The concept of monetary equilibrium has a long history in economics, going back at least to Wicksell. Wicksell’s idea has been incorporated into divergent schools of thought in the century plus since its inception. Chief among these are the monetarist school, in particular an offshoot of that tradition, known as monetary disequilibrium theory, primarily represented by the works of Leland Yeager, and the Austrian school. While the definition of monetary equilibrium has changed significantly over the years, both schools currently accept very similar definitions. There are subtle differences in the two approaches, however, and the importance attached to the equilibrium state in the two traditions is very different as well. This differential emphasis has profound consequences for the theories developed by these two schools of thought, especially in the area of business cycle theory. While monetary disequilibrium theory does include some consideration of the market process so important in Austrian theory, at its core lies a view of equilibrium as essentially a static state. I show in this paper that this incorrect definition, along with an over emphasis on maintenance of the equilibrium state has led to an inadequate explanation of the business cycle in the Yeagerite tradition. The Austrian theory of the business cycle examines business cycles from within the context of the entire economic process and thus, far from being overly specific, is the only theory that provides a complete explanation of that phenomenon.
INTRODUCTION

The concept of monetary equilibrium has a long history in economics, going back at least to Wicksell (1962). Wicksell’s idea has been incorporated into divergent schools of thought in the century plus since its inception. Chief among these are the monetarist school, in particular an offshoot of that tradition represented by the works of Leland Yeager, and the Austrian school. While the definition of monetary equilibrium has changed significantly over the years, both schools accept essentially identical definitions. The emphasis placed on monetary equilibrium, however, is very different in those two traditions. This differential emphasis has profound consequences for the theories developed by these two schools of thought, especially in the area of business cycle theory. We shall see that an overemphasis on monetary disequilibrium has led to an inadequate explanation of the business cycle in the Yeagerite tradition.

EARLY MONETARY EQUILIBRIUM THEORY

While the investigation of the nature of money and the effects of monetary debasement is as old as political economy, framing that question in terms of monetary equilibrium is relatively recent. Wicksell was primarily concerned with the behavior of the general level of prices, especially as influenced by changes in interest rates. He did this in an explicitly Walrasian equilibrium context, so his discussion was permeated with equilibrium considerations. At the outset, he asserts that “the ideal condition … would undoubtedly be one in which, without interfering with the inevitable variations in the relative prices of commodities, the general average level of money prices ... would be perfectly invariable and stable.” (p. 4)

Although he admits to difficulties in defining that average price level, he has no doubt that it is possible to do so. As described by Myrdal (1939), Wicksell based his definition of monetary equilibrium on the existence of three conditions.

The first of these is the equivalence of the “natural” rate of interest and the money rate of interest. Wicksell, a student of Böhm-Bawerk, begins his analysis with a definition of the natural rate based on
the physical productivity of capital. Myrdal rejects this definition, but for the wrong reasons. Wicksell’s
definition is predicated on the assumption of the absence of both money and credit transactions. These
are obviously unrealistic, but, in this author’s view, serve only to demonstrate that interest is a real, not
a monetary, phenomenon. They are not essential to even this flawed definition of the natural rate of
interest. Still, Myrdal rejects Wicksell’s original definition and replaces it with his own, based on the
“exchange value productivity” (p. 51) of capital. This is to his credit, since he realizes that simple
physical productivity is irrelevant to the return to capital. Instead, the return to capital is based on the
value that is created in the marketplace through its production. Correct though this insight was, it still
does not salvage Myrdal’s analysis. Even though Wicksell’s initial point is essentially correct, that there
is some interest rate that is exogenous to the market process and that there will be problems if the
money rate differs significantly from it, this incorrect definition dooms both Wicksell and Myrdal to
wandering down a dark, blind alley.

Wicksell’s second condition of monetary equilibrium is equilibrium in the capital market. That is, equivalence between the supply of and demand for savings, or in other words, as Myrdal points out (p. 86), between saving and investment. Properly understood, of course, this condition is a corollary of the first. Here, though, Myrdal’s (and Wicksell’s) misunderstanding of the nature of interest sends him even further off the correct track. With the natural interest rate based on capital productivity, Myrdal is able to posit changes in saving and investment with neither a causal nor an effective change in the money interest rate. This error leads him to describe a condition resembling the Keynesian liquidity trap, with increased savings implying decreased consumption and thus instigating or aggravating a depression (pp. 106-112). Although Myrdal does admit the possibility that an increase in saving might decrease the money interest rate and spur investment, he does not think this is a very strong factor and ultimately misses the equilibrating function of interest rates in the capital market.
Finally, Wicksell’s third condition of monetary equilibrium concerns equilibrium in the commodity market, defined here as a stable price level. Myrdal takes exception to this definition, but again for the wrong reasons. He correctly notes that any particular “price level” can be consistent with monetary equilibrium; he then wrongly concludes that only changes in relative prices are symptomatic of disequilibrium. He fails to realize that a change in overall prices, even if price relations were unchanged, can also be the result of monetary disequilibrium. Myrdal has no problem with the notion of a price level in general – the incomparability of prices for different goods does not occur to him. He even postulates a complex weighting system, based on the flexibility and “importance to profits” of different prices, that would result in a price index usable for monetary policy decisions (pp. 133-138). Much of his analysis is based on the consequences of sticky prices and especially sticky wages. His policy analysis revolves around the goal of adapting the levels of more flexible prices to the less flexible ones. Although monetary equilibrium would certainly have some implications for prices in the goods market, then, Wicksell and Myrdal miss them because of their acceptance of the fallacious concept of the price level. Overall, Myrdal seems to offer a very proto-Keynesian treatment of monetary equilibrium.

MONETARY EQUILIBRIUM IN THE AUSTRIAN SCHOOL

As mentioned before, Wicksell was a student of Böhm-Bawerk, so his ideas were well known among the members of the nascent Austrian school. This was very different intellectual soil, however, and here Wicksell’s ideas bore fruit that resembled only in the most general terms that which had sprung from the mind of his Swedish compatriot.

Mises did much with Wicksell’s basic concepts. In his early work (von Mises 1980) he used Wicksell’s idea of the natural rate but he did not, however, accept the capital productivity definition in any form. Rather, he defined the natural rate as “the rate determined at the time by the whole economic situation” (p. 398). Though Mises does not define the natural rate here in any further detail, it is obviously a more complex concept for him than for either Wicksell or Myrdal. He goes on to
emphasize that the productivity of capital, however defined, is not a determinant of the interest rate, but instead is a decision point for entrepreneurs as to which projects to undertake, based on the market interest rate. Later on, Mises (1998) integrated Wicksell’s basic concept with the Austrian principle of subjective value in a pure time preference definition of the natural rate, which Mises called “originary interest” (p. 523). Placing his theory of interest on this firm foundation was instrumental in allowing Mises to avoid Wicksell’s errors and move on to a sound concept of monetary equilibrium.

Also integral to Mises’ view of monetary equilibrium is his application of subjective valuation to the question of money demand (von Mises 1980, pp. 154-158). Mises was then able to move beyond the simple concepts of the quantity theorists and explain the process by which the market achieves monetary equilibrium. Thus, as with other aspects of Mises’ economic theory, this market phenomenon is based in individual action.

For Mises, then, monetary equilibrium first happens at the individual level. Each actor wants to keep a cash balance on hand for future transactions, both planned and contingent. This desired cash balance constitutes the individual’s money demand and is based on that individual’s subjective valuation of holding money as compared to their valuation of obtaining more goods or services with that money. The amount of money the individual actually has on hand constitutes his supply of money. Through their spending behavior, individuals will attempt to equate their desired and actual cash holdings. As individuals engage in market transactions, the desire for individual monetary equilibrium, that is, the desire to hold a specific cash balance, is translated into the total demand for money and overall monetary equilibrium. In this respect, then, actors treat money exactly the same as other goods. Actors demand goods based on the marginal utility of each particular good, as subjectively determined. They hold differing quantities of each good such that the marginal utility of each good is more or less the same as any other. Money simply takes its place on each individual’s unitary value scale.
It is important to remember here that the nominal amount of the cash balance is irrelevant to the individual (von Mises 1998, p. 418). Money is not valued for its own sake, but rather for the services it provides in being traded for other goods or in being available to trade for other goods. Thus the individual’s goal is to hold a particular real cash balance, a particular amount of purchasing power held in reserve. This realization is instrumental to the Austrian analysis of the effects of changes in the money supply.

Rothbard (1962) made a more detailed analysis of the demand for money, analogous to his total demand analysis of the market for goods. Here money demand is divided into exchange demand, the demand for money by sellers of all other goods, and reservation demand, the demand to hold money by those who already have it (p. 662). Since the total stock of money must, at any given time, be owned by individuals, these two categories of demand sum to the total demand to hold money. Rothbard, then, comes to the same endpoint as Mises, that the demand for money is the demand to hold cash balances. This demand will interact with the given supply of the money commodity in the total economic market for goods and services, and the market will tend toward an equilibrium level of the purchasing power, or exchange value, of money (PPM). Rothbard emphasizes that the PPM is a concept that can be defined and understood, but not measured. It is not the inverse of any average price level, since that term cannot even be meaningfully defined, Wicksell’s and Myrdal’s (and countless others’) efforts notwithstanding. Instead, since money exists in a state of barter with all other goods, the PPM is the array (properly, the vector) of the prices of all other goods and services in the economy. The elements of this vector are not comparable, since there are no common units, and while in principle countable, they are for all practical purposes infinite.

We already see, then, a dichotomy in the approach to monetary equilibrium. On the one hand, there are the analysts who concentrate on the equilibrium state itself, emphasizing on the conditions necessary for certain measured quantities to remain constant. This view is couched in terms of
aggregated variables and functional relationships. On the other side are the Austrians, who emphasize the operation of the market process and view money as just one part of an integrated whole. Monetary equilibrium here is just one aspect of the general state to which the economy tends to move as individual actors seek to satisfy their wants.

MODERN MONETARY DISEQUILIBRIUM THEORY

In modern times we see a sort of hybrid of these two strands in the work of Leland Yeager. Yeager starts with an essentially Misesian definition of monetary equilibrium, founded on the demand for cash balances, but uses that definition in an analysis that focuses on the equilibrium state, or rather departures from it (hence “disequilibrium”). Yeager adheres to the monetarist school of thought, which he defines as the view that “money matters most” (Yeager 1997). He offers an analysis that is similar to the Austrian view in certain respects, but that nonetheless has definite limitations.

Yeager’s (1986) definition of monetary equilibrium is essentially the same as Mises’ and Rothbard’s. Individuals have a demand for money to hold as cash balances, based on their income and desire to provide for future contingencies. He begins his analysis by correctly stating that markets tend to clear, and if markets in general fail to clear, as in a depression, it must be because of some disturbance that affects the entire economy and cannot be corrected quickly. He reasons that since money, as the medium of exchange, enters into all market transactions, the most likely candidate for such a disturbance must be a discrepancy between the demand for and supply of money, or monetary disequilibrium, at the current level of prices.

Also integral to Yeager’s analysis is a somewhat Keynesian conception of sticky wages and prices. This stickiness is a particularly important factor in the situation where money demand exceeds supply, and thus prices would have to adjust downward. Yeager claims that this condition could be produced if money supply growth falls short of the trend, but for simplicity’s sake considers the case of an actual decrease in the money supply, which generates the classic “who goes first” problem. A smaller money
supply will bring about a higher PPM and thus lower prices, but individuals are not immediately aware of the change in supply. Knowledge of the smaller money supply is transmitted through the market at least in part by lower nominal prices, which don’t happen immediately. As individuals restrict their purchases to try to maintain their cash balances with a decreasing supply, sellers are faced with increased inventories. The larger inventories signal the need to decrease prices, but each seller has a problem. He can lower his prices sufficiently to sell his excess inventory, but if he is not reasonably sure that his suppliers will also lower their prices, he may end up selling at a loss. Since this is not a sustainable situation, sellers will be unwilling to lower their prices enough to reach the new equilibrium quickly and the depression will linger.

In Yeager’s system, wages are even stickier than prices. Here and in (Yeager 1956) he in fact describes a view of the labor market that very much resembles Keynes, despite his criticisms of Keynesian economics elsewhere. Workers respond almost exclusively to nominal wages in Yeager’s model, so much so that they will accept unemployment rather than lower nominal wages even if those wages are unchanged or even higher in real terms. Deflation, then, is to be avoided at all costs since it will inevitably result in unemployment and depression. Authorities must in fact rely on the ruse of inflation to get workers to accept a change in real earnings, masked as a change in the relative rate of increase of wages and the money supply.

The opposite case of supply of money exceeding demand does not concern Yeager much, since wages and prices are not nearly so sticky upwards as downwards. Consumers may be reluctant to pay higher prices and employers reluctant to pay higher wages, but the increased money supply generates higher levels of spending as people try to get rid of their excess cash balances. Thus an increase in the money supply does not cause a “who goes first” problem and in fact stimulates a higher level of business activity overall. The bulk of Yeager’s analysis, then, as well as his policy recommendations, revolve around preventing or correcting deflation and the ensuing depression. In Yeager’s view, when in a
situation where money demand outstrips supply, the monetary authority has two options: either allow prices and wages to adjust until the real value of cash balances adjusts to individuals’ desired levels, or increase the nominal money supply to match individuals’ desired nominal cash balances at current prices and wages. Since the latter action can always take place more quickly than the former, that is Yeager’s preferred course.

Yeager makes much of the empirical support for monetary disequilibrium theory in the historical record. History abounds, he says, with episodes when an increase in currency, often paper currency, relieved a recession or depression, and also episodes when a decrease in the money supply brought about a downturn. He specifically criticizes the Austrian theory and its adherents for an almost complete lack of empirical support, but citing only Wainhouse (1984) as an empirical study supporting the Austrian theory. For some reason, he did not decide to discuss Rothbard’s (2000) contribution to the empirical support for Austrian business cycle theory. In particular, Yeager claims that Austrian theory is not necessary to account for the larger fluctuations in the demand for, and thus price of, capital goods relative to consumer goods over the course of the business cycle. Investment is much more elastic to changes in income and credit conditions than is consumption, and in an uncertain world some investment projects will always turn out to be unprofitable. The simpler monetarist view can account for this phenomenon just as well; Yeager encourages Austrians to heed Occam’s razor and enter the monetarist fold.

Horwitz (2006) has attempted a synthesis of the monetary disequilibrium and Austrian approaches to the macroeconomy. In his view these two approaches are complements rather than alternatives, and can be fruitfully combined with one another to produce a more comprehensive theory of macroeconomic phenomena, rather than one theory being subsumed within the other. His basic point is that Yeager’s approach is incomplete, and can be augmented by Austrian capital theory, while Austrian macroeconomics is asymmetric, disproportionally emphasizing the problems caused by
inflation at the expense of the analogous problems connected to deflation, which Yeager’s approach explicitly examines.

Horwitz begins his argument with a discussion of the basic properties of money, as identified by Yeager. The first two properties are very familiar to all Austrians. Money is the generally accepted medium of exchange, and the demand for money is the demand to hold real cash balances. The third property Horwitz (and Yeager) define is that we routinely acquire money; Horwitz claims Austrians pay less attention to this property. The crux of this definition is that “we will always accept money in exchange even if this means temporarily having more of it than we might wish to hold.” (p. 168) We do this because we know we can always trade the excess money for other goods or assets. This seems to be very similar to Menger’s point that money is the most saleable, most liquid commodity. The consequence of this property, though, is that monetary disequilibrium is corrected by changes in expenditures, since that is the means of changing cash balances that actors have near total control over. Most individuals cannot change their income at will, and selling assets depends on finding a willing buyer.

This leads Horwitz to develop a highly symmetric theory of adjustment to monetary disequilibrium. Excess demand for money, as well as excess supply, causes changes in expenditures that eventually bring about changes in prices and wages. Changes in both directions are not uniform, since either an increase or a decrease in expenditures involves a change in the overall structure of demand. Since these adjustments always take time, and because of the stickiness of prices and wages, the adjustment process always involves economic distortion. In addition, Horwitz claims symmetry in causation as well. Monetary disequilibrium and the resulting adjustment process can be initiated by a change in demand as well as a change in supply; the outcome is the same in either case.

Horwitz’ recommendation for Austrians is twofold: First, there has been insufficient attention paid to the destructive effects of deflation, which can be similar to those of inflation. In particular, monetary
disequilibrium theory can augment Austrian business cycle theory in understanding and explaining secondary depressions, as happened during the Great Depression, brought on by a decrease in the money supply. Second, Horwitz claims that in cases of a change in money demand Austrians should be willing to consider the benefits of a change in the money supply, even without a change in the quantity of the money commodity, as a quicker, less painful adjustment than a change in prices and wages.

PROBLEMS WITH MONETARY DISEQUILIBRIUM THEORY

From an Austrian point of view, monetary disequilibrium theory starts on the wrong track. As Yeager stated, monetary disequilibrium is part of the monetarist tradition, which takes as its first principle the conviction that “money matters most” (Yeager 1997). This is an absurd statement. If economics is the study of human decision making and action, then in terms of economic analysis actors matter most. Money is indeed half of every transaction and as such is an extremely important factor in action, but it is still an inanimate tool that actors use to achieve their ends. Thus money per se cannot be a causative agent, as Yeager seems to assert. Even though changes in the money supply have definite effects that can be traced through the economy, if we are to truly understand these effects we must also understand the initial cause, in terms of decisions and actions, that brought about the change in supply in the first place. Yeager seems to think tracing the causal chain back beyond a change in supply is unimportant.

This is because the emphasis on money leads Yeager and his disciples to hold an essentially mechanistic view of economic phenomena, overemphasizing equilibrium states at the expense of market processes. Yeager is certainly more cognizant of the importance of process than the mainstream; he emphasizes the adjustment process to changes in money supply throughout his analysis, and correctly locates the pernicious effects of those changes as occurring during that process. The problem here is more subtle than with mainstream general equilibrium theory, but a problem nonetheless.
As both Holcombe (1999) and Kirzner (1982) have demonstrated, there is an essential tension between the concepts of equilibrium and market process. The two concepts are complementary and both essential to understanding; equilibrium is where the economy is going, even if the destination is constantly changing, and market process is how we get there. However, one’s definition of equilibrium is critical to the ultimate character of one’s analysis. As Holcombe points out, while Austrians have advanced a few different definitions of equilibrium, all are based on how market processes play out. For instance, Holcombe notes that Hayek defined equilibrium in terms of plan coordination, while Kirzner emphasized the presence or absence of entrepreneurial opportunity. These definitions stand in contrast to the static equilibrium constructs of modern neoclassical economics, which emphasize constancy in some economic variables.

Unfortunately, while Yeager adopts an essentially Misesian view of monetary equilibrium on the individual level, he uses a very neoclassical definition on the macroeconomic level. In fact, his definition of equilibrium, in terms of its macroeconomic effects, hearkens back to Wicksell and Myrdal: a constant price level. While Yeager outlines the putative benefits of a stable price level (Greenfield and Yeager 1983), he unable to give a precise definition or means of measurement for that concept. As noted above, of course, the concept of a single price level is neither definable nor measurable. And, as Mises (1998) pointed out, any quest for constants in economics is futile; all things vary. Thus a flawed, static definition of equilibrium lies at the heart of monetary disequilibrium theory.

Even if the price level could be defined and measured, it is not at all clear how stabilization would work or if it would in fact be desirable. We must remember that individual prices are constantly changing for a variety of reasons. New, more efficient production methods can alter supply and demand relationships of existing products and therefore relative prices. As new products are introduced and old ones go away, individuals’ value scales adapt to the changes, causing changes in relative prices. If, at the same time, the overall price level drifts up or down, changing the PPM, there is no reason to expect this
to be harmful. Instead, it would be just part of the normal, constant equilibrating change of a functioning economy. Significant disequilibrium of the kind described by Yeager can only occur as the result of a sudden, unexpected, and large change in PPM that would result from, for instance, expansion or contraction of a fiat money.

Horwitz (1992) acknowledges this latter problem in his attempt at defining the equilibrium state. He abandons the possibility of a completely stable price level, and instead defines equilibrium as a state where prices are only influenced by conditions in the market for goods and not by conditions in the money market. This definition superficially sounds more reasonable but is no more practical. As Austrians generally point out, there is only one price that truly exists: the market price. The market price is the result of total market conditions. Any attempt to separate the effects of different forces, even so general a separation as goods market vs. money market influences, is as futile as any other task resembling central planning. Since we cannot know the market factors that interacted to produce any given price (Hayek 1945), neither can we separate out the particular contribution of each factor to the final market price. So Horwitz is chasing a phantom here just as much as Yeager is.

Yeager’s twin emphases on money and equilibrium lead him to an oversimplified analysis that boils down to (1) a departure from equilibrium is the problem and (2) a return to equilibrium, by whatever means, is the solution. This neglect of the wider market process, outside of the adjustment to changes in money supply, leads him to propose that a depression (excess of demand over supply) could be corrected equally well by either a fall in prices or an increase in the nominal money supply (Yeager 1956). The former would increase the PPM to equate real cash holdings with the now smaller supply, while the latter would increase nominal cash holdings to match desired holdings at the current PPM. Problem solved, according to Yeager.

Yet we know that depressions are not cured by infusions of new money, both from Rothbard’s excellent analysis of the early part of the Great Depression (Rothbard 2000) and from the experience of
the last two years. Unless Yeager dogmatically holds that the increases simply weren’t large enough, we must admit that there is something else going on.

That something else, of course, is the rest of the market process that takes place outside of the specific equilibrium relationship that Yeager, and to a lesser degree Horwitz, concentrates on. This might be summarized by an alternative to a statement made earlier: when it comes to growth, it is not money but rather production that matters most. And production matters not only in terms of quantity but also in quality. An equilibrium treatment of the issue, like Yeager’s, naturally emphasizes quantities. Quantities are the things that can easily be equated in a supposed equilibrium condition. Thus a deflationary scenario, when expenditures sag, reflects a drop in aggregate demand. There is no notion of heterogeneity in either production or consumption, and thus no notion that these two need to match up qualitatively. The fact that “investment” drops more than “consumption” is explained only by a difference in elasticity between the two. This simple explanation may be correct as far as it goes, but it neglects one outstanding feature of the business cycle. Yeager can only explain why investment would decrease after the downturn begins, when less money is available for investment. He does not explain why so many previously (apparently) profitable investments suddenly turn out to be not so profitable. In short, Yeager all but ignores Rothbard’s question of why the sudden cluster of entrepreneurial error. Important here is that in a debt-based monetary system, the entrepreneurial error and business failure is often a cause, rather than an effect, of the monetary contraction; again Rothbard’s analysis of the Great Depression demonstrates this fact.

The “why” question in fact plagues the cash balance interpretation of depression, as Yeager terms it, on other levels as well. While he discounts the Austrian account of the unsustainable boom, there is no clear explanation of why the money supply would suddenly decrease. Presumably there are many different potential causes in the monetarist model, and specifying them would make the theory “overly specific”, which is the main criticism of the Austrian theory. However, something this momentous
cannot be a random event, nor could it always be attributed to inept monetary policy. There must be at least some general class of macroeconomic phenomena that would help bring about a decrease in the money supply. Yeager offers no suggestions.

The “why” question comes up again in Horwitz’ synthesis. After a slightly inaccurate description of the Austrian analysis of the unsustainable boom, described below, he makes the statement that “the cycle can conceivable be triggered by a fall in the demand for money that is not met with a decline in the nominal money supply.” This statement has a bigger problem, as we see below, but still the question remains of how this could happen. Certainly an individual’s demand for cash balances can vary over time. But as Mises (1980, p. 160) observes, “Those variations in the ratio between the individual’s demand for money and his stock of it that arise from purely individual causes cannot as a rule have a very large quantitative influence in the market. In most cases they will be entirely, or at least partly, compensated by contrary variations emanating from other individuals in the market. ... The probability that the compensation will be complete is the greater, the more individual economic agents there are.” Thus Horwitz is faced with a question rather like Rothbard’s question of the cluster of entrepreneurial error. Why would everyone’s money demand change at once? If we cannot put this into an economic context of cause and effect, how can we understand this proposed phenomenon or even take the possibility seriously? Furthermore, if that did happen, could the change be of sufficient rapidity and magnitude to produce an economic downturn or depression? If holding cash balances is a form of saving (Horwitz 1992), then a change in money demand would necessarily entail a change in time preference. The nature of time preference is such that we would not expect any sudden changes, absent a cataclysmic cause, but rather an overall change in time preference would happen with the slow drift of cultural change. The resulting change in money demand and PPM would be imperceptible except in long retrospect.
However, Horwitz makes an even larger omission in his attempted synthesis of Austrian and monetarist views. In his quest for symmetry, Horwitz makes the point that in the Austrian story of the unsustainable boom, “the problem here is not the expansion of the money supply per se, but it being in excess of the demand to hold real balances.” (Horwitz 2006, p. 175) Again Horwitz’ overemphasis on the equilibrium condition has led him to overlook the subtleties of the market process. The unsustainable boom is produced not merely by an increase in the money supply above demand, but when that increase enters the economy through the loan market. There are many historical examples of the money supply increasing as a result of new discoveries of gold or silver. In many cases, this new money entered the economy by way of consumer spending by miners. While this increased spending, undoubtedly a case of monetary disequilibrium on the part of the miners, certainly drove up prices, it did not necessarily kick off an Austrian business cycle. The bust that nearly always followed such a boom was generally local, and the result of the end of the supply of new spending when the mines ran out.

The point that both Horwitz and Yeager miss is that the business cycle starts with not merely monetary disequilibrium, but when that disequilibrium enters the market for loanable funds and produces disequilibrium there, such that the supply of loanable funds exceeds the pool of real savings. It is this disequilibrium that is at the heart of Austrian business cycle theory. Neither Horwitz nor Yeager gives any consideration to this issue, or even mention real savings. The boom is unsustainable not only because production is not matched up with consumer time preferences, that is, with future “aggregate demand”, (although the real Austrian position is that it is not matched with the structure of future demand) but also because investment is not matched up with the real resources available for use in investment projects. Thus Horwitz’ statement that a cycle could be triggered by a fall in money demand is wrong on two counts.
This illustrates the other critical flaw in monetary disequilibrium theory: it is, as its name implies, a strictly monetary explanation of a set of economic phenomena. It is not sufficiently connected to either real economic factors, like the pool of real savings, nor does it take into account sufficiently market processes that surround and influence business cycles. This, along with its static equilibrium goal of a constant price level, makes it an incomplete and insufficient theory of business cycles. It can only appear to be a workable theory if the discussion is limited to those areas where it does apply.

SYNTHESIS OR SUBSUMPTION?

As noted above, Horwitz has high hopes for a synthesis of Austrian and monetary disequilibrium theories, as opposed to either one being subsumed within the other. The Yeagerite approach can be fruitfully augmented by Austrian capital theory, in his view, and Austrian theory could be improved by becoming more symmetrical, recognizing Yeager’s emphasis on the negative effects of monetary deflation. While adopting Austrian capital theory could be an improvement to any body of economic theory, this author believe the potential benefits to Austrian theory of the Yeagerite approach are more apparent than real. In fact, the significant features of monetary disequilibrium theory, excepting the inclusion of the “stable price level” definition of equilibrium, have been present in Austrian monetary theory for a long time.

We have already seen that the basic concept of monetary equilibrium (and disequilibrium), defined in terms of an individual’s demand for cash balances, was described by Mises in 1912 in his *Theory of Money and Credit*. There the concept is quite symmetric, as Mises described the adjustments that occur both in the event of excess demand as well as excess supply. Rothbard, as well, recognized the real world significance of deflation, explicitly citing it as a major cause of the panic of 1819 (Rothbard 2007), but also placing it in the context of the prior monetary expansion of the Second Bank of the United States and many state banks.
Modern Austrian economists no doubt do emphasize the pernicious effects of inflation more than the harm caused by rapid deflation, as Horwitz claims. This is most likely due to the twin facts that inflation is the more immediate problem in our current system and that, in Austrian theory, deflation is the result of prior inflation. Given that we operate within a system of debt-based fiat money, when the boom ends and debts are paid, liquidated, or written off with less new credit extended, the money supply must shrink. The decrease is a necessary part of the correction, however difficult it may be. We have certainly seen over the last few years that inflating the money supply to prevent that deflation does not make the recovery quicker or easier. The best way to prevent the harmful effects of deflation, then, is to limit monetary expansion in the first place. The Austrian emphasis on inflation is not misplaced – it is there, at least in part, because we do recognize the harmful effects of deflation.

Thus we see that a synthesis of Austrian and monetary disequilibrium theories is a pointless quest, because monetary disequilibrium has always been a part of, always subsumed within, if you will, Austrian monetary theory. Yeager’s monetary equilibrium theory is certainly simpler than Austrian theory, but too much so. It leaves out important parts of our economic system and thus provides an incomplete view of business cycles. Austrian business cycle theory, far from being unnecessarily complex, is the only theory that properly places business cycles in the full context of a functioning economy. As Horwitz trenchantly observed, Occam’s razor cuts both ways.
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