Forbes
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TECH

9/14/2011 @ 8:30AM |47 views

Sushi and Malinvestment

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Last week I wrote about Paul Krugman's story of the baby-sitting co-op, which he used as a metaphor for monetary policy. The story helps explain the basic argument of today's Keynesians and quasi-monetarists. In a nutshell: there's a shortage of money, leading to a slowdown in economic activity as people are reluctant to part with the cash they've got. The solution, on this view, is for the Fed to create more money and give it to people.

I've been looking for a analogous story to explain the "other side," and a while back someone recommended that I start reading Robert Murphy, who counts himself as a member of the Austrian school of economics. In 2008, he explained the Austrian theory of the business cycle using an imaginary island economy:

> Every day, 25 people row boats out into the water and use nets to catch fish. Another 25 of the islanders go into the paddies to gather rice. Yet another 25 people take rice and fish (collected during the previous day, of course) and make tantalizing sushi rolls. Finally, the remaining 25 of the islanders devote their days to upkeep of the boats and nets. In this way, every day there are a total of (let us say) 500 sushi rolls produced, allowing each islander to eat 5 sushi rolls per day, day in and day out.
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> But alas, one day Paul Krugman washes onto the beach. After being revived, he surveys the humble economy and starts advising the islanders on how to raise their standard of living to American levels. He shows them the outboard motor (still full of gas) from his shipwreck, and they are intrigued. Being untrained in economics, they find his arguments irresistible and agree to follow his recommendations.
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> Therefore, the original, sustainable deployment of island workers is altered. Under Krugman's plan for prosperity, 30 islanders take the boats (one with a motor) and nets out to catch fish. Another 30 gather rice from the paddies. A third 30 use the fish and rice to make sushi rolls. In a new twist, 5 of the islanders scour the island for

> materials necessary to maintain the motor; after all, every day it burns gasoline, and its oil gets dirtier. But of course, all of this only leaves 5 islanders remaining to maintain the boats and nets, which they continue to do every day.

It's a fun story, and I encourage you to read it in its entirety. The key point is that this re-arrangement allows a temporary increase in output, but this increased output comes at the expense of continued maintenance of the islanders' equipment. Eventually, their boats and nets start to wear out, and production falls to the point where the islanders no longer enjoy five sushi rolls per day. At this point, there's a period of hardship and unemployment as the islanders scramble to re-build their depleted capital stock.

Austrians call this kind mis-allocation of resources "malinvestment," and it's at the heart of their explanation for the booms and busts of the business cycle. And the story has a great deal of intuitive plausibility. In the 2008 crisis, the key malinvestment was the housing boom, in which builders overestimated the demand for housing and office space, and were eventually forced to abandon buildings that couldn't be sold.

It's a plausible story, but it's not clear how much explanatory power it has. Murphy wrote it as a response to Cowen and Krugman as a defense of Austrian theory, who asked him to explain why the collapse of one sector (fishing in Murphy's story, housing in the real world) should lead to unemployment throughout the economy. Murphy's story offers a plausible answer: until the boats and nets are rebuilt, there isn't enough machinery to keep all the workers busy.

But that doesn't seem to get to the heart of his disagreement with Cowen and Krugman. The latter don't dispute that malinvestment can occur, or even (I think) that too-loose monetary policy can contribute to the problem during a boom. Clearly, too many houses were built in the previous decade, and loose money was a factor. The key dispute is over what to do about it after it happens. Krugman's claim is that in the wake of an economic collapse, the central bank should expand the money supply in order to avoid the contractionary effects of everyone trying to hold too much cash at once. Murphy's response, I think, is that that would lead to more malinvestment.

But because there's no money in Murphy's toy economy, it doesn't give us an intuition for why monetary expansion after a crash is harmful. Obviously, you can't address every objection with one model. But given that the fundamental dispute here is over monetary policy, it's a little surprising that Murphy would choose a model economy with no money in it.