Mises and Austrian Economics

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The fifth in a series of six lectures on The History of Economic Thought.

Transcribed and Donated – Thomas Topp

Rothbard: It's going to be difficult to explain all of Austrian economics and Mises' role in a short period of time, but I will try my best. In the first place, about Austrian economics, contrary to many impressions, it has nothing to do with Austria. I know nothing about the economics of Austria. Doesn't mean it's not a viable subject—I don't know much about it.

Also, there are very few Austrians left in Austria. [laughter] They're all here. Austrian economics began in the University of Vienna with Carl Menger. The early Austrians were indeed located in Austria, and then the doctrine permeated outward.

The essence of Austrian economics, it's based on—in contrast to all other schools, including alleged free market schools of economics—Austrian economics is based on an analysis of individual action. In other words, individuals doing things, having purposes and goals, and pursuing them. This immediately sets us apart from all the other schools of economics, who deal with aggregates, groups, classes, wholes of one sort or another, without focusing on the individual first and building up from there.

I could easily make this about five hours instead of 45 minutes, so I'm going to try to truncate this. Austrian economics basically builds on an earlier tradition, a French and Italian, especially French continental tradition, really beginning with the Spanish scholastics in the 16th century, and then proceeding on in France with Kantalon and Turgo in the 18th century.

This was buried for various reasons. This knowledge was lost to economic thought and superseded by the British classical school, by Smith and Ricardo and their followers. So this immediately starts a new history of thought, because most economists I think still think that

economics began out of the forehead of Adam Smith in 1776, he sort of created it like Athena springing from the brow of Zeus.

Actually, economics not only predated Smith by several centuries, but also was much better than Smith. In other words, Smith represents a decline. At any rate, the British classical school—Smith, Ricardo, etc., John Stuart Mill—focused on aggregates and groups and classes rather than the individual, number one.

Basically, you sum up the classical school, several key fallacies, and this was dominant until Menger came around in 1871. One, that value, economic value, price was determined by the cost of production, the cost of production embodied in some fashion in the product, and specifically by the quantity of labor hours embodied in it.

And we can pretty well see almost automatically, if we look at this thing in a clear-eyed fashion, there's something wrong with it, because I could work… There's a movie, a charming movie, a great Z movie that came out about 20 years ago, I forget the title, but the essence of it was some great inventor somewhere in the west of England, totally isolated, and he kept inventing great things, like a radio and television and all that, except it had already been invented 20 years before, and he didn't know about it.

So he was a great inventor; it's just he invented the wheel or whatever too late. But he must've put in 100,000 labor-hours in these inventions. How many did he sell? Obviously, zero. So the economic value would not obviously depend on his quantity of labor hours. What the classical school had to do was dismiss as unimportant a whole group of economic goods, and not able to explain their value—namely, known and reproducible objects, goods that are not being produced anymore, like Rembrandts.

Rembrandt put in a certain number of labor hours, I suppose, but the price of Rembrandts keeps fluctuating since then, not in accordance with somebody's input, one hopes. Otherwise, it'd be forgery. So what determines the value of Rembrandts? Well, they couldn't figure it out; they just had to leave it aside as unimportant.

They couldn't deal with consumers either, because a consumer that came up against a famous value paradox, which the history of economic thought always tells about, that Smith was buffaloed by the value paradox. The curious thing was he solved it himself about 20 years before, so it's a very odd kind of situation.

At any rate, in *The Wealth of Nations* he sets forth the value paradox, it's a terrible thing, he can't understand it. On the one hand, there's diamonds, let's say; on the other hand there's bread or water, you could use either one of the two. And bread is the staff of life, it's philosophically extremely important, very necessary, and yet it's very cheap on the market. In other words, its economic value is zilch. It's cheap, not zero. Water, its economic value used to be zero.

And on the other hand, you have diamonds, which are mere frippery, a luxury item and so forth and so on. Adam Smith, being a good Calvinist, said they have zero value, diamonds, and yet they're very expensive, they have very high economic value, so he couldn't figure that out, the value paradox.

Here's bread, which is extremely useful, yet has very low economic value, and diamonds, which are useless or almost useless and have very high economic value. And he concluded economics can't solve this. Just split the thing, value in use and value in exchange, there's no way to solve it, and we have to deal with exchange value, and forget about use value.

You see right away this sets up the conditions for a whole bunch of left wing thought in the late 19th, early 20th century. It's still going, I suppose. The separation between value for use and value for, I mean production for use and production for profit. It immediately sets that up somehow as a big distinction.

He said, "Therefore we can't deal with consumers, we can't deal with non-reproducible goods; we have to deal with producible, reproducible goods," and again, we talk about, since you can't talk about consumers, value must come from something inherent in the object—namely, labor hours.

Another reason he used labor hours is that at the time he and Ricardo were trying to measure value all the time, because science meant measurement in those days for these people. And so therefore, how do you measure value, how do you measure changes? He's looking for some hard quantity, and he concluded labor hours was about the best thing they could get to.

So that was one big fallacy, one big dominant fallacy in economic thought when Menger started to write. Another big fallacy is that they said, since couldn't deal with individuals at all, they're dealing with classes, they had a separate thing called distribution, theory of distribution, trying to figure out—this is Ricardo particularly—who decides how much of the national output goes to wages, how much goes to profits, how much goes to landlords?

The way he set it up was a class struggle between these three mighty groups. In other words, the good is produced somewhere, they produce it, then they fight for who gets the different shares of income. Laborers get messed up here. Labor's at the dirty end of the stick, because wages are determined by the iron law of wages, the Malthusian iron law,

down at the subsistence level, as we all know. We're sitting here living at subsistence level at the Anaheim Hilton.

Everybody gets the lowest possible wages, so that takes care of the workers, and capitalists and landlords fight it out for the rest of it, with usually landlords winning out, because they get an increasing share of, this unproductive group of people get an increasing share of income. This obviously led, this analysis seems to me led logically straight away to Marx and Henry George, two different sets of thinkers, but each focusing on different aspects of it—

Marx focusing on the alleged surplus value going to the capitalists as against the workers, and somehow capitalism conspiring to keep the wages down at the subsistence level. On the other hand, Henry George focusing on the evil, unproductive landlords, getting an increasing share of a natural product, they should be expropriated.

Now, of course, Smith and Ricardo did not believe they should be expropriated, they didn't think in those terms. It seems to me it's pretty logical that if you're looking, if you're interested in justice, then only economic analysis, you'll wind up with either, if you're a Ricardian, you'll wind up with either a Marxist or a Georgist.

Some people of course take both paths—Marxo-Georgists. So the second big dominant force in British classical economics. The third thing is asking how could they be so wrong? How could they focus on this unreal situation, labor hours? By the way, the labor theory of value—I think I should backtrack slightly on that—this is pure speculation, but I think it's probably true that it's not accident, only in Scotland did the labor theory of value originate. Nobody on the continent, nobody in France, Italy, none of the Spanish scholastics ever thought in terms of—they said

labor comes from consumers, consumer demand, and they didn't talk in terms of labor value.

It seems to be not an accident, because Scotland of course was the classical home of Calvinism, and Calvinist doctrine is that labor is a key thing. Everybody is doomed to work, and consumer enjoyment by the way is evil, and as Adam Smith said, diamonds are useless. The only reason you consume anything is to allow you to keep working, because of God's commandment to suffer, keep suffering.

So this sort of Calvinist attitude leads pretty quickly, I think, to a labor theory of value. So that's two big fallacious aspects of the British classical school—labor theory of value or cost theory of value, one. Two, classes or aggregate class struggle over shares of income.

And the third thing is they focused totally on nonexistent, unreal, long-run equilibrium. This is done right now by modern microeconomics, and macroeconomics, for that matter. Current neoclassical economics focuses solely on—the reason [unintelligible] mentioned before, they don't talk about entrepreneurs.

It's very simple why they don't talk about entrepreneurs—they don't talk about entrepreneurs because entrepreneurs deal with change and uncertainty. You make a profit if you can forecast better than the next guy. You make losses if you can't forecast. In long-run equilibrium you don't have to forecast anything; nothing ever changes.

Since nothing ever changes, everybody has perfect knowledge, as they call it, perfect knowledge, everybody's in perfect competition, there's no uncertainty, no risk, no profits, there are no losses. So the entrepreneur then becomes a pain in the neck. It's messing up your neat mathematical system.

And this, again, stems from the British classical school. They didn't have mathematical diagrams or anything, but they had the essence, Ricardo in particular, focusing only on long-run equilibrium. As a result of three, the fourth thing, which goes along with this, is again, Ricardo's contribution to economic thought, "contribution," is to separate, divide totally the macro from the micro sphere.

We're all familiar with that, those of us who take current economics. Is micro the first term or, whatever, second term? Micro, you learn about supply and demand or whatever, and then suddenly you leap into macro and nobody talks about supply and demand, they all talk about growth curves and velocity and all that, totally different.

And this whole split starts with Ricardo also. So with Ricardo, the quantity of money only determines the general price level. Increase the money supply, prices go up. Has no impact on production, on profits, on interest, on relative prices or anything else. It's like two hermetically sealed spheres.

There's the microsphere where things are going on, it's fairly understandable, supply and demand, prices and all that. Then there's the macro sphere, totally cut off from the micro, where you have money and prices bouncing up and down with no relationship between the two.

Within that kind of British classical school dominance—by the way, now it turns out not everybody was Ricardian from 1819 until 1871. The British themselves began to peck away at Ricardianism shortly after he died. By 1830 there were no Ricardians left. But what happened was that John Stuart Mill resurrected Ricardianism with his famous *Principles* in 1848. He had such tremendous moral authority in the public, he was so revered, almost anything he said was accepted as gospel truth.

So he restored Ricardianism, he placed it at a dominant pedestal, and he did it because he was brainwashed by his father, who was a [unintelligible] and so forth and so on. Better not get into that can of worms at this point. At any rate, it was an atmosphere that Carl Menger, the founder of Austrian economics, writes in his great, path-breaking, magnificent book, *Principles of Economics* in 1871…

What he does, he builds on the earlier continental tradition, but essentially he develops this whole path-breaking system. What is it? To sum it up, the Austrian system is created by Menger and a student, Böhm-Bawerk, at the University of Vienna. Essentially, it's based on methodological individualism. In other words, focusing on the individual first, the individual's actions. The idea is the individual has a purpose, has goals that he or she wants to pursue; in order to pursue these goals, you have to use resources or means to pursue them, and it takes time to do all this, etc.

You start with Crusoe and you work on up to different individuals and exchanges, and building up a whole economic analysis from the individual. It hadn't really been done before; it'd been done partially, but it had never been done systematically, as Menger did it, and as Böhm-Bawerk did develop it even further, especially in capital theory and entrepreneurial theory.

So looking at it that way, you realize that the purpose for production is consumption. The idea that the reason why the inventor worked 200,000 labor hours is that he hopes that somebody will buy it. And so value is conferred by the consumers, by the demand of consumers, and goes backward from the subject of valuations of consumers down through to the factors of production, the people who receive income.

So you have, in other words, a demand theory or a consumer demand theory of value, the subjective value theory, instead of the cost of production doctrine. And that would of course immediately explain why Rembrandts might be $2 million now, $1 million ten years ago, because consumers are paying more for it. They're willing to pay more for it now than they were before.

The valuations are higher, either because of general inflation, they have more money, or because Rembrandts are now preferred more to other art than they were ten years ago. And secondly, focusing on the individual action, we can see that individuals make their valuations in marginal units. This is the so-called marginal revolution.

In other words, take the bread-diamond paradox, which Menger and the other marginalists solved—namely, nobody's confronted in real life—see, we're looking at real life action—nobody's confronted with a choice of all the bread in the world versus all the diamonds in the world. In other words, if the Angel Gabriel came down to us tonight and captured worldwide television and said, "People of earth, listen—you're now confronted with a choice between all the bread in the world from now on forever, and all the diamonds in the world. You're going to lose one of them, one set," probably most of us would vote for bread.

But the point is we're not confronted with that kind of choice—yet. We're confronted with individual choices like should we buy a loaf of bread or a five-karat diamond or something like that? And in these marginal units, then we realize that supply becomes a major focus—in other words, the more abundant, if bread is very abundant, the [unintelligible] the bread is not going to be worth much, because it's super-abundant.

On the other hand, if diamonds are very rare, each individual diamond is going to be worth a lot. In other words, these valuations take place in

units, in so-called marginal units, in loaves of bread or pounds of butter or whatever. If you look at it that way, you'll see why water might be priced very highly in the desert, and worth not that much in a very high-water area.

So this solved the value paradox. It had been solved before in the continental [unintelligible] before, but this is a much better, meatier and fuller explanation. Another thing that Austrianism focused on is that economics is not really a qualitative subject; it's not really a subject where you can make correlations and qualitative measurements and that sort of stuff, because value is subjective and can't be measured.

How much do I prefer…? I prefer, for example, Wonder Bread to Tasty Bread. How much? Who knows? It'd be pointless for me to say I prefer it 3.8 times as much as a loaf of Tasty Bread. And everybody's got different—you certainly can't add up people's subjective preferences. Preferences are ordinal. Rankings [unintelligible].

But for Wonder Bread or Tasty Bread, etc. So by looking at this, we can look at any Austrian book, you can almost tell an Austrian book by looking at it and thumbing through it. There's no math in there, almost none. And one of the reasons is because it's not really a mathematical subject. It's really a philosophic subject.

On the distribution front—I said the British classical school talk in terms of a class struggle between different classes of income receivers. Again, the Austrians focus on each individual, the individual factor owner, the individual laborer, individual capitalist, etc. By doing that, they're able to explain individual factor prices, which the classicists never even talked about.

And it's pointed out that the free market, through competitive action, entrepreneurial action, tends to impute to each individual factor how

much his productive share of a product—so-called marginal product or marginal value product. Each factor tends on the market to earn its marginal value of product, its contribution to the goods being produced.

So there's no longer any split between production on the one hand and distribution on the other. John Stuart Mill said the theory of production is all worked out, and it's totally separate from the theory of distribution. This of course leads very quickly to a socialist position because you say, "Sure, we're in favor of production, we'll allow people to produce, then we'll grab the income and divide it. Equal shares, more to people six feet tall," whatever theory of distribution you've got.

With Austrian economics, you realize that there's no separate process called distribution; distribution comes right out of production. People earn what they contribute to production. It's very simple then. And also, Böhm-Bawerk pointed out for the first time, and Frank Feder, the American Austrian developed it, clarified it—first, long-term profit is determined or comes from time preference.

This is something, by the way, the poor anti-usury people could never figure out—the Catholic theologians—who tended to be in favor of the free market, but they couldn't figure out what their justification for interest is, interest on a pure loan. They could understand about risk, they understood about uncertainty and all that; they just didn't understand about, why should people be able to charge three percent or eight percent or whatever on a pure loan?

And the answer is the people prefer a good right now to waiting for it or the present expectation of a good coming in a year from now, 10 years from now, or 100 years from now. Everybody's got a time premium rate on present goods immediately available, and a discount to the future. That determines the rate of interest.

Also, Böhm-Bawerk pointed out, and Menger too, that—by the way, modern economics still has not learned, capital takes time, production takes time. Capital is a time structure. Some goods are very close to consumers, like producing Wonder Bread, where the retailer is very close to the consumer.

On the other hand, machinery, the iron ore that goes into making the machinery that produces Wonder Bread is way up the structure, takes a lot of time to get to the earlier phase of production or a higher order of production. So we have then production taking time. We have capital, not as a homogeneous lump, which modern economics still tends to say, just add more capital, as if it's somehow a blob out there.

Capital is a latticework, it's a network, a structure which all has to fit in together. And by the way, only the free market can fit it in. Only entrepreneurs, the profit and loss test, profit and loss, incentive, and free price system can do the fitting. One of the problems with socialism, for example, is they can make some stuff, but they can't fit it together.

Often in Russia you have a situation where the bristles, you have a toothbrush shortage all of a sudden. Why is there a toothbrush shortage? The bristles are in Omsk and the handles are in Tunsk, and they never fit the bristles together with the handle. In the free market you never have this problem. Everything fits because there's a constant feedback mechanism, so to speak, of profit and loss and a free price system.

And Böhm-Bawerk pointed out that the capitalist entrepreneur—again, we focus on the entrepreneur, Austrians—in other words, the equilibrium is a tendency, it's never reached. It's a goal. It's an ever-changing goal and you never reach it. So Austrians focus on the process, the real world process by which the economy tends to move toward equilibrium,

and thereby of course we have the whole world of risk and uncertainty and change, which is the real world, which equilibrium economics doesn't talk about.

So therefore the entrepreneur becomes a key figure in the whole process, the profit and loss system, the incentive to make profits and to avoid losses. So the capitalist entrepreneur in Austrian theory earns a two-part routine. One as an entrepreneur by forecasting better than the next guy, and you're able to forecast the future, forecast what demand will be for its product, what costs will be.

And also, too, as a capitalist, saving up money, and then paying workers right now in advance of the production and sale, for which the workers, in a sense, pay him a discount. They pay him the interest return. And happy to do it, because they don't have to wait five years for payroll.

So these are the two basic functions of a capitalist entrepreneur. Entrepreneurship and capital saving and investment. In this atmosphere, I'm trying to briefly sketch out Austrian economics before von Mises. Menger, Böhm-Bawerk, Feder. Ludwig von Mises is born in 1881. He's a brilliant young student of Böhm-Bawerk's famous seminar at the University of Vienna. Essentially, what he saw was that the Austrians had already fixed up these classical errors—the four big British classical errors—value, distribution, and equilibrium. But the one thing they hadn't done yet, the main thing they hadn't done yet was to heal the micro-macro split.

In other words, the Austrians still only talked about micro; they weren't able to extend Austrian economics to the theory of money. So that was Mises' first great accomplishment, and his magnificent first book, *Theory of Money and Credit* came out in 1912, and it's still the best thing ever written on money.

What he did was he healed the split, this artificial split. He applied the marginal utility theory of Austrian economics to money, integrated it. He made micro and macro one whole beautiful integrated system of economic analysis. He pointed out, for example, when you get to money, you don't use M and V, you don't forget about supply and demand.

The purchasing power of money, in other words, the value of money can be decided on the same basis as individual goods and services, namely supply and demand. An increase of the supply of money lowers its value, just as in cases of bubble gum and coffee. An increase of demand for money raises its value, just like any other good.

However, there's a big difference, and in this he applies some of the Ricardian currency school insights. The big difference between money on the one hand and other goods on the other hand is that other goods are necessary to production. In other words, specific quantities.

For example, other things being equal, if you increase resources or increase the supply of goods and services, people's standard of living go up. That's a good thing, so to speak, to have more, to find new resources, to find a new oil strike or to increase productivity. But in the sphere of money it's very different.

The only real use of money is exchange. You don't eat money, to put it bluntly. And once you have enough money to become money on the market, you don't need any more. In other words, any supply of money which is arrived at on the market is optimal. You don't need any more money coming in.

So the only thing an increase in the money supply does, then, the only social effect is to dilute the purchasing power of each existing, preexisting dollar, gold ounce or mark or whatever the currency unit is.

So any increase in the money—whereas increase in goods and services is good, it increases the standard of living, an increase in capital equipment is good, increases future standard of living—an increase in the money supply is pointless, because all it does is dilute the purchasing power of the original, of the existing unit.

There's no social utility whatsoever. Under the gold standard it does because the increase of gold supply is a non-monetary function. In other words, you can use more gold for jewelry, watches, teeth, and that sort of stuff. But under paper money, of course, there's no social function whatsoever. It simply dilutes the purchasing power of the dollar.

Mises goes into this and he shows basically that the more money, an increase in the money supply beyond the amount of gold available or silver available redistributes, destroys economic calculation, generally messes everything up. Messes up the production system. What happens is that it tax—the first receivers of money benefit at the expense of the late receivers. It's very much like counterfeiting. As a matter of fact, it is. The Fed essentially is a legalized monopoly counterfeiter. And the effect of the Fed increasing the money supply, or the Bank of England or any central bank, is almost the same as any counterfeiter.

You have a legalized counterfeiter pouring out money down here in Anaheim, you'll have the same sort of effect. An increase of income of people in Anaheim, first of the counterfeiters, next are the people the counterfeiters spend the money on, retailers in Anaheim, they're in great shape, they love counterfeiting. So then they begin to spend more, prices begin to go up.

Those of us who don't live in Anaheim or who have a fixed income, lose. So the inflation process is essentially a counterfeiting process, except it's

not people on the run from the Treasury Department; it is the treasury, it is the Federal Reserve doing it.

Mises also built on Carl Menger's classic article on how money originates, and expanded it to show that money has to originate in this way, and that namely, out of the free market, out of the voluntary actions of individuals trying to overcome the tremendous difficulties of barter. He shows that money has to originate that way.

Money cannot originate as a government edict or by some social compact where everybody gets together in one big convention and says, "Let's make that money." It can't work that way. It has to work out of a market commodity. Unfortunately, of course, then the government can take it over and mess it up.

But it has to originate as a valuable market commodity, such as gold or silver, which have always outcompeted all the other marketable commodities, once it's given a chance, if people know about gold and silver, if society knows about it, it will outcompete them. Also, Mises showed in his theory of money and credit that fractional reserve banking is essentially fraudulent, is essentially issuing fraudulent warehouse receipts to nonexistent gold or cash, creates this whole process.

And the ideal system would be 100% reserve banking. He believed, however, and I think it's true, under a genuine free banking system—in other words, if the banks were compelled to meet their contracts like everybody else is, forced to meet their contracts; if they say, "I'm going to give you gold on demand," if you don't give it to them, you go bankrupt—if that were true, we'd have a hard money, we'd have an approach to a 100% reserve system.

Unfortunately, of course, it's never worked that way because the banks are always being bailed out in one way or another. And also, he showed

in the theory of money and credit that the utility, he fixed up the marginal utility theory. He showed it's ordinal and can't be measured. Böhm-Bawerk was a little bit weak on that, and he showed you can't, since it's subjective, you can't mathematize it.

Right now micro textbooks, if you look at any micro textbook, they talk about utils, when they talk about utility theory, they say, "We have utils." Some things are worth five utils; other things are worth eight utils. What the heck is a util? It doesn't exist. But if you assume there's such a thing as a util and you can mathematize it and use calculus and have graphs and tangents and all that junk… It just doesn't work, because it's not true. It's not junk in mathematics; it is junk, however, in economics.

In addition to all that, which is an enormous contribution already, the theory of money and credit had the genesis—in a few pages he outlined what would become his theory of the business cycle, the Austrian theory of the business cycle, the Misesian theory of the business cycle. And during the 1920s he expanded on that, and a work which has been translated since then, called, *On The Manipulation of Money and Credit.*

Interestingly enough, what happened was most of, Böhm-Bawerk and most of his students of course rejected [unintelligible] application of money and business cycles, considered this unsound and so forth. So Mises was a pioneer, scorned even in Austria, even in that situation. The Austrian business cycle theory, which develops during the 1920s with FA Hayek as a famous major follower, but lots of other followers as well, basically what Mises did was he took his own money and banking theory, and what determines the prices, purchasing power of money, and he also took the currency school, the old Ricardian currency school insight, the famous model that if you increase the money supply, prices will go up, and then you have a deficit in the balance of payments

because prices will be too high, and imports will go up and exports will go down.

He realized, a tremendous insight, this is actually the business cycle theory—they never talk about such in the textbooks. It's not only a theory of money and a theory of international payment, but also a business cycle theory. A simple model, the banks pump in money, prices go up as euphoria, and if something happens they have to contract, and there's bankruptcies and liquidation.

It's a very simple model of a business cycle. He combined that, Mises, with Viksel's, Viksel was a Swedish Austrian, Swedish Böhm-Bawerk follower—combined that with Viksel's analysis of interest rates and how, if a banking rate falls below the natural rate of interest of the free market rate of interest, there'll be inflation.

He combined that and he wound up with an integrated, magnificent, path breaking theory of business cycle. Essentially, what it says is an increase in the supply of money and credit through the banking system, through central banking, not only causes inflation—everybody will admit that; at least all the neoclassicals will admit that—it also causes other disturbances.

It's not just what Milton Friedman called "The Helicopter Effect." Milton Friedman said we assume that everybody gets an proportionate increase in the money supply dropped by some magical government helicopter, so everybody gets a 30% increase in their cash—it doesn't work that way, of course; if it did work that way, there'd be no point to it.

The reason why—because we don't have [unintelligible] Angel Gabriel doubling everybody's money supply overnight to try to improve their lot. What we have is legalized counterfeiters in Washington or in London,

increasing their money supply first, and lending it out or spending it, and it ripples out to the rest of the society.

So they always have one leg up in this expropriation process. So at any rate, Mises showed that an increase in money and credit not only increases prices; it also disturbs, messes up the production system, the whole capital structure.

Because one of the problems with business cycle theory—there are two really basic problems which any business cycle theory has to explain. One is, how come entrepreneurs suddenly make severe losses? In other words, entrepreneurs are trained in forecasting, they tend to be great forecasters.

If they're lousy forecasters, they go out of business pretty quickly. So successful entrepreneurs tend to be good forecasters. How come all of a sudden it turns out that all of them or many of them or most of them go bankrupt? They didn't forecast successfully their costs would be much higher than the selling prices.

There's a sudden cluster of entrepreneurial error, and this doesn't usually happen. Usually, economists are trained, or Austrians are certainly trained, if something's really messed up in a system, you look to government; government must be messing things up somewhere, and sure enough, okay, this is…

So the second thing which has to be explained is how come there's a much greater fluctuation in capital goods than there is in consumer goods? In other words, there's a much bigger boom, let's say, in machine tools or construction, industrial raw materials than there is in retail sales.

Contrarily, when a depression or recession hits, a much bigger crash in machine tools, construction and that sort of thing, and then a higher order [goods] than there is say in retail goods. It should be just the opposite. If the Keynesians are right, it should be just the opposite. The first thing should be hit would be consumer goods; quite the contrary.

As a matter of fact, during the 1929-33 Depression, in fact all during the '30s retail sales were in pretty good shape, they only decline about 15-20%. It was other things, it was construction or machine tools, which declined 90%, 80-90-100%. Almost 100%. So that's the, you have to focus on and try to explain those two things.

Only the Austrian, only the Mises theory, only Mises' [unintelligible] theory explains these two problems—mainly, that an increase in supply of money and credit disturbs the production structure, messes up the interest rate because more money is pouring into business loans than would have by voluntary savings, and leads to overexpansion of capital goods—so-called higher order goods in particular—construction, raw materials, machine tools, that sort of thing, plant, basic plant—and the under-production of consumer goods.

So what you have then is a malinvestment in a whole bunch of capital goods. And the longer the boom continues, the worse the malinvestment gets. So what happens is costs are bid up too high for the supply of savings available, and as soon as the credit expansion stops or slows down significantly, the recession hits, because then these malinvestments are revealed, it's revealed now starkly to the people, the entrepreneurs, that they've overbid costs and wage rates too high, much too high for what they can sell to their buyers—not to the consumer so much, but to the other people down the capital goods structure.

What happens is that the recession, in the Austrian analysis, a recession is an unfortunate but necessary process by which the market returns, washes out the unsound investments, and returns to a proper balance capital goods and consumer goods. In other words, the labor, land and capital resources are shifted back to consumer goods, a certain amount, and out of these excessive capital goods.

The result is a recession, is a necessary liquidation process, and any government interference with a recession prolongs it and makes it permanent. It doesn't allow the recession process, adjustment process to work. Also, in particular, a key thing that has to happen is resources have to shift out of capital goods and into consumer goods.

This means that wage rates and capital goods prices have to fall so that, relative to consumer goods, so that people will shift, the resources will shift. To prop the wage rates up, which the New Deal did, of course, to prop them up, to prevent them from falling totally destroys the whole investment process and prolongs the Depression permanently, which is what happened in the 1930s.

This is essentially the capsule summary of the Austrian business cycle analysis. And also, by the way, it also explains our current stagflation. It's the only theory that explains inflationary recession, because in every business cycle, whether it was pre-World War Two or right now, capital goods prices are always going up higher than consumer goods prices in a boom, and consumer goods prices are always going up higher relative to capital goods prices in a recession, are still going [in].

Except in the good old days, that means before the New Deal period, during a recession everything would fall, there'd be a healthy deflation. In other words, prices would fall in general, money supply fell because the banks were in bad shape, so the whole money supply would go

down, prices would go down, but consumer goods prices would go down not as fast as capital goods prices. In other words, in retail sales, furniture will go down 20% in price, let's say.

In construction, cement would go down 50%. So consumer goods prices would be higher relative to capital goods prices than they were before, which is what you need in a recession. However, consumers loved it because the absolute prices in money terms were cheaper. Well, now that we have a Keynesian, monetarist or semi-Keynesian takeover since the 1930s, the money supply is never permitted to fall ever, ever again.

In other words, the Fed is always pumping more money into the system, sometimes a little less, sometimes a little more. As a result, during a recession we never have falling prices, ever. So this healthy mask of, the sugar-coating of the pill is now gone, so the consumers in a recession now are faced with two problems—one, unemployment and bankruptcies and all that, which they always were faced with, plus the cost of living keeps going up, because consumer goods prices are still going up relative to capital goods prices, except now they're both going up in absolute terms.

They're not going down because of healthy deflation. So at any rate, we now have a situation where we're getting the worst of both worlds every time there's a recession. You still get a big increase in the cost living, plus we get unemployment. This is the result of 50 years of fine tuning by our beloved economic experts in Washington.

To get back to Mises, Mises taught and developed his views at the University of Vienna, but he never had a paid post at the University of Vienna. He was discriminated against even in Austria. And then he worked for the Chamber of Commerce or Department of Commerce, I

guess it is in Austria, and his seminar, his very famous seminar was purely private. He held it in his offices at the Chamber of Commerce.

And his seminars attracted all the top young economists in Europe and philosophers and whatever. He converted very many of them. To just list a few, Hayek, Mokla, Pavel, Robbins, Bogelund, Schutz, and on and on. Even future British Prime Minister Gatskol was in Mises' seminar. He was a Labor Party Prime Minister, wasn't nearly as bad as the other Labor Party people, possibly because of a Misesian influence.

In addition to that, this tremendous intellectual force that Mises had, the so-called Mises kreis, which means Mises circle—by the way, it must've been a wonderful thing. They used to go out, every group of intellectuals in Vienna, they had their own café. There were 2,000 cafés. So each one had the psychoanalysts, the shrinks had their café, and the positivists had their café, and the Misesian had their café.

So after the Mises seminars were over, they all repaired to a café and talked and so forth over coffee and whatever, must've been great. Also, politically Mises singlehandedly stopped the Austrian inflation in the 1920s, stopped it from becoming hyperinflation. There was a big inflation, but it didn't get as bad as Germany, largely because of Mises' constant pressure by memos and political influence.

He later, in his notes and recollections, said maybe he shouldn't have done that, maybe it would've been better if the whole thing collapsed earlier. But anyway, he was quite depressed at that point, I'll mention in a minute. Another thing with Mises was that he warned about the Great Depression.

The 1920s was a period, essentially a Friedmanite period in many ways. A monetarist period. Benjamin Strong, the leader of the Federal Reserve Banks here, was putting into effect Irving Fischer's doctrine, which is

essentially pre-Friedmanite. And basically what it was was to keep the price level constant. That's the key thing. And the price level was indeed constant—wholesale prices remained the same all during the 1920s. So they figured, "There's no problem with inflation; what's everybody complaining about?"

By definition, if price level is constant, there's no problem. However, the Austrian position was, and still is, the price level is not the key thing, especially because in capitalist development, in free market capitalism, prices tend to fall, because you have tremendous increase and outpouring of business services, especially in productive goods. So prices tend to fall in a free and unhampered market, thereby spreading the advantages of capitalist development to everybody in the country.

We can see that now with specific things like computers and calculators. Calculators started off at $500, and now there are much better ones at $18. Or TV sets or personal computers. Tremendous fall in prices during a tremendous inflationary period, by the way. So what Mises pointed out was the fact that price level is constant is not such a great thing, but they should be falling, and the reason why it's not falling is because the Fed and all the central banks were inflating money and credit and propping it up and causing malinvestment, which will cause a recession, a big recession, even though prices haven't gone up.

He was laughed at, considered ridiculous. However, of course, the Depression, the crash proved him correct. He was doing that during the '20s, developing his business cycle theory. He did many other things during the '20s, unbelievable achievements, an unbelievable decade for Mises. Socialism arises, of course, in World War I, after World War I, or communism, really the same thing.

And everybody had to start analyzing socialism, socialist economy. Everybody realizes, then and now, by the way, that socialism has an incentive problem. That's clear to everybody. In other words, even socialists will admit this, "Yes, yes, we have an incentive problem." The incentive problem was summed up in a famous motto, "Under socialism who will take out the garbage?" It doesn't really work.

Or, "Who will go to Siberia?" Another way to put it. Who will go to Alaska? Who's going to develop the underdeveloped—who will schlep out to the underdeveloped region and build it up? Well, you can't use economic incentive under socialism, because either incomes or equal or else they're set by some government authority.

The good communists get higher incomes, whatever it is; it's certainly not set by marginal productivity. So who's going to go to Siberia and who's going to carry out the garbage? The socialist traditional answer is, of course, moral incentive. In other words, the creation of what's called the New Socialist Man. Everybody would be molded by socialist government, become totally altruistic and love the collective and do everything for the collective.

In other words, slave labor will carry out the garbage and go to Siberia. So even socialists recognize that this is a problem. But what Mises saw was something nobody else had seen. There's another problem, even deeper economic problem. Even if everybody had the incentive, even if everybody is brainwashed to be a New Socialist Man or Woman and go out there and work for the collective—"Whatever the collective does, I'll do it—I'll go to Siberia, I'll go to a salt mine, I don't care, as long as the state tells me, I'll do it."

How will the state decide what to tell them to do? That's the real problem in socialism. There's no way a socialist government can

calculate and try to figure out who do we send to Siberia, how many people? What price do we set? Who's going to carry out the garbage? How many people should carry out the garbage?

There's no way the socialist government can calculate—because, as Mises pointed out, there's no free price system, there's no private ownership of the means of production. By definition, there's no—and therefore there's no property titles, there's no free market in property titles, there's no way to set up a real price system.

There's no way a socialist government can calculate it, it's economic chaos. He pointed out in his famous article in 1920, which really upset the socialists in Europe—they tried to answer it all the 1920s and '30s—the famous calculation debate. And he also expanded this in his great book called *Socialism* a couple of years later, and he dealt with other aspects of socialists.

At any rate, when I was going to college too many years ago, the answer was that Oscar Alonga had already solved, there's no problem, because you have equations and all that, and government acts as if it's a market. As Mises already pointed out, this is nonsense. You can't—this so-called solution assumes perfect competition, perfect knowledge.

The socialist government has the perfect knowledge already, of course, and prices, which obviously they don't have—that's the whole point. And also, no socialist government has ever tried to put the Alonga solution into effect, never. As a matter of fact, what's happening is that socialist planning has broken down, Yugoslavia and Hungary have gone fairly rapidly toward a free price system, and even China in the direction of a price system—they realize that this doesn't work.

This is true in a situation where they still the world market and world prices, to which the socialist governments can refer, because they know

what the price of wheat is. In a world socialist government, they wouldn't know that, they'd be totally at a loss. So Mises pointed out, in other words, in addition to other problems, socialism can't work.

I can't calculate the modern economic system. Also during the 1920s, Mises put out a critique of interventionism which shows that interventionism doesn't work. In other words, price controls create shortages, taxes cripple savings and investment, inflation causes problems, as we've seen, protectionism is destructive.

And also he showed that interventionism tends to be cumulative, as we see all the time. In other words, interventionism—a government sets out to solve a problem—somebody goes and says, "There's a big problem. Too many people over 60 have hangnails, let's say, have a big hangnail gap."

Create a multi-billion-dollar hangnail-solving federal funding. So the government investigates, pours billions of dollars, doesn't solve the hangnail problem, it creates other problems at the same time.

Whatever, too many side effects from anti-hangnail drugs or whatever it is. So every time the government intervenes, it doesn't solve the original problem, and creates two or three more problems, at which the government says, "We need to have more intervention to solve the two or three others," or they can't just forget the whole thing.

So interventionism is unstable, it has a cumulative effect. Either you go onward towards socialism or you go back to the free market. But Mises has already shown that socialism can't work. So socialism can't work, interventionism is unstable—you're left with only one viable option for the modern industrial world—laissez-faire capitalism.

So Mises then becomes an uncompromising, hardcore laissez-faire capitalist, pounding away day after day on this question, making himself very unpopular, as you might expect.

And there's a great book on liberalism, which came out in 1927, [unintelligible] which also shows in liberalism, the political and civil liberties aspect—that economic, private property rights, free market, civil liberties and international peace are all inextricably tied together. They're all tied together, which is something very few of us even know to this day.

So that's a book that everybody could read with tremendous profit. In addition to all this, in the 1920s—we're not through yet with Mises' accomplishments—he also sees as a challenge to Austrian economics on the methodological, philosophical front. The challenge was twofold, basically, and it's still there, by the way, the same two challenges.

On one hand, institutionalism, which Mises called anti-economics. The idea of economic theory is no good anyway—there's no such thing as economic theory. And essentially economics becomes only history, a record of what's going on. This is quite dominant in the United States in the 1920s, institutionalist approach.

And two, which has been the dominant neoclassical approach, logical positivism—the idea that economics has to be like physics, a quantitative, measurable science, where you deduce things, you have false axioms [unintelligible] but you do stuff from them to predict. The whole unfortunate econometrics, mechanistic approach which we're very familiar with now, where people are treated as they are stones and atoms.

Unfortunately, people are not stones and atoms; people have choices, they have consciousness, they choose, they have purposes and goals,

etc. So this whole neoclassical economics is totally off on the wrong track. So he thinks about this and he sets forth his views on praxiology, what he calls praxiology—the correct analysis, the Austrian analysis of individual action, where economics essentially deals with the logical implication of the fact that people act.

How do you know that people act? You just look at yourself and you look at other people. You see that they act, and they're not like stones and atoms, they have purposes. And with this knowledge, all economic theory is reduced. This is very unfashionable, it's even more unfashionable now than the free market is.

You see, Mises had a tough problem. He not only has to fight for laissez-faire capitalism, which is unfashionable enough; he also had to fight for a methodology which is totally out of fashion, has been, in the race to try to ape physics, try to imitate physics and math, and successive nuclear energy, that sort of thing.

So he sets forth, that's what his great book [unintelligible] *International Economy* in 1933, which has been translated later, follows this up with his *Theory And History*, his marvelous book he wrote in 1957, showing a difference between theory and history and what their different roles are.

Having done all this, as if he hadn't done enough yet, which is like 20 times as much as the average economist accomplishes in a lifetime, he now proceeds—he sets forth the proper methodology; it's now his task to do something with it. In other words, to construct a whole integrated system of economic thought based on the correct methodology, and he does it.

He does it with a magnificent crowning achievement, *National Economy*, which came out in 1940 in Geneva, which unfortunately was neglected—it was during the middle of a war anyway, so it was totally neglected.

And then expanded it and rewrote it in English and expanded it in *Human Action,* 1949, which is the great work, as far as I'm concerned, of the 20th century.

While he was doing this in the 1930s, things were happening with [unintelligible] economics, so to speak. In 1931, Mises' follower, Hayek, shifts from Vienna to the London School of Economics. He's brought there by Robbins, who had been at Mises' seminar, and he starts giving lectures and translating his book on Misesian capital and business cycle theory, and he wows everybody.

First of all, it's the middle of the Depression. The Depression hadn't been predicted by any orthodox economists. And he converts, Hayek manages to convert all the top young economists in England. Hicks, Lerner, Chandlor, Sir William Bevridge, who wasn't so young. But all these guys became Austrians at that point.

If you read some of the journal articles in England in the early '30s, they all sound like Mises, it was fantastic. [unintelligible] for years. And they accept the Misesian analysis of the Depression. The Depression came about because of Federal Reserve and Bank of England, etc., central bank credit expansion, and then was prolonged by New Deal intervention into the wage rates, and public works, etc.

Unfortunately, even Americans—in those days American thought, essentially we were followers of English. In other words, we looked at England as the center of economic thought. So with English economics becoming Hayekian, Americans began to pick up the ball. Alvin Hansen, who later became the top American Keynesian, was becoming sort of semi-Austrian, plus a few other people.

And suddenly, bingo, Keynes' *General Theory* comes out in 1936, and that's it. It sweeps everything in its path. And by the way, Keynesianism

did not win out by patiently refuting Austrian economics, it did not work that way. Aside from the fact it can't be refuted. They didn't even try doing it.

It was changes in pen lines, a change in fashion. Everybody forgets the old stuff and goes onto the new bandwagon. All these people, except Hayek, all the people Hayek had converted shifted to Keynesianism, which now was the big fashion, totally the opposite in almost every way of Austrian thought.

Hayek had repeatedly smashed, literally, Keynes' previous great work, *The Treatise On Money*, which came out in 1931. Hayek gave two long reviews in *Economica* showing the whole thing is hogwash.

It was so effective that Keynes had to go back to the drawing board and do something else. So when the *General Theory* came out, Hayek made a great strategic error. He said, "Why should I refute this? It'll be gone in a couple years also." So unfortunately he didn't do anything about it, and the rest is, unfortunately, history.

Historically, economists have always been the ones who oppose inflation and deficit spending. And here all of a sudden deficit spending becomes a great thing, becomes economically required. So of course all the governments loved it, and all the economists loved it, because then they could get cushy jobs in the establishment.

So while this is going on, poor Mises now is a refugee. He flees Vienna, which had become Nazi in the '30s, and goes to Geneva. And when Germany conquers Western Europe, he and his wife flee to the United States. It was sort of like the movie scenario. They would go just ahead of the German army.

In his *Notes and Recollections,* which is an autobiography he wrote during 1940—he was very depressed then, as you can imagine—he writes that he didn't think when he started off that his fate was to chronicle the decline of civilization or the end of civilization. And he also says something interesting there.

He says, "Menger [unintelligible] from economics, and Böhm-Bawerk committed suicide because of World War One. In other words, he figured World War One's the end, it's the finish, it's the end of all the ideals of liberalism, classical liberalism and international peace and free markets.

So in this state, Mises comes to the United States, he's penniless, he's about 60 years old or so. He starts writing in a new language, and he can't get an academic post. This is the eternal blot on academia. This is a situation where every Marxist and semi-Marxist and three-quarter Marxist was getting cushy top chairs at Harvard and Princeton and whatever, and Mises couldn't find an academic post, and he finally got one at NYU as a visiting professor with a salary paid for by outside businessmen and foundations. Same thing happened to Hayek. Hayek's salary at the University of Chicago was never paid for by Chicago; it was paid for by outside business groups.

As a result, Mises was scorned, the dean was against him, the dean advised people not to take his courses and things like that. He was in a fantastically miserable situation, and yet—and here's where I come into the picture; I get to know him at this point—when he started a seminar at NYU.

What was [unintelligible] about this? How did he act? It was magnificent, I couldn't believe it. He was cheerful, was never bitter, never said an unkind word about anything, any person, and very sweet,

was constantly trying to urge people to be productive. Any spark of productivity in any of us clunks was immediately nourished by Mises.

[unintelligible] far below the level of Hayek and [Harbul], etc. It didn't seem to bother him at all, just great. He tried to reestablish the seminar atmosphere of Vienna. We went out to Chiles Restaurant, I think it was afterward, and discussed things.

He was kindly, he was uncomplaining, was never bitter, and it was just a magnificent experience. I've told this story before, and I'll tell it again because I think it's classic about Mises: People were very intimidated. First of all, half the people didn't know anything, didn't care. They were just there to get their automatic B or A or something.

The rest of the people, those who were interested, outside auditors mostly, were too intimidated—"Here's this great man. What do we know? How can we say anything?" So he said, "Look, say anything you want, but whatever you say, however idiotic it is, it's already been said before you by some unknown economist." [laughter]

Of course, he was right. He'd tell these great anecdotes about his friend Max Weber and things like that. It was just marvelous. Being scorned, etc., and not having any followers at the beginning, he writes *Human Action*, this great crowning work. When *Human Action* came up, I was going to FEE at the time, which was Foundation For Economic Education, which was literally the only free market outfit in the country.

It's not like now, where every Tom, Dick and Harry says he's in favor of the free market. I hadn't met Mises yet. They said, "He's coming out with a new book." I said, "Oh, what's it about?" They said, "Everything." And sure enough, it's about everything. That's it. The whole ball of wax. I urge you to read it. More than urge you; it's magnificent.

But despite these conditions, despite the oppression under which he worked, there were many good people that emerged out of this Mises seminar. Professor Zenholtz, Israel Kirsner, Sylvester Pitro, Chrissy Graves, and many other people. Mises has inspired much of the current hard money movement.

So it's really all due to him. He died at the age of 92 in 1973 after a remarkably productive life, and a year later Hayek got the Nobel Prize, which sort of inspired other economists, "Who's this guy, Hayek? Why is he getting a Nobel Prize?" And it's interesting that he got the prize specifically for the Misesian work that he did in the 1930s, Misesian business cycle theory, which was swept away in the Keynesian revolution.

And since then there's been a notable Austrian revival, and I think it's all due to Mises, and it's just unfortunate he didn't live to see it. Thank you very much. [applause]

end of transcript.