THE FREE MARKET

THE MONTHLY PUBLICATION OF THE MISES INSTITUTE

What Henry Hazlitt Can Teach Us About Inflation in 2014

JAMES GRANT

Believe me, ladies and gentlemen, when you stand at the pinnacle of financial journalism, you're standing at sea level. There are exceptions to the rule, of course. The Victorian polymath Walter Bagehot, second editor of *The Economist*, was one. The twentieth-century Americans Garet Garrett, John Chamberlain and—my old mentor at *Barron's*—Robert M. Bleiberg were others. Each brought something extraordinary to the prosaic business of financial and economic reporting and commentary. Then there was Henry Hazlitt (1894–1991), author, critic, self-taught economist, and visionary. I stand before you in the reflected glory of his reputation.

The author of *Economics in One Lesson*, a longtime columnist for *Newsweek,* and an editorial writer for *The New York Times* in the distant, pre-Krugman era, Hazlitt waged a career-long battle against inflation. He was at it in 1946—and he was still going strong in 1966. It may be well at this point to define terms—Hazlitt would have certainly wanted us to.

You have heard inflation reduced to the phrase, "too much money chasing too few goods." It is an overly narrow definition. Inflation is too much money. What the redundant increment of purchasing power chooses to chase is variable but always mischievous. It varies from cycle to cycle.

In one market interval, the dollars may chase skirts—or toothpaste or automobiles. This is inflation at the checkout counter, the familiar CPI variety. Or the dollars may chase stocks—or bonds or Iowa farmland. On Wall Street, where I work, this is the kind of inflation known as a "bull market," and most of us cheer it on. The inflation of asset values is the kind of inflation that is prevalent today.

In the past year, the world's central banks have materialized—net—$1.9 trillion (net, for

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instance, of the substantial shrinkage of euros effected by the European Central Bank). They conjured it on their computer keyboards. It may help to grasp the meaning of this vast pile of scrip to note that it is more than the GDP of India. One hears constantly that these central bank effusions are merely helping us adjust to the "new normal." I dispute it—and I'm sure that Henry Hazlitt would dispute it if he were here today.

"Deflation," too, is a perennially misunderstood term. It is not—as one so often hears it defined—a simple decline in aggregate prices. Let's try a mind experiment. Suppose you lived in a time of material and technological wonder: of digital technology that sets robots to work, makes universally accessible the canon of human knowledge (and, to be sure, of human error), and coordinates and arbitrages the world's far-flung labor markets. As it costs less to make things, so it should cost less to buy them.

Would you call this happy state of affairs "deflation"—or might you call it "progress"? Most Americans seem not to mind it, whatever the Federal Reserve chooses to call it. They spend half their weekends looking for it.

With this in mind, let's hear from Hazlitt himself, master of economic clarity. Here he is in June 1946—in *The New York Times*, no less—taking the government to task for its misplaced worry about a return to the 1930s.

"A Washington correspondent of the *Wall Street Journal* reports that the government economic experts are now convinced that 'deflation' and not inflation will be the big problem six months to a year from now," Hazlitt began. "Planners of federal financial policy make no secret of their belief that the danger of post-war inflation was passed in late spring, and that from now on the greater danger lies in too-rapid deflation. Such a belief on the part of the government planners in Washington would not be surprising; the whole economic philosophy they have adopted leads them to believe that 'the real danger is deflation,' whatever the evidence may be on the other side."

In 1946, as now, the government held up the threat of deflation to justify a policy of ultra-low low interest rates and easy money. Now ladies, and gentlemen, I have devoted 31 years of my life to writing about interest rates, and I have to tell you that I can't see them anymore. They're tiny. And so they were in 1946. Then, as now, the Fed had been conscripted into the government's financial service. Just as it does today, the central bank pushed money-market interest rates virtually to zero and longer-dated Treasury securities to less than 3 percent. Just as it does today, the Fed had its thumb on the scales of finance.

Hazlitt urged the government to remove it:

"When interest rates are kept arbitrarily low by government policy, the effect *must* be inflationary," he wrote. "In the first place, interest rates cannot be kept artificially low, except by inflation. The real or natural rate of interest is the rate that would be established if the supply and demand for real capital were in equilibrium. The actual money interest rate can only be kept below the natural rate by pumping new money into the economic system. This new money and new credit add to the apparent supply of new capital just as the judicious addition of water adds to the apparent supply of real milk."

Hazlitt concluded that "the money rate of interest can be kept below the real rate of interest only as long as the supply of new money exceeds the supply of new real capital. Excessively low interest rates are inflationary in the second place because they give an excessive stimulation to the volume of borrowing."

Why, I could quote those perfectly formed sentences in *Grant's* today (and I believe I just might).

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Investors *and* Austrian Economics

An Interview with Robert Blumen

Robert Blumen, a software engineer with a background in financial applications, recently spoke with the Mises Institute about the Austrian School's growing influence among investors. Blumen, who lives in San Francisco, has a physics degree from Stanford University and writes frequently for mises.org, LewRockwell.com, and other sites. He has spoken at economic and finance conferences on Austrian economics, and he is the editor of the podcast Software Engineering Radio.

Mises Institute: In recent years, we've seen more and more Austrian-tinged economic analysis coming from investors like Mark Spitznagel and Jim Rogers, to just name two. As someone personally involved in the investment world, have you yourself seen growth in Austrian ideas among investors and similar professionals?

Robert Blumen: There has been tremendous growth in interest in Austrian economics among financial professionals. I started an interest group for Austrians in Finance on LinkedIn which, in a few years, has grown to almost 2,000 members from the US, South America, East, Southern, and Central Asia, Africa, and Eastern and Western Europe. Peter Schiff appears regularly on financial shows. The Mises Institute drew hundreds of people from the investment world to an event in Manhattan.

Since 2002, a number of Austrian-themed books in financial economics have come out. Alongside titles from established writers such as James Grant, there is Detlev Schlichter's *Paper Money Collapse*, and several books by Peter Schiff. There are many popular Austrian bloggers such as Grant Smith and Robert Wenzel. Over two million viewers watched a 2006 video in which a parade of condescending media hosts heap ridicule on Peter Schiff, who, to his credit, did not back down in the face of their smugness.

MI: Did the financial crisis of 2008 help increase the sympathy for Austrian economics?

RB: I have heard the same story from many people in finance. When the bust of 2000 (or 2008) happened, it did not fit what they had been taught in school, nor could it be explained within the belief systems of their colleagues in financial markets. Their next step was reading, searching for answers, and then, finding the writings of Mises, Hayek, or Rothbard that enabled them to make sense of what had happened.

To answer your question, yes, I think that the failure of the popular economic theories—evidenced by these inexplicable crises—has driven the search for superior ideas. The Mises Institute has been publishing for years, explaining these boom and bust cycles with Austrian economics. When people searched, many of them ended up at mises.org.

MI: In spite of lackluster growth on Main Street, Wall Street appears quite happy with growth over the past two years. For the casual observer, one might argue that the Fed has managed things well. What do you see as problematic with the current approach, and are there some in the finance world skeptical of the Fed's current strategy?

RB: The Fed has a series of mistaken theories supporting their belief that higher stock prices indicate the success of their policies.

The first is the thinking that asset prices are actual wealth, when they are only the prices of the capital goods, which are a form of real wealth. Asset prices, in real terms, are the exchange ratios between consumption goods and capital goods. Artificially-boosted asset prices mean only that the owners of assets who bought them at lower prices have increased their consumption possibilities in relation to non-owners of assets. The owners of most assets, the so-called "1 percent" are the beneficiaries of Fed policies.

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News from Auburn

Our Annual Academic Conference

The Austrian Economics Research Conference (AERC) was an enormous success this year, with national figures James Grant and Judge Andrew P. Napolitano both delivering lectures to a packed house. Graduate students, undergrads, and faculty attended more than 40 talks, lectures, and presentations by colleagues working in the Austrian School.

The AERC is the Mises Institute's scholarly conference for professionals, where graduate students, faculty, and other scholars come together to discuss new research, books, working papers, and research projects.

All named lectures were presented online to our global audience, and have now been archived at MisesTV online. In addition, numerous presentations from other sessions are now available in audio format online from Mises Media.

Hayek Society Member Caitlin Long and Jim Grant

The three-day conference began with presentations on new books from scholars in the Austrian tradition. Mark Thornton presented on his new book, *The Bastiat Reader*, a collection of Bastiat's most influential and seminal works. Dr. Thornton revealed that *The Bastiat Reader* is the first in a future series of readers to include *The Rothbard Reader* and *The Hoppe Reader.* (Contact Kristy Holmes at 334.321.2101 for information on becoming a Patron of these works.)

The final day of the conference included a panel of participants from the 1974 South Royalton Conference credited with reviving the Austrian school of economics in the United States. The panelists discussed the gains made by the Austrian School in the 40 years since the conference, and included Ed Dolan, Randall Holcombe, Roger Garrison, Harry Watson, Gary North, Joseph Salerno, William Butos, and Richard Ebeling via skype.

Special thanks to the sponsors of named lectures: Dr. James Walker, Helio Beltrão, Butler Shaffer, James Rodney, and the Lou Church Foundation. And to sponsors of special panels: Jing Jin, Wai Chan, Carolyn Foss, Greg Krehel, and former Mises Fellow Dr. John McCallie.

Students attending the Institute's seminar on inflation.

Students Tune In for Our Inflation Seminar

We followed up March's scholars conference with April's conference on inflation for high school and undergraduate students: "Inflation: Causes, Consequences, and Cure." Hundreds of students and educators either attended in person or watched live as Jeff Deist, Mark Thornton, Joseph Salerno, Dan Sanchez, and Peter Klein presented a diverse and informative half-day seminar on inflation. Presentations included topics on inflation, hyperinflation, and the nature of money. Special thanks to an anonymous donor for sponsoring this event.

INVESTORS AND AUSTRIAN ECONOMICS CONTINUED FROM PAGE 3

There is no systemic economic benefit to any particular value for stock prices. Young people saving for the future and entrepreneurs who are looking to pick up capital goods at bargain prices would find lower stock prices give them a better deal. This is the same as for any good.

Their second error is that higher stock prices create a "wealth effect," in which people see their asset values rise, feel richer, and consequently save less and spend more. Their goal is to boost consumption through pumping up asset prices. As Keynesians, they are all in favor of this because they think that consumption drives production.

Sound economic thought has recognized, at least since the classical school, that production must precede consumption, and that production drives demand, not the other way around. The Fed understands none of this because they have no understanding of the purpose of capital goods in the production process, which is to increase the productivity of labor.

They believe this about home prices as well, which is arguably an even greater fallacy because homes are consumption goods. A rising standard of living means that we are able to buy consumption goods at *lower* real prices over time, not higher.

And finally, they see the stock market as a sort of public referendum on their policies. They point to the stock market and say, "see, the market approves of what we are doing." But when you realize that through its monetary expansion, the Fed itself is responsible for the rising stock market, that calls into question whether we can use it as independent measure of public opinion, or instead, the Fed voting for itself with money that it prints.

Austrian-informed financial thinkers understand this. There are hundreds of Austrian-oriented blogs and commentary sites, as well as some excellent heterodox sites with a very Austrian-friendly perspective such as *Zero Hedge*, Jim Rickards, Marc Faber, and *Fofoa*.

MI: We've mostly been talking about the US so far, but speaking globally, do you see any areas that are of particular concern, such as China or the Eurozone?

RB: Credit allocation in China is not market-based. They import the Fed's inflation through their currency peg, which diverts dollars into their sovereign wealth fund where it is "invested" by bureaucrats in various forms of dollar-zone assets. Their domestic savings go into their banking system, where it is wasted on politically-favored projects due to non-market allocation of bank credit. The entire system is experiencing a series of bubbles in real estate and other sectors.

Their rate of infrastructure spending for comparably developed economies is about twice as high as normal. This is because the communist party officials are under great pressure to hit GDP targets—as if prosperity could be spent into existence by hitting a number. Infrastructure such as roads and empty cities present an opportunity to spend a large amount of money, all in one place, on a lot of Very Big Stuff, which under market-based economic calculation would be revealed as wasteful.

The problems in Europe are a combination of the massive debts that can never be paid back, the unfunded entitlements, and the growth in the burden on producers, a theme that I addressed in my recent *Mises Daily* article on Say's law. This burden consists of the totality of regulation, taxation, inflexible prices and labor markets, and the threat to the confiscation of wealth. If you project these trends into the near future, I'm not sure where the lines cross, but the system is clearly unsustainable in its present form because it relies on sustaining current levels of consumption as fewer and fewer people produce. ▮

WHAT HENRY HAZLITT CAN TEACH US
CONTINUED FROM PAGE 2

They're as timely now as they were during the administration of Harry S. Truman. The effective federal funds rate has been zero for well-nigh six years.

There is a doctrine in finance called the dividend discount model. It says that the price of a common stock is the present value of its future cash flows discounted by a suitable rate of interest. Now what would happen to the calculation of the value of that stock if the rate of interest were unsuitable—if it were artificial?

Hazlitt says this: "Excessively low interest rates are inflationary because they mean that bonds, stocks, real estate, and unincorporated businesses are capitalized at excessively high rates, and will fall in value even though the annual income they pay remains the same, if interest rates rise."

If interest rates were artificially low, it would follow that prevailing investment values are artificially high. I contend that they are, and you may or may not agree. But you must allow the observation that we live in a kind of valuation hall of mirrors. We don't exactly know where our markets should trade, because we don't know where interest rates would be in the absence of central-bank manipulation. Natural interest rates—free-range, organic, sustainable—are what we need. Hot-house interest rates—the government's puny, genetically modified kind—are the ones we have.

Hazlitt understood the effects of these intrusions in the market. More than that, he was able to explain them in words so simple, yet so elegant, that the proverbial milkman in Dayton could follow his argument. What a remarkable man was he, and how well it would suit us all to live more closely to his example. ■

James Grant is an associated scholar of the Mises Institute. He founded *Grant's Interest Rate Observer* in 1983 following a stint at *Barron's*, where he originated the "Current Yield" column. His latest books include *John Adams: Party of One; Mr. Market Miscalculates;* and *Mr. Speaker! The Life and Times of Thomas B. Reed, the Man Who Broke the Filibuster.*

Austrian Research at the University of Angers

Peter Klein Reports Encouraging News from France:

Pictured from L to R: Matt McCaffrey, Philipp Bagus, and Guido Hülsmann at McCaffrey's 2013 graduation at the University of Angers.

The University of Angers, France has become an excellent place for doctoral work in Austrian economics, thanks to the leadership of Mises Institute Senior Fellow Guido Hülsmann. Several top younger Austrian scholars such as Eduard Braun, Amadeus Gabriel, and Matt McCaffrey—all former Mises summer fellows—received their PhDs under Professor Hülsmann's supervision. Senior scholars such as Jeff Herbener, Shawn Ritenour, and myself are frequent visitors.

This week I was privileged to participate in a research seminar at the University's GRANEM research center, along with Hülsmann and former Mises Institute Summer Fellow Philipp Bagus of Rey Juan Carlos University in Madrid, on financial markets and institutions. Bagus presented a paper on the government bailout of the Spanish banks, and I presented a paper on the US private equity sector and its relationship to entrepreneurship, with Hülsmann as moderator and discussant.

Look for more exciting activities at Angers in the years to come.

In Memoriam

Both the Mises Institute and the cause of liberty mourn the passing of two good friends. Their support for our mission and concern for the future of freedom will always inspire us.

Mr. John W. Toebe, charter member of the Mises Institute, passed away on March 25, 2013. Mr. Toebe was founder of Klenzoid Equipment Company and co-founder of the Allen-Toebe Foundation.

Supporter and friend of the Institute, **Lt. Colonel Donald H. Standiford, USAR (Ret.)**, passed away on January 20, 2014.

COMING EVENTS

Register online at mises.org or by phone at 800.636.4737.

June 8–13, 2014	ROTHBARD GRADUATE SEMINAR • Mises Institute
July 20–26, 2014	MISES UNIVERSITY • Mises Institute
Nov. 8, 2014	WEST COAST REGIONAL MISES CIRCLE IN COSTA MESA, CALIFORNIA
Jan. 24, 2015	SOUTHWEST REGIONAL MISES CIRCLE IN HOUSTON, TEXAS
Mar. 12–14, 2015	AUSTRIAN ECONOMICS RESEARCH CONFERENCE • Mises Institute

Members Jared, Susan, and Nate Strum visited the Mises Institute offices in April. The Strums are a homeschooling family and the founders of Free Oak Farm in southwestern Alabama.

Susan Strum writes: "It was such a pleasure to meet you and the other staff members. Everyone was just as warm and gracious as I thought you would be."

You are welcome to visit the Mises Institute campus year round.

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