *Money, Interest, and Prices* (1965). Having profited greatly from that course, I show, in Chapter 10, that Patinkin's account of interest-rate dynamics complements the more conventional Monetarist theory in a way that moves Monetarism in the direction of Austrianism. For another, his exposition and development of Monetary Disequilibrium Theory have persuaded me, as I explain in Chapter 11, that pre-Friedman Monetarism is an essential complement to the Austrian theory – though Yeager himself sees the Austrian theory as an embarrassingly poor substitute for Monetary Disequilibrium Theory.

I had occasion to learn from and interact with Ludwig Lachmann in the early 1980s when he was a visiting professor at New York University and I was a postdoctoral fellow there. As recounted in Chapter 2, Lachmann's ideas about expectations and the market process served as an inspiration for many of my own arguments.

Though I met and talked with Friedrich Hayek on several occasions, I can hardly claim to have known him. However, the reader will not fail to notice his influence in virtually every chapter – and in virtually every graph – of this book. His writings fueled my interest in the early years and in later years provided the strongest support for my own rendition of Austrian macroeconomics. It is to Hayek, then, that I owe my greatest intellectual debt.

Roger W. Garrison
January 2000

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Part I

Frameworks

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