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REJOINDER TO COWEN: AUSTRIAN BUSINESS-CYCLE THEORY

ABSTRACT: *Cowen and I agree that rational-expectations theory is unrealistic and that risk is difficult to quantify. However, we continue to disagree about the riskiness of consumption as opposed to investment. Since more investment might lead to a recession if investment is relatively risky, Cowen's use of rational-expectations theory to buttress the Austrian school's claim that market economies can shift toward relatively more investment without experiencing macroeconomic disruption remains suspect.*

I welcome Tyler Cowen's thoughtful response to my remarks on his *Risk and Business Cycles*, which lays out a New Austrian view of business cycles based on risk analysis within a rational-expectations framework. I appreciate his ability to overlook some of my harsher remarks and to appreciate my sympathy for certain of his efforts. I seek here to clarify our areas of agreement and disagreement in light of his Reply. I shall focus on the four areas of apparent disagreement that he identifies.

The first involves the concept of rational expectations. I welcome Cowen's acknowledgement that he is open to the possibility that rational expectations may not be descriptively true. I agree that it can nevertheless be useful to contemplate the implications of models that assume rational expectations. As I said in my original essay (Rosser 1999), Cowen pinpoints awkward problems regarding assumptions about expectations in the Old Austrian business-cycle theory.

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However, it would have been useful if Cowen had made it clearer in his book that he does not necessarily believe that people actually have rational expectations. There has been altogether too much macroeconomic literature in which rational expectations are assumed to hold both in theory and reality. Cowen's apparent dismissal of the Old Austrians because of their violation of this assumption made it easy to believe that this was Cowen's view also.

As Cowen notes, the recent experimental evidence has not been friendly to the assumption of rational expectations, quite aside from the kinds of complexity arguments that I raised. How strained the rational-expectations assumption has become can be seen by some recent defenses of it. Thus, it has been argued that people in the United States have rational expectations because they consistently underpredicted the rate of inflation during the 1970s and then consistently overpredicted it during the 1980s, thus averaging out to having predicted it correctly with the errors balancing out. This may technically conform to the definition. But it certainly violates the spirit of "random errors" when one sees many years in a row of consistent errors in the same direction, as appears to have happened.

I appreciate that Cowen understands that if risk is to be properly quantified, it may need to be done in a multidimensional manner. Again, it would have been useful if this had been recognized explicitly in the book, given the centrality of risk to the analysis. Although Cowen detects in my remarks a "hard line," which would allow only nonquantifiable uncertainty, my view accepts a spectrum of approaches, depending on the circumstances of the analysis.

Thus, with regard to the effects of monetary variability, one might observe a monetary policy that reduces the variance of fluctuations but increases the leptokurtosis (fatness of tails) of the fluctuations. The extreme version of this type of policy would have been Soviet socialism, which eliminated short-term business cycles but eventually experienced total collapse. A milder version might arise from an apparently successful discretionary policy that smooths out short-term fluctuations but leads to a larger occasional fluctuation. In any case, it is clear that Cowen and I agree that we do not yet have a fully adequate theory of risk.

As regards the issue of new investments bringing greater risk, Cowen is right that we have a sharp disagreement. He suggests that I did not understand the difference between his argument that consumption is safer than investment and the argument that the 27th investment is

riskier than the 26th investment, *ceteris paribus*. I understood his point but disagreed with it. If consumption is so safe, why do people who perceive the future to have become somehow riskier tend to save more and consume less, as for example when they come to fear possible job loss? Cowen might argue that what is individually safer is riskier at the macroeconomic level because of fallacy-of-composition (or "paradox-of-thrift") effects. But he has not done so, to my knowledge.

With respect to the issue of rational expectations and real interest rates, I grant that there are reasonably consistent models of loanable funds in which rational expectations hold and increases in loanable funds can reduce real interest rates.

Finally, let me note some new confusion regarding terminology that creeps into the end of Cowen's reply. Cowen justifies his use of the term "New Austrian" by linking it to a presumably "more catholic" version of "neo-Austrian capital theory." I think it would be better to let "neo-Austrian" refer to modern Austrian economists who are not from Austria, a usage I have already seen implemented, and to let "New Austrian" refer more specifically to an approach based on the rational-expectations assumption. After all, it is rational expectations that distinguishes "New Classical" from "Old Classical" economics, with both drawing from the more general "neoclassical" school. Likewise, "New Keynesians" assume rational expectations in contrast with "Old Keynesians" and "neo-Keynesians," each of which represent distinctive viewpoints. I believe that Cowen should take credit for his "New Austrian" neologism and not muddy the waters by attempting to confound it with the already existing and distinct "neo-Austrian."

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