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Overinvestment and Malinvestment

Overinvestment refers to a greater than sustainable amount of spending on production projects -- that is, spending on the production of higher-order goods in general. Malinvestment refers to a unsustainable shift in spending on production projects away from those with shorter periods of provision toward those with longer periods of provision (Mises: 1966: 493-9).

A Strict Gold Standard

To help understand the distinction, consider first a a_strict_gold standard. Under this standard, a banker could not issue unbacked gold certificates. The quantity of money could be increased only by the discovery of new gold. A boom and bust, due to monetary factors, could occur. The bust would signify a rearrangement of entrepreneurial activity and factors of production after the period of discovery was over. But the bust would not necessarily signify malinvestment. The bust would amount to a recognition by entrepreneurs that the preferences of people in the gold industry were less influential as consumers than they had been during the previous boom and additional gold.

An increase in the amount of gold-backed money could cause overinvestment if the suppliers of the factors of production did not anticipate that future prices would rise. They might increase their supplies of factors beyond the level that is sustainable after the increase in consumer

goods prices. In other words, if there was a money illusion, an increase in gold-backed money could cause overinvestment due to the lag in the rise of the prices of the factors of production.

A Credit Money System

Now consider a credit money standard, where banks are permitted to issue unbacked gold certificates. This is equivalent to a credit money standard. Suppose that banks do, in fact, issue additional credit money. If the additional money was issued solely for the purpose of making additional loans, the market interest rate would fall. If, in addition, the money issue was unexpected and if entrepreneurs did not predict its ultimate effects, they would _malinvest_. That is, they would shift the proportion of their investments. They would finance proportionately fewer shorter-term production projects and proportionately more longer-term ones.

If suppliers of factors failed to anticipate future price increases, the entrepreneurs would also _overinvest_. That is, if we added up all of the money borrowed in the loanable funds market and destined to be used in the production of goods, it would be greater than that which could be sustained by the inflation-adjusted demands for new consumer goods and producer goods.

A bust would later occur. It would be a combination of a malinvestment bust and an overinvestment bust. The proportion of money going into the loanable funds market relative to the money going into the consumer goods market would fall. The market rate of interest would rise and both the malinvestment and the overinvestment would be revealed, resulting in a bust.

We can imagine a case in which there would be overinvestment without malinvestment. This could occur if banks invest newly-created credit money directly in shorter-term production

projects without injecting them into the loanable funds market. Or, banks could distribute the new money by secretly making gifts to people who have high time preference.

The important point is this. If banks unexpectedly issue additional credit money and supply it to loanable funds markets, (1) there will be malinvestment because entrepreneurs will invest disproportionately in longer-term production projects and (2) there will be overinvestment because suppliers of the factors of production do not anticipate the future increases in the prices of consumer goods and, therefore, supply more factors than they will after the price increases are revealed. (There is a money illusion.)

Why is this distinction important to Austrian economists? Because the concept of malinvestment, as defined above, is a distinctly Austrian idea invented by Mises. It is the essence of the Austrian theory of the trade cycle. The idea of overinvestment is not distinctly Austrian.

References

von Mises, Ludwig (1966). *Human Action: A Treatise on Economics*. Chicago: Henry Regnery Company.

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Abstract

This essay distinguishes between the concept of overinvestment and the distinctly Austrian concept of malinvestment. It first describes these phenomena in a strict gold standard environment. Then it describes them in a credit money environment.

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