Book Review

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Theorie der wirtschaftlichen Entwicklung
(Theory of Economic Development)
by: Joseph Schumpeter
Published 2006[1912]
by Duncker & Humblot
Berlin, Germany, EU, 548pp
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Joseph Schumpeter's *Theory of Economic Development* was first published in 1912 (in German) with a reprint published in 2006, also in German.[1] His book takes a significant step towards a theory of finance, merging the monetary and the real sides of the economy. Hyman Minsky built on Schumpeter's work, using the concepts of hedge, speculative and Ponzi finance; but unfortunately, most neoclassical economists have ignored him and his wonderful insights, especially on endogenous money, the viability of the banking system, and its power to create deposits through lending. His insights are very helpful for understanding current monetary economics and the financialisation of the economy.

Although Schumpeter was born in what was then Austria-Hungary (and today the Czech Republic), he was not a card carrying member of the Austrian school, even though his analysis of the entrepreneur shares common elements. Whereas Austrians were rather sceptical of the net benefit of credit booms and busts, Schumpeter embraced credit booms as the driver of development.

The opening chapter of the *Theory of Economic Development* is 'The circuit of the economy conditional on given circumstances', in which he explains production and exchange as the economy's two major concerns. Schumpeter then introduces the entrepreneur, and although his entrepreneurial archetype is an abstraction, he lets the reader decide whether this abstraction is realistic. The entrepreneur creates 'new combinations' – the essence of entrepreneurial activity – by making correct decisions in an environment of uncertainty. Of course, the entrepreneur cannot examine the myriad of potential influences on outcomes before making a decision, which is the crux of the problem for Schumpeter's entrepreneur.

Schumpeter argued that not everything can be known (ontological uncertainty), and that not everything is known (epistemological uncertainty). Decisions of the entrepreneur are validated by the market and only with hindsight can be judged as correct. One might see a Darwinian process in which entrepreneurs move the economy forward through their decisions. Development happens where entrepreneurs make the correct decisions, i.e., entrepreneurial activity that is validated ex-post. He seems to imply that sufficient profits to repay loans are the key issue. This view contrasts with George Soros, a modern

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financial entrepreneur, who refers to fertile fallacies – ideas that work for some time, but eventually are no longer appropriate due to a change in circumstances.

After discussing his theory of the entrepreneur, Schumpeter turns to the monetary system and asks how the entrepreneur acquires the purchasing power he needs to start his business (for Schumpeter the entrepreneur is male). Using profits to finance investment is ruled out since profits are the consequence of development and hence cannot be its cause. The typical way an entrepreneur acquires purchasing power is by asking a banker for a loan. "Without great sin", Schumpeter writes, "one could say that bankers create money". The banker sanctions the entrepreneur's plans by giving him access to purchasing power, "Like the entrepreneur is king, the banker is the Ephor of the market". (An Ephor is an overseer in ancient Sparta.)

In chapter three, Schumpeter turns to credit and capital. He describes as *herrschende Auffassung* (mainstream) the idea that banks create money by writing IOUs and that money is created mostly to grant loans. It is exactly this function of credit creation that creates economic development, lifting the economy out of its static equilibrium. Schumpeter thus differs from the loanable funds approach where investment is financed by (limited) savings instead of (theoretically unlimited) loans. The creation of additional purchasing power does not directly create more supply of goods and services, but creates more demand for whatever is used in production. Higher prices of capital goods result, shifting resources towards new uses.

Schumpeter uses the analogy of token money to explain that money is relative and not absolute. In general, giving more tokens to everybody will not influence the end result, whereas just giving a few does.[2] How many tokens are banks able to give to entrepreneurs? Schumpeter, who generally writes very clearly, does not provide a satisfying answer. Theoretically, no bank can emit unlimited amounts of bank notes, he writes, and because loans must be repaid, the amount of money held by the debtors must at least equal or exceed what is needed for repayment. Schumpeter claims that loan repayment does not destroy money, but that loan default does. Here, his analysis is confusing and perhaps Schumpeter should have discussed Wicksell, who was much clearer on money creation.

The second section of the book discusses capital and elucidates *why* an entrepreneur would borrow: Entrepreneurs use loans to acquire deposits – not goods – which are then used to buy goods and start production, hoping to sell for a profit. Without profit there is no development and without development there is no profit. Schumpeter adds that the current money supply is instrumentally used to possess more money in the future. He argues that ignoring money would lead to an incomplete picture of economic development, and needless to say, his view sharply differs from the standard neoclassical view.

Schumpeter also recognised that entrepreneurs pay interest out of their profits. While not an original insight, it nevertheless is fundamental: If firms do not expect profits, they will not be able to pay any interest rate. Thus, low interest rates are a symptom of, and not a cause, of economic weakness. Based on this insight Schumpeter developed a theory of interest rates, where interest is a consequence of development, paid out of profits, and does not depend on actual goods. Schumpeter consequently defined the interest rate as a price element of purchasing power over investment goods. He denied that the interest rate is linked to a monetary aggregate but believed that if the quantity of money in circulation increases, all prices would increase, which would also cause nominal interest rates to

increase as entrepreneurs demand more bank loans to purchase needed goods for production.

Schumpeter admits that central banks can influence the interest rate, but claims that a central bank could not hold rates relatively lower than other countries for an extended amount of time. In capital markets, the existence of risk leads to variations in the interest rate that entrepreneurs face. “Lenders generally”, Schumpeter writes, “where they would lend without collateral and security, extend credit only to those he [the banker] knows and whose plans he understands to some extent and approves” (p.383). Schumpeter indirectly negates the neoclassical idea of scarcity in the context of financial markets: Given that the financial sector is spatially concentrated, the importance of personal contact and trust seems undiminished.

For Schumpeter, the supply of credit is determined by risk and potential differences in purchasing power of static and newly created money. Static money is the ‘usual’ supply of money; newly created money is added through the extension of bank loans. Schumpeter sees an unlimited demand for credit and a somehow limited supply. His ideas on the supply of money are far from clear and the connection between money, credit, and the static and dynamic economy is rather confused. Schumpeter seems to understand that bank liabilities can be accepted by the public and thus are ‘circuitable’, but he does not go into detail. The discussion ends with Schumpeter underlining the importance of profits for interest rates.

The penultimate chapter deals with *Das Wesen der Wirtschaftskrisen*. Schumpeter argues that economic crises are turning points for economic development: New combinations of goods and services turn static, heretofore dynamic elements of the economy over time changing relative prices, so that costs of static producers rise and profits go from zero to negative. And the purchasing power of money changes due to the creation of new deposits in the banking system. Schumpeter is very explicit in pointing out that an increase in money need not result in a price level increase, since output has also increased.

All development disturbs static equilibrium. Unintended consequences cause some product prices to increase, especially those demanded by entrepreneurs to create new combinations. Entrepreneurs are unable to form a set of full information about reality, in contrast to the neoclassical assertion. Unforeseen changes force some entrepreneurs into liquidation. Full-blown depressions are caused when the liquidation process is overly excessive, although the timing cannot be forecast, as *Zufall* (randomness) plays a large role.

In the last chapter, Schumpeter draws the big picture, linking his theory to the (social) culture of societies, which, in turn connects economics to other social sciences. For Schumpeter, the economy moves from one static equilibrium to another through a process of spurts of development, financed by credit and driven by entrepreneurs. This non-equilibrium process in which some entrepreneurs (and hence bankers) make mistakes constitutes a very different worldview than the neoclassical theory that Schumpeter attacked. Connecting both supply and demand-side into one theory, Schumpeter made his reputation with a *general* theory of development. Schumpeter’s theory of development includes depressions, but no cures; thus, not surprisingly his theory lost favour during the great depression. The next phase of development (or solution) was supposed to arise when entrepreneurs would be infused by euphoria, rather than the public sector increasing its spending (and debt).

Schumpeter's book should be essential reading for every student of economics. The description of the role of entrepreneurs and banks that finance their undertakings describes very well the boom phases of the economy. Both the *dot-com* boom and the real estate boom in the USA are typical Schumpeterian phenomena where the private sector takes the lead, going into debt and establishing new combinations. Schumpeterians and neo-Schumpeterians have stressed that firms often compete on the level of innovation rather than price, putting the focus on innovation and growth. The methodological choices by Schumpeter are helpful in making sense of real world phenomena and inform policy-makers about their options. While today many commentators call for a decrease in debt in order to return to a path of development, Schumpeter has shown that rising debt can be beneficial for societies. This, perhaps, has been and still is, his main achievement.

Notes

1 The translations from German to English are mine and not taken from any English edition. An English translation of the first edition does not exist.

2 The German-speaking world is quite fond of board games. Schumpeter speaks in very general terms here.