Vol 9 No 3

Austrian Economics Newsletter

Spring/Summer 1988 • The Ludwig von Mises Institute

W. H. Hutt's Pen Falls Silent

by Morgan O. Reynolds

One of the great economists of our age, W. H. Hutt, died in June, just two months shy of his 89th birthday. As he once told me, "I was born in the century of Napoleon." The comment typified Bill Hutt's amiable pride and gentle character.

Hutt's admirers have long lamented their hero's lack of fame and influence–no knighthood, Nobel prize, etc. Yet it was partly due to Hutt's fateful decision to depart his native England for South Africa in 1928, a career venue almost guaranteed to insure academic obscurity. In recent years, however, a distinct Hutt revival has been underway. And the timeless quality of Hutt's contributions to our body of knowledge promises a growing Hutt impact.

Hutt's academic career began with a 1926 *Economica* article exposing the myth that production methods were antiworker in "The Factory System of the Early Nineteenth Century," since reprinted in Hayek's *Capitalism and the Historians.* Hutt was amused and pleased that he still received about $40 a year in royalties from a 60-year-old paper.

The article was only the beginning. His minor classic, *The Theory of Collective Bargaining* (1930), effectively debunked the errors of countless labor writers and economists by demonstrating the anti-labor consequences of union coercion; *Economists and the Public* (1936) unfortunately was swept away by the Keynesian tide; *The Theory of Idle Resources* (1939), perhaps Hutt's most original contribution to economics, was a general theory of unemployed resources clearly superior to Keynes's theory; *The Plan for Reconstruction* (1943) was a valiant if utopian scheme to dismantle market impediments in the postwar world; his important 1954 article, "The Yield from Money Held," extended Mises's theory by integrating the demand for money assets into the general theory of the consumer; *Keynesianism–Retrospect and Prospect* (1963), later revised as *The Keynesian Episode: A Reassessment* (1979), was a wide-ranging dissection of faulty macroeconomic analysis; *The Strike-Threat System* (1973) exhaustively showed that union aggression in the long run cannot deliver on its claim to redistribute income from the owners of capital to owners of labor services; and *A Rehabilitation of Say's Law* (1975) straightened out Keynes's distortions of Say's law and focused on the real villain in deficient employment and output: "defects in the pricing system."

Hutt's key ideas–that fiscal and monetary policy cannot offset pricing problems, except temporarily; that restraints

W. H. Hutt 1899-1988

on market competition impoverish the poor and disadvantaged rather than helping them; that free-market pricing is the only device available to coordinate and maximize employment and output; that politically expedient concessions to sectional interest groups harm the social interest; that every increase in employment and output via a price cut adds to the source of demands for noncompeting outputs and employment; and that free markets maximize employment and

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INSIDE

A Monetary Explanation of the October Stock Market Crash: An Essay in Applied Austrian Economics

by Joseph T. Salerno

This article will attempt to place the events of "Black Monday" in perspective by explaining how they fit into the broader boom-bust cycle, as this sequence of phenomena is conceived by the Austrian theory of the business cycle. The monetary aggregate known as TMS, initially outlined in the works of Murray Rothbard, plays a central role in my explanation. In particular, I will argue that the October stock market crash was the inevitable consequence, not of new-fangled computer trading programs, but of an old-fashioned inflationary boom. As in the case of all inflations, the Great Inflation of 1982-87 was fundamentally a monetary phenomenon, orchestrated by the Federal Reserve System and financed by a massive and prolonged increase in TMS.

Setting the Stage: The Inflationary Boom of 1982-1987

In analyzing the development of the inflationary boom, I focus in turn on developments in the supply of money, the market for consumer goods, capital markets, and foreign exchange markets.

The Supply of Money

The Penn Square bank failure and the threat of default by Mexico and then other LDCs on their international loans in the summer of 1982 underscored the precarious stability of the world financial system, including and especially U.S. money-center banks. These events in conjunction with the continuing recession in the U.S. economy–whose persistence had repeatedly defied official forecasts–prompted the Federal Reserve System, in July of that year, to initiate a policy of vigorous monetary expansion.

The dimensions of this inflation of money, which propelled the U.S. economy on a rapid recovery from the recession of 1981-1982, can be seen in the sharp acceleration of the growth of adjusted bank reserves.[1] From III-82 (third quarter, 1982) to IV-83, adjusted reserves increased from $49.3 to $54.2 billion or at an annual rate of 9.94%, which represents a tripling of the 3.31% annualized rate of reserve growth occurring over the seven quarters from IV-80 to III-82.[2] To supplement its reserve-creating open market operations and to emphatically signal the markets of its resolve to reinflate the economy, the Fed cut the discount rate seven times just in the latter two quarters of 1982. Fueled by this rapid increase in bank reserves and by the introduction of MMDA's, TMS shot up from an average of $929.8 billion in III-82 to an average of $1355.2 billion in III-83, equivalent to a 45.75% annual rate of growth.

By the fourth quarter of 1983 the Fed had switched to a more restrictive monetary policy, signalled by a freezing of adjusted reserves at a level of $54.2 billion from III-83 to IV-83. The restriction of reserve growth constricted TMS growth over the same quarter to a per annum rate of 2.7%. The Fed's less expansionary policy remained in force through the fourth quarter of 1984. Over the five quarters from III-83 through IV-84, adjusted reserves expanded at an annual rate of 6.05%, from $54.2 to $58.3 billion, a reduction of more than 3 1/2 percentage points in its annual growth rate when compared to the previous four quarters. In the same period, TMS was inflated at an annual rate of 4.27% or from $1355.2 to $1427.6 billion.

The third quarter of 1984 saw the reduction of the rate of money creation begin to "bite" into the real economy, causing a "growth slowdown" and precipitating fears of an imminent recession. By IV-84, real GNP growth had slowed to an annual rate of 1.7%, compared to 10.7% and 5.5% in I-84 and II-84, respectively (Federal Reserve Bank of St. Louis 1987). In addition to the looming specter of an economy-wide recession, the Fed also confronted localized depression in particular U.S. export and import-competing industries, attributable to ongoing international shifts in comparative advantage and the relentless strengthening of the dollar on foreign exchange markets. Thus, as early as August 1984, some members of the policy-setting Fed Open Market Committee (FOMC) were advocating a return to vigorous monetary stimulation, couched in terms of "a lessening of reserve restraint" (Hafer 1985). Between the FOMC's November and December meetings, open market operations were "... directed at achieving some reduction in pressures on bank reserves against the background of lagging growth in the narrow money supply, generally sluggish expansion in the economy, subdued inflation, and continued strength of the dollar in the foreign exchange markets" (Hafer 1985). Finally, at the December 1984 meeting, an imminent renewal of the inflationary boom was declared in euphemistic terms, as ". . . most of the members expressed a preference for directing open market operations toward some further easing of reserve conditions to encourage satisfactory growth in M1 and to improve the prospects for economic expansion in 1985" (Hafer 1985).

"...the October stock market crash was the inevitable consequence, not of new-fangled computer trading programs, but of an old-fashioned inflationary boom."

Thus the third and final phase of the boom was ushered in at the beginning of 1985 when the Fed unleashed a new and sustained burst of monetary inflation on the U.S. economy with the aim of forestalling the impending recession and driving down the value of the dollar on world currency markets. From December 1984 to the end of the boom in May 1987, adjusted reserves grew by over 24% (from $58.4 to $73.2 billion) or at a rate of slightly more than 10% per annum. The result was an explosion in TMS, which increased by almost 34% in this period (from $1452 to $1942.2 billion) or at an annualized rate of increase equal to about 14%.

Prices of Consumer Goods

What enabled the Fed to stoke the fires of monetary inflation as vigorously and as long as it did was the fact that the effects of this inflation were obscured in U.S. consumer goods markets, especially in 1985 and 1986. For example, in the years 1983-1986, consumer prices, as represented by the CPI, increased at annual rates of 3.8%, 4.0%, 3.8%, and 1.1%, respectively. In the same four years, the fourth quarter-to-fourth quarter rates of increase for TMS were: 38.8%; 4.62%; 13.44%; and 12.7%

The large discrepancy between money inflation and price inflation is attributable to the simultaneous operation of a number of adventitious factors. These include the prolonged appreciation of the dollar on foreign exchange markets, which began in 1980 and propelled the dollar to postwar peaks against the German mark and a trade-weighted basket of foreign currencies in February 1985. The downward pressure that this exerted on the dollar prices of internationally traded goods, and thus on the overall U.S. price level, was reinforced by concurrent developments affecting supplies on various world commodity markets.

For example, the spread of technological advances in food-grain production to developing countries resulted in increased supplies and reduced prices of food products on the U.S. market. The collapse of OPEC and ITA cartel agreements led to supply gluts and sharply lower prices for oil and tin, as well as for substitute fuels and metals. Moreover, the belated and sluggish recovery of Western Europe from recession dampened the world demand for imports of primary commodities at the same time that the supply of these products to world markets was being stepped up by producing nations desperate for foreign exchange, especially dollars, to finance debt repayments.

These exchange-rate and supply factors heavily influenced domestic input prices, as exemplified in annual rates of change of the U.S. producer price index for crude materials for the four years 1983-1986. After a 4.7% increase in 1983, changes in the index for the next three years were: -1.6%; -5.6%; and -9% (Federal Reserve Bank of Cleveland 1988). To use Mises's terminology, the tendency to higher consumer prices emanating from the "money-side" of the economy was partially offset by temporary price-reducing factors operating concurrently on the "goods-side" of the economy. We may gain some perspective on the moderating effect of goods-side factors on the overall rate of U.S. price inflation by comparing the GNP deflator for service-producing industries with the GNP deflator for manufacturing industries, whose product costs and prices tend to be directly affected by developments on world currency and commodity markets. In 1982-85, the former index rose at an average annual rate of 5.4%, while the latter was rising at a 1.9% average annual rate. Alternatively, we note that, for the years 1983-1986, the average annual rate of increase of the CPI computed for all items except food and energy exceed that of the CPI for all times by 1.3 percentage points (4.5% vs. 3.2%) (Federal Reserve Bank of Cleveland 1987).

Another deflationary influence on prices of consumer goods was an increase in the total demand to hold U.S. dollars, which, *ceteris paribus*, tends to increase the purchasing power of the dollar in goods markets. One component of this increased demand can be traced to the enormous expansion of the volume of transactions in U.S. financial markets, which, for a variety of reasons, has been under way in the eighties. To finance this growth in transactions, both domestic and foreign investors were required to acquire and hold larger dollar balances. In addition, capital fleeing from hyperinflationary and collapsing currencies abroad, e.g., Mexico and Argentina, found a "safe haven" in U.S. bank deposits and currency. Indeed, as Murray Rothbard has pointed out, there has occurred a substantial but unmeasurable leakage of dollar currency out of the U.S. into foreign hoards and to finance transactions in the subterranean economies of foreign nations, especially in Latin America and Asia. There is also evidence that the ever-growing, worldwide drug trade, now estimated at $100 billion per year, absorbed substantial quantities of U.S. currency and thereby contributed to a rise in the global demand for dollars.

Capital Markets

Austrian business-cycle theory leads us to expect that monetary inflation will have an earlier and more intense impact on capital markets than on markets for consumer goods for two reasons. First, in the modern economy, most newly-created money initially enters the economy via increased commercial bank lending to business firms, which directly tends to lower interest rates. The additional loan funds are used by borrowing firms to increase investment in productive assets, especially fixed investment in long-lived capital goods such as producers' durable equipment and business structures. The increased investment spending, in turn, leads to higher prices for capital goods (relative to consumer goods), and higher earnings and capital values for firms producing these goods. Furthermore, the lowered interest rates, produced by the flow of new money through the credit markets, tends to increase the capital values and market prices of existing capital goods and of productive land factors, and this is reflected in increased market values for the firms which own these productive assets. Stock, credit (bond, commercial paper, commercial bank loan), and real estate markets, therefore, react most sensitively to monetary expansion, because these are the markets in which ownership titles to capital goods are exchanged.

The second reason why price inflation in consumer goods markets is generally presaged by boom conditions in capital markets involves the nature and formation of inflationary expectations. As Mises points out, during a progressing monetary inflation, inflationary expectations do not abruptly take hold of all market participants at once, but spread gradually through the ranks of those who are most keenly attuned to developments affecting the future state of market prices, and subsequently to the public-at-large. In particular, the premium on interest rates which reflects generally prevailing expectations of inflation in credit markets ". . . comes into existence step by step as soon as first a few and then successively more and more actors become aware of the fact that the market is faced with cash-induced changes in the money-relation [i.e., the supply of and demand for money] and consequently with a trend oriented in a definite direction"

(Mises 1966).

Empirically, those who are first to anticipate a decline in the purchasing power of the monetary unit and to adjust their buying and selling decisions accordingly tend to be the "entrepreneur-promoters," who regularly and successfully operate on capital markets and whose livelihood depends on rapidly and correctly adjusting their current activities to anticipated changes in future market conditions.

Thus the "promoter" concept is central to the theory of inflationary expectations, because it

> refers to a datum that is a general characteristic of human nature, that is present in all market transactions and marks them profoundly. This is the fact that various individuals do not react to a change in conditions with the same quickness and in the same way. The inequality of men, which is due to differences both in their inborn qualities, and in the vicissitudes of their lives, manifests itself in this way too. There are in the market pacemakers and others who only imitate the procedures of their more agile fellow citizens. . . . The driving force of the market, the element tending toward unceasing innovation and improvement, is provided by the restlessness of the promoter and his eagerness to make profits as large as possible. . . . (Mises 1966, p.255)

Moreover, in the modern economy, the main locus of entrepreneurial activities tends to transcend the narrow confines of the organization of the business firm and to center in markets in titles to capital goods, in capital markets. As Mises explains:

> The entrepreneurs and capitalists . . . perform all those acts the totality of which is called the capital and money market. It is these financial transactions of promoters and speculators that direct production. . . . These transactions constitute the market as such. If one eliminates them, one does not preserve any part of the market. . . . The speculators, promoters, investors and moneylenders [determine] the structure of the stock and commodity exchanges and of the money market. . . . (Mises 1966, p.708)

These theoretical considerations account for the accelerated price inflation evidenced in capital markets during the inflationary boom of 1982-1987.

For example, the bond market rallied and short-term interest rates fell steadily from the inception of the inflationary boom in mid-1982 and reached a plateau in 1983. After trendless fluctuations through the period of slower monetary growth ending in early 1985, rates tended sharply downward during the renewed burst of monetary expansion of the next two years. The three-month commercial paper rate fell almost three percentage points, from 8.77% to 5.87%, from March 15, 1985 to January 23, 1987. Over approximately the same period, the yield on Corporate Triple A bonds declined from 12.64% to 8.31% and the prime rate fell from 10.5% to 7.5%. One bond price index, the Dow Jones Index for 10 Industrials, rose from an intrayear low of 57.36 for 1982 to a yearly high of 93.10 for 1987, an increase of about 62%.

In the case of the stock market, the great bull market(s) of the 80's coincided almost exactly with the accelerated monetary inflations of 1982-83 and 1985-1986. In the fifteen months from July 1982 through October 1983, the broad-based Standard & Poor's Index of 400 Industrial stocks increased by about 54%, from 122.49 to 189.00. After a period of stagnation, decline, and recovery, which lingered through 1984, the bull market resumed in 1985, propelling the index upward to 334.65 by March 1987. Over the entire period, the index rose by 173%. Concomitantly, the annual yield on stocks (the inverse of the P/E ratio), averaged over the same 400 stocks, was driven down from 5.91% in July 1982 to 2.51% in March 1987.

Foreign Exchange Markets

The latest approach to foreign exchange markets, which was clearly formulated by Mises as early as 1912, treats them as efficient asset markets, wherein current prices or exchange rates quickly adjust to take account of changes in expectations regarding the future development of the relative purchasing powers of the various currencies. Mises's statement of the approach, however, is more realistic than the modern approach. Whereas the latter assumes "rational expectations," Mises bases his statement of the approach on the empirical theory of expectations formation and revision that focuses on the entrepreneur-promoter as noted above. An important implication of this asset market approach to exchange rates, in both its Misesian and rational-expectations variants, is that exchange rates adjust to monetary inflation very rapidly and certainly before consumer prices and the internal purchasing power of the currency fully adjust.

As Mises explained in 1919:

> Price increases, which are called into existence by an increase in the quantity of money, do not appear overnight. A certain amount of time passes before they appear. The additional quantity of money enters the economy at a certain point. It is only from there, step by step, that it is dispersed. It goes first to certain individuals in the economy only and to certain branches of production. As a result, in the beginning it raises the demand for certain goods and services only, not for all of them. Only later do the prices of other goods and services also rise. Foreign exchange quotations, however, are speculative rates of exchange—that is they arise out of the transactions of business people, who, in their operations, consider not only the present but also potential future developments. Thus, the depreciation of the money becomes apparent relatively soon in the foreign exchange quotations on the Bourse—long before the prices of other goods and services are affected. . . . (Mises 1978, p. 51)

In the first part of the boom, the dollar continued to appreciate against foreign currencies generally, including the Japanese yen and the German mark, reaching its peak in February 1985. The dollar appreciation was due to the fact that the price inflation rate in the U.S. before 1985 was not significantly higher than in Germany and Japan, while relatively high U.S. interest rates, resulting from heavy government borrowing to finance federal budget deficits, attracted a substantial influx of foreign capital. In early 1985, however symptoms of the ongoing dollar inflation finally began to appear in world currency markets as inflationary expectations were kindled by the ballyhoo and publicity surrounding the decision of the Fed to cure the yawning U.S. trade gap by deliberately driving down the foreign-exchange value of the dollar.

As a consequence, the dollar price of a German mark was bid steadily upward from approximately \$.31 at its all time low in February 1985 to around \$.55 at the end of the boom in April-May 1987, representing a price increase equal to 77.42%. Over the same period, the dollar exchange rate for the yen rose from just under \$.004 to just over \$.007 per yen, a price inflation of 75% (Federal Reserve Bank of St. Louis 1988). Against a trade-weighted basket of foreign currencies, the dollar lost about 40% of its market value for the period.

Monetary Deflation and Crash

The monetary deflation of 1987 was motivated by the Fed's desire to arrest the two-year decline in the external value of the dollar. In late January, the U.S. and Japan undertook "coordinated intervention" into the foreign exchange markets to support the dollar. Under the terms of the Louvre accord, concluded in late February, monetary authorities of six industrial countries including the U.S. agreed "... to cooperate closely to foster stability of exchange rates around current levels" (Federal Reserve Bank of New York 1987).

The decision to prevent further depreciation of the dollar on foreign exchange markets and to stabilize its exchange rates with the mark and yen within "narrow bands" established by the Louvre accord brought monetary inflation to a screeching, if only temporary, halt in February 1987. During the six months prior to this date, the annualized growth rates of adjusted reserves and TMS were 18.27% and 19.59%, respectively. Suddenly, monetary policy was thrown into reverse as the Fed sold \$8.4 billion of government securities—disgorging almost 4% of its entire stock in one month—producing a virtual halt in the growth of bank reserves and a collapse of TMS, which fell from \$1920.4 to 1873.3 to yield an annual growth rate of -29.4% for February. The result was that from late January to early March, dollar exchange rates held firm.

"...the bull market(s) of the 80's coincided almost exactly with the accelerated monetary inflations of 1982-83 and 1985-86."

Despite the fact that the Fed's actions continued to lean to a policy of monetary tightness in March (open market operations were slightly expansionary and adjusted reserves grew negligibly), TMS continued to spiral upward at an annual rate of 13.8%, fueled by a mammoth 9% expansion of the nonreservable savings deposit component that swamped a net decline in other elements of TMS. With the onset of the bond market collapse in April, however, the Fed turned expansionary with a vengeance, swelling its stock of government securities by 4% and driving up adjusted reserves and TMS at annual rates of 24.6% and 27.7%, respectively. Predictably, the dollar once again depreciated sharply on foreign exchange markets from mid-March through April despite active and strong intervention by the U.S. and foreign central banks. From its levels in mid-March, the dollar had depreciated 8.38% against the yen and 4.38% against the mark by the end of April (Federal Reserve Bank of New York 1987).

Alarmed at the accelerating free fall of the dollar, Paul Volcker announced in late April that the Fed had "snugged up" monetary policy to counteract exchange rate pressure. Thus in May, reserve growth virtually ceased and TMS increased at an annual rate of 2.2%, with the dollar falling to near a 40-year low against the yen and to a seven-year low against the mark before beginning to sharply appreciate in late May. The Fed continued efforts to bolster the external value of the dollar through the next three months by contractionary open market operations, which saw it shrink its government securities portfolio by 4.2%. The result was a three-month monetary deflation, with TMS contracting by a total of about \$21 billion or at annual rates of -4.6%, -1.0%, and -7.0% for June, July, and August, respectively. The deflationary policy came to an end in September when the Fed reinstituted expansionary open market operations (although adjusted reserves declined for the month) and TMS increased at a 6.3% annual rate, fueled mainly by a large increase in U.S. Government Deposits.

As noted above, the bond market began a steep fall in early April that persisted through May. The interest rate on Triple A corporate bonds rose over one percentage point, from 8.36% to 9.49%, between March 27 and May 22. Other credit markets followed, as the commercial paper and prime rates increased, respectively, from 6.29% to 6.96% and from 7.5% to over 8%. After relative stability through June, July and most of August, credit markets became firmly convinced that the monetary inflation was at an end and interest rates resumed their steep ascent, which continued until the October crash. By October 16, the corporate bond rate had reached 10.73%, over one percentage point higher than its rate on August 28. Likewise, short-term interest rates rose rapidly between these two dates, with the commercial paper rate jumping from 6.64% to 7.86% and the prime rising from 8.25% to 9.25%.

Equities markets followed a different pattern than credit markets in 1987. During the steep run-up in interest rates that occurred during March-May, the stock market experienced only a temporary pause, with the S & P 400 Industrials averaging 334.65 in March and 336.10 in May. While conditions stabilized in credit markets during the summer months, the stock market resumed its boom, the S & P index averaging 14.53% higher in August than in May. The deflationary monetary policy of the summer months finally brought the stock market boom to an end in August. However, it took another month and one-half and a series of further events to fully break the back of inflationary expectations in the stock market. The renewed depreciation of the dollar on the foreign exchange markets, which had begun in early August, provoked a discount rate hike in early September, which failed to more than momentarily strengthen the dollar. Against the background of further weakening of the dollar in early October, Treasury Secretary James Baker's desperate bashing of and threats against the West Germans for raising the discount rate in the week before the crash at long last galvanized investors into the realization that tight monetary policy was here to stay and that the Fed was not about to reignite boom conditions.

The result of the divergent movements in credit and equities markets during April-September 1987 was to create a growing differential between bond and stock yields. Thus, between 1981 and Spring 1987 stock and bond prices and yields tracked one another quite closely (Federal Reserve Bank of Cleveland 1987). However, from April to September 1987, the average yield for S & P's 400 Industrial stocks fell from 2.52% to 2.33%, while the yield on Triple A bonds rose from 8.85% to 10.18%. With inflationary expectations no longer operative in the stock market, this unprecedented yield differential became unsustainable. During the boom–but especially from early 1985 onward–stock P/E ratios were driven to dizzying heights by investors' expectations of a continuation of low interest rates and of the imminent arrival of price inflation and inflated corporate earnings. The Fed's volte-face on monetary policy eventually compelled a wrenching revision of expectations among bull-market investors, who now were convinced that interest rates would remain high for the foreseeable future and began to use these higher rates to discount their lowered estimates of future corporate earnings.

"...raising the discount rate in the week before the crash... galvanized investors into the realization that tight monetary policy was here to stay."

The precipitous fall of stock prices on Meltdown Monday thus represented a fundamentally rational, if belated, adjustment of the market to the termination of the Fed-induced inflationary boom. The remedy for stock-market volatility therefore does not lie in the proposals offered by the new Luddities on the Brady commission, who seek to seriously impede, if not destroy, the new productive machinery of stock index trading, portfolio insurance, and computer program trading. No, the aim of preventing stock-market crashes can be attained only by successfully preventing monetary inflation. And *this* can be achieved only by restoring the ultra-hard money of a genuine gold standard and putting a definitive end to political manipulation of the supply of dollars.

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Notes

1. (a) I focus on adjusted reserves to gauge the intended thrust of Fed policy, because variations in adjusted reserves are directly related to variations in the aggregate money stock and because the Fed possesses the means for controlling the rate of growth of total reserves if not in the short run then certainly in the intermediate run (quarter to quarter). In addition, since 1979, the Fed's policymaking arm has been using reserve targets to guide its actions toward policy objectives. (b) To ascertain short-run changes in monetary policy, I resort to month-to-month changes in the Fed's stock of government securities, which are determined solely by Fed open market operations, although changes in Federal Reserve credit or even in the adjusted monetary base could also have been used for this purpose.

2. All statistics relating to adjusted reserves and the Fed stock of government securities are drawn from *Monetary Trends*, published monthly by the Federal Reserve Bank of St. Louis.

3. Much of this enormous increase in TMS coincided with an anomalous one-shot increase in the overall demand to hold money by a public eager to add high interest-earning and federally-insured dollars in checkable MMDA's to its cash balances. Since (personal) MMDA's require no legal reserve backing, their expansion did not absorb the existing bank reserves, and it was therefore possible for the banking system to meet this demand without a net contraction of other elements of TMS. Yet, it is still the case that TMS, net of MMDA's and saving deposits (a close substitute at the margin for MMDA's) suffered a large decline when the latter were introduced, expanded over the period at the dramatically inflationary rate of 14.17% per year. In the same period, the reserve-absorbing aggregate of demand plus other checkable deposits expanded at a combined annual rate of 14.45%.

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Roger Garrison, Murray Rothbard and a student take time out from the busy schedule at the Advanced Instructional Conference in Austrian Economics at Stanford.

A "New" World Currency?

by Ludwig von Mises

John Maynard Lord Keynes has acquired world-wide reputation as an antagonist of stability of foreign exchange rates and as a champion of currency devaluation and credit expansion. His doctrines triumphed when England went off the gold standard in 1931 and embarked upon increased protectionism, and when all other nations very soon followed the British example. The disintegration of the international division of labor and the excesses of economic nationalism were corollaries of some of the teachings of this eminent advisor of the British Government.

Lord Keynes, however, seems ready to learn from experience. He realizes now that one of the main prerequisites of a better post-war order is the return to monetary stability. He has elaborated a sophisticated scheme for an international clearing bank and a new international currency unit, the "Bancor." This rather awkward neologism is apparently only a name for a weight of gold to be defined by an international agreement.

Lord Keynes's new plan obviously cannot work, however, without a radical change in current economic ideologies. If governments cling to the belief (which owes much of its popularity to Lord Keynes himself) that stabilizing foreign exchange rates and abstaining from currency devaluation mean sacrificing vital national interests to the benefit of foreign nations, they will discover some means to elude the articles of the monetary covenant that Lord Keynes now urges. The vicissitudes of the Austro-German monetary union of 1857, of the Latin Monetary Union and of other similar conventions demonstrate clearly that treaties are no serious check for governments eager to devalue their currencies.

If, on the other hand, each nation were fully convinced that it would best serve its own interest by maintaining the integrity of its currency unit, no elaborate international agreements or clearing houses would be needed. Every nation, rich or poor, is free to stabilize its own currency system with respect to gold, and to maintain permanently the gold parity of its monetary unit, provided that it abstains from domestic credit expansion and inflation. The gold standard was, without any international agreements, the most satisfactory international standard that has ever been devised. It stabilized foreign exchange rates within very narrow margins. It is often said that the gold standard "failed." The truth is that governments sabotaged it deliberately, because it interfered with the nationalistic "planning" that governments preferred to stability of exchange rates.

It is not necessary to invent elaborate technical devices to secure monetary stability. The nineteenth century developed them through the gold standard. What has been lacking is the conviction that it is harmful, from the viewpoint of every nation's own ultimate interests, to devalue its national currency system in order to stimulate exports, to bar imports or to hurt the interests of foreign creditors. The only way to financial "disarmament" lies through the recognition of this truth.

Dr. Robert W. McGee, associate professor at Seton Hall University, has been gathering information and research in the preparation of compiling an updated bibliography of the works of Ludwig von Mises.[1] While working on the project Dr. McGee came across several long forgotten newspaper articles by Mises.[2] This article is from that collection,[3] written for the *New York Times*, March 3, 1943, and is as timely as ever.

Notes

1. The author is working with Bettina Bien Greaves, of the Foundation for Economic Education, on this project. The bibliography will be a much expanded edition of her earlier book *The Works of Ludwig von Mises* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1969).
2. Thanks go to Bettina for pointing these articles out to me. She found the articles in Mises's personal papers located at Grove City College. An invoice attached to each article in the file shows that Mises was paid $10 per article.
3. McGee, Robert W., "Ludwig von Mises and the *New York Times*" (unpublished manuscript). ■

On the Issue of Causality in Modern Empirical Economics

by Roger W. Garrison

Considerations of technique prevent the modern economist from addressing the full range of economic questions. As a mathematician, he can shed no light on issues of causality, but as an economist, he is continually confronted with such issues. The melding of classical statistics with formal mathematical modeling, which establishes a link between theoretical abstractions and historical experience, does not close the gap between issues and answers. All respectable texts on statistics and econometrics acknowledge that statistical inference can never identify cause and effect; they warn against interpreting correlation as causation.

In recent years it has become acceptable within the economics profession to ignore all such acknowledgments and warnings and to make claims about cause and effect on the basis of empirical tests. For a hypothetical example, the claim that a rising interest rate *causes* the wage rate to fall may be supported by time-series analysis in which an inverse relationship between wage rates and lagged interest rates is demonstrated. The long-respected strictures against reading causality into statistical patterns are flouted. Empirical causality tests are increasingly common in the professional literature.

Only in the early phase of this empirical innovation was it made clear that such tests are based upon a newly stipulated definition of the word "cause." Stripped of all its subtle and difficult philosophical content and of its etymological link with reason, the word "cause" is used to describe observed temporal patterns in time-series data. In the judgment of Clive Granger and Paul Newbold [1977, p. 225], "A better term might be *temporally related*, but since cause is such a simple term we shall continue to use it." It is interesting to note that, though this usage is defended on the basis of simplicity of expression, economists who employ empirical techniques developed by Granger use the decidedly unsimple and unaesthetic term "Granger-cause," as in: Falling interest rates Granger-cause wage rates to rise.

Christopher Sims, most widely known for his development and use of techniques suggested by Granger, is explicit about the nature of his enterprise. "The method of identifying causal direction employed here does rest on a sophisticated version of the *post hoc ergo propter hoc* principle" [1972, p. 543]. "After this, therefore because of this," of course, is not a principle at all, but a fallacy. And sophistication cannot convert fallacy into principle.

The linguistic technique introduced by Granger is nothing short of a scandal. (A better term might be *professionally motivated innovation*, but since scandal is such a simple term I shall continue to use it.) Publishers and editors are not likely to be interested in research that yields limp conclusions about the temporal relationships in the movements of economic variables; they are interested in research that demonstrates that one thing *causes* another.

Granger-inspired research is often reported guardedly in the section on the testing procedure and then unguardedly in the summary section. Gerald P. Dwyer, Jr. [1982], for instance, conducts Granger-causality tests to determine whether or not federal budget deficits Granger-cause inflation. Failing to find any statistically significant post-hoc relationship, he tentatively reports in his summary that "...there is no reason to predict that a reduction of deficits has a causal role in any policy to reduce inflation."

The economist's audience is interested in the issue of causality; his mathematical and econometric techniques are not up to the task. The result–for those who confine themselves to mathematical and statistical methods–is a scandalous abuse of the English language.

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Hans Hoppe, Roger Garrison, and Richard Ebeling discuss topics of interest at a recent Mises Institute Conference.

Barry Smith: On the Genesis of Austrian Economics

by Parth Shah

Barry Smith, Lecturer in Philosophy at the University of Manchester, England, visited the Mises Institute and Auburn University on February 4-5. Fluency in German, frequent visits to Austria and Germany, and numerous scholarly publications has established Smith as an authority on the history of the development of Austrian philosophy and economics. His latest book is edited with Wolfgang Grassl and entitled *Austrian Economics: Historical and Philosophical Background*.

In his first talk, "The Austrian-ness of Austrian Economics," presented at the Mises Institute, Smith outlined the unique and rich background of Austrian philosophy, the foundation in which Austrian economics is embedded. The Papal prohibition on the books of Kant and Hegel sheltered Austrians, albeit temporarily, from the grand philosophemes of the German type (e.g., Reason, Transcendental Ego, Nation-State), and thus facilitated continuing development of the Aristotelian and scholastic traditions. There emerged, under the Aristotelian influence, a distinct "Austrian" approach to economics and psychology–Carl Menger's subjectivism and marginalism in economics and Franz Brentano's Gestalt psychology. On the other hand, Kant's Germany was mired in nihilistic historicism and destructive collectivism.

Smith's second talk, "Philosophical Foundations of Austrian Economics," was given at the Department of Economics. He began by pointing out how the Aristotelian roots distinguished Austrian philosophy from German-Kantian philosophy in two crucial aspects: in its relation to realism and its distinct emphasis on *a priori*. In Austrian philosophy, realism was understood both in an ontological sense (the world exists, more or less as we find it) and in an epistemological sense (knowledge and science are possible). Thus the Austrian metaphysics was not dichotomized into "phenomenal" and "noumenal" worlds.

The Kantian epistemology divided knowledge predominately into analytic/synthetic categories but left little room for synthetic *a priori* propositions. The analytic-synthetic dichotomy implies that scientific propositions are either analytical (tautological), that is, true by definition or synthetic (contingent), dependent on continual empirical verification for their validity. For Kant the domain of synthetic *a priori* (experience-dependent true) propositions, though important, was restricted primarily to arithmetic. In contrast the Austrian philosophers inspired by Menger and Brentano developed entire disciplines of synthetic *a priori* propositions which include, in addition to economics and psychology, the disciplines of phenomenology, geometry, phonology, legal theory, universal grammar, and speech-act theory, to name a few.

For Austrians, therefore, *a priori* propositions–such as, "human action is purposeful," "a promise involves mutual obligations and duties," "nothing can be red and green all over"–underlie all spheres of human experience. These propositions express pre-theoretical or proto-scientific knowledge and are intrinsically intelligible, that is, they are capable of being grasped as evident by anyone who has familiarity with the domain in question. The complex phenomena of money, rents, profits, and such are intelligible only through *a priori* propositions.

Works of later Austrians like Edmund Husserl, Alfred Schutz, Adolf Reinach, and Felix Kaufman have not only provided philosophical grounding for *a priori* true propositions, but it is without the limitations and dichotomies of the Kantian epistemology.

One would conclude, from these talks, that Austrians were (are) not only good economists but also pioneers in the philosophy of social sciences. Austrian economics is but one fruit, though well developed, of the Austrian philosophy. Our understanding and extension of Austrian economics, Smith argues, must begin with the recognition of the influence of Aristotle as its genesis. ■

"Comment on Hoppe"

by David Osterfeld

Professor Hans-Hermann Hoppe's essay, "The Justice of Economic Efficiency," is pathbreaking. By the use of what is, in fact, *praxeological* reasoning, i.e., reasoning grounded in the logically necessary implications of the principle of human action, he attempts to lead the reader to the conclusion that private property is a natural, inalienable, right. Being the utilitarian that he was, Ludwig von Mises would no doubt have been astounded by the exercise. But the question is: does it succeed? In large part it does; but not totally.

Since I find myself in agreement with most of Professor Hoppe's position, I will confine my remarks to those points at which I either disagree or feel need for further amplification.

(1) Hoppe states that the starting point of both political economy and political philosophy is the recognition of scarcity. The goal of economic theory is to maximize wealth production; that of political philosophy is to avoid conflicts by "assigning a set of rules for the exclusive control over scarce goods." These two goals complement each other. Together, they "lead to the greatest possible production of wealth."

I have no disagreement with the statement regarding economics, but I do think it is questionable in regard to political philosophy. Political philosophers have written for a multitude of reasons. It seems to stretch the point to say that all have been concerned with assigning a set of rules to deal with scarcity. For example, philosophers and government rulers have long wrestled with such issues as freedom of religion and freedom of speech. Since there was great fear of the consequences of permitting people to worship and to speak as they wished, political philosophers, e.g., Hobbes, and Rousseau to name but two, felt that the state had the right, in fact the duty, to *limit* these activities. To put it in the terminology of economics, the perceived problem was not scarcity but *surplus*, and the proposals, and the government policies, were designed to limit both religion and speech, thereby making them more, not less, scarce. These policies were no doubt ill-advised, but that is another matter.

(2) Professor Hoppe argues that "as long as there is argumentation, there is mutual recognition of each other's property right in his own body." I have no disagreement with this as stated. But what is left unstated here is the *source* of that right. Hoppe believes that it is a natural right embedded in the very nature of argumentation. But could it not be derived from a contract negotiated behind a Rawlsian "veil of ignorance"? Could it not have emerged, a la Hume or Burke, from tradition, or experience, or custom? Or could it not have been the result of a Benthamite utilitarian calculus? I don't see how Hoppe can simply dismiss these other possibilities, *a priori*.

(3) Hoppe argues that socialism is "argumentatively indefensible" because if private property is not recognized, then one would have to come to an agreement with the "entire world population" prior to committing oneself to any course of action, a requirement that would paralyze all human action, and thus all life. It is not clear that the only alternative to individual ownership is ownership by the "world community." (In fact, I don't see how the alternative can be ownership by a "world community" since that community, like all communities, is composed of individuals. If ownership by individuals is denied, then ownership by a community composed of individuals must also be ruled out. Thus, the alternative to individual ownership is not ownership by the community but total non-ownership, leaving property in an ethical limbo. Nevertheless, Hoppe implicitly grants the argument that the alternative to individual ownership is some type of community ownership.) For there is the possibility of intermediate communities. Isn't it possible for members of community *A* to agree on their own set of rules regarding property, for members of community *B* to establish their own set of rules, etc.? And then isn't it possible for representatives of communities *A*, *B* . . . *N* to agree, bilaterially or collectively, on the principles governing interactions between their communities? I don't see how Hoppe's argument, as it is presented, rules out these possible alternatives between the poles of the individual and the world.

(4) Finally, Hoppe's argument is an example of ethical naturalism. From the factual claims regarding the nature of man and the nature of argumentation, Hoppe derives an ethical justification from private property. His claim is not merely that private property is just but that "any deviation from it is . . . unethical." This is a large claim and one that risks falling afoul of the naturalistic fallacy. Wouldn't it be possible for someone, say Rawls, to say that, (a) what Professor Hoppe says about the factual aspect of property is quite true, (b) however, it is neither necessary nor desirable that this remains the case? And isn't it also quite possible for Rawls to then proceed to use his *de facto* private property to try to get the rules regarding property changed? I don't see any contradiction in this. After all, libertarians do run for government office with the intention of dismantling the government. And totalitarians have commonly used free speech in order to acquire the power to eliminate free speech. Why is it impossible to move from one set of *(de facto)* norms, say the Hoppe-norms, to another, allegedly superior set of norms, say the *x*-norms? I don't see how Hoppe has ruled out this

possibility.

I am afraid that my paper is mostly negative. I don't want to give the wrong impression. I find Professor Hoppe's argument to be both pathbreaking and compelling. I agree with the thrust of his analysis. Because of that I have focused my attention on four possible objections to his paper. I believe that these objections can be successfully surmounted.

A common failing of commentators is that they call the author to task either for not doing everything in the space of a single paper or for not doing something he had no intention of doing in the first place. In reviewing my comments it is clear that I have managed the unenviable feat of committing both mistakes in the remarkably short space of a single comment. Again, I think that Hoppe's use of praxeology is a challenging and unique approach to demonstrating the right of private property and I look forward to further work along these lines by him and others.

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"Comment on Osterfeld"

by Sheldon L. Richman

Dr. Osterfeld's interesting response to Dr. Hoppe is mistaken on at least one count. He writes, "It seems to stretch the point to say that all [political philosophers] have been concerned with assigning a set of rules to deal with scarcity." He asserts that important political philosophers were actually concerned with the *surplus* of such things as religion and expression. But I think this is the wrong way to look at state interference with these activities.

What motivated the state was not a surplus but a *scarcity.* The scarce "commodity" was the allegiance of the state's subjects. The state could never get enough and so it was fearful of the competition for that allegiance: Church and Truth. The people's allegiance to either of these would diminish, if not eliminate, allegiance to the state, a situation that the state could not tolerate. Thus, in the tradition of all who fear free competition, the state tried to limit or destroy its competitors: freedom of religion and freedom of expression.

The state's interference with church and truth can also be shown to be a concern with the maximization of production and wealth. As noted, the state has clearly been concerned with producing the maximum "amount" of allegiance to it. Second, this "production" was calculated to be the easiest route to the maximum amount of wealth *for the state* as well. Economics, of course, can show that state intervention dimishes the amount of wealth produced. But in this context we must look at things from the ruler's point of view. He has historically not been interested in the absolute amount of wealth produced, but in the amount he can get *his* hands on easily. The state can be expected to opt for a lower overall amount, provided, other things equal, that its share is larger than it would be were the overall amount higher.

The Lafferites, of course, have challenged this strategy, claiming that the state would garner more wealth if the people were freer to produce. But they have been theoretically weak. After all, though people may work fewer hours if marginal tax rates are raised, it is also possible that they will work more hours in order to maintain their standard of living.

But regardless of the validity of supply-side economics, it seems undeniable that the state's activities, and the political philosophers who apologized for them, fall well within the framework set out by Dr. Hoppe.

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Sheldon Richman discussed the history of the income tax at the Mises Institute Conference on Taxation.

Demonstrated Preference and Private Property: Reply to Professor Osterfeld

by Hans-Hermann Hoppe

Professor Osterfeld, after generously acknowledging the "pathbreaking" nature of my *a priori* defense of the ethics of private property, concentrates on four objections to my arguments.

I will comment on all four objections that Professor Osterfeld addresses. However, since they depend on a correct understanding of my central argument and its logical force, I will first restate my case in the briefest possible way.

As Osterfeld correctly notices, I want to give a praxeological proof for the validity of the–essentially Lockean–private property ethic. More precisely, to demonstrate that only this ethic can be argumentatively justified, because it is the praxeological presupposition of argumentation, and that any deviating ethical proposal can hence be shown to be in violation of demonstrated preference. Such a proposal can be raised, but its propositional content would contradict the ethic for which one would demonstrate a preference by virtue of one's own act of proposition-making, i.e., by the act of engaging in argumentation. In the same way as one can say "I am, and always shall be, indifferent towards doing things," this proposition contradicts the act of proposition-making, which reveals demonstrated subjective preferences (saying this rather than saying something else or not saying anything at all). Deviationist ethical proposals are falsified by the reality of actually proposing them.

To reach this conclusion and properly understand its importance, two insights are essential.

First, the question of what is just or unjust–or, even more general, what is valid or not–only arises insofar as I am, and others are, capable of propositional exchanges, i.e., of argumentation. The question doesn't arise for a stone or fish, because they are incapable of producing validity-claiming propositions. Yet if this is so–and one cannot deny that it is without contradicting oneself, as one cannot argue the case that one cannot argue–then any ethical proposal, or any other proposition, must be assumed to claim it is capable of being validated by propositional or argumentative means. In producing any proposition, overtly or as an internal thought, one demonstrates one's preference for the willingness to rely on argumentative means in convincing oneself or others of something; and there is, then, no way of justifying anything, unless it is a justification by means of propositional exchanges and arguments. It must be considered the ultimate defeat for an ethical proposal if one can demonstrate that its content is logically incompatible with the proponent's claim that its validity be ascertainable by argumentative means. To demonstrate such incompatibility would amount to an impossibility proof; and such proof is deadly in the realm of intellectual inquiry.

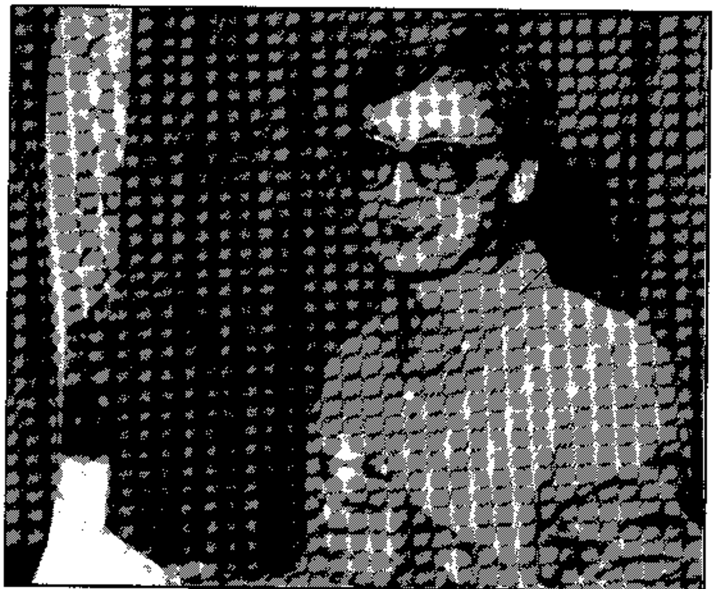
Secondly, the means with which a person demonstrates preference by engaging in argumentation are those of private property. Obviously, no one could propose anything or become convinced of any proposition by argumentative means if a person's right to exclusive use of his physical body were not already presupposed. Furthermore, it would be equally impossible to sustain argumentation and rely on the propositional force of one's arguments if one were not allowed to appropriate other scarce goods through homesteading action, i.e., by putting them to use before somebody else does, or if such goods, and the right of exclusive control regarding them, were not defined in objective, physical terms. Because if such a right were not presupposed, or if latecomers were supposed to have legitimate claims to things, or things owned were defined in subjective, evaluative terms, no one could survive as a physically independent decision-making unit, and hence no one could ever raise any validity-claiming proposition.

By being alive and formulating propositions, then, one demonstrates that any ethic except that of private property is invalid.

Osterfeld's fourth objection to my article states that my argument is an instance of ethical naturalism, but that I then seem to fall afoul of the naturalistic fallacy of deriving an "ought" from an "is." I am willing to accept the first part of this proposition but not the second. What I offer is an entirely value-free system of ethics. I remain exclusively in the realm of is-statements and nowhere try to derive an "ought" from an "is." The structure of my argument is this: (a) justification is propositional or argumentative (*a priori* true is-statement); (b) argumentation presupposes the recognition of the private property ethic (*a priori* true is-statement); (c) no deviation from a private property ethic can be justified argumentatively (*a priori* true is-statement). Thus, my refutation of all socialist ethics is a purely cognitive one. And that Rawls or other socialists may still advocate such ethics is completely beside the point. That one plus one equals two does not rule out the possibility that someone says it is three, or that one ought not attempt to make one plus one equal three the arithmetic law of the land. But all this does not affect the fact that one plus one still *is* two. In strict analogy to this, I "only" claim to prove that whatever Rawls or other socialists say is false, and can be understood as such by all intellectually competent and honest men. It does not change the fact that incompetence or dishonesty and evil still may exist and may even prevail over truth and justice.

The second objection suffers from the same misunderstanding of the value-free nature of my defense of private property. Osterfeld agrees that argumentation presupposes the recognition of private property. But then he wonders about the source of this right. Yet how can he raise such a question? Only because he, too, is capable of argumentation. Without argumentation there would be nothing but silence or meaningless noise. The answer is that the source of human rights is, and must be, argumentation as the manifestation of our rationality. It is impossible to claim anything else to be the starting point for the derivation of an ethical system, because claiming so would once again have to presuppose one's argumentative capability. Could rights not be derived from a contract behind a "veil of ignorance," asks Osterfeld? Yes and no. Of course, there can be rights derived from contracts. But in order for a contract to be possible, there must already be private owners and private property, otherwise there would be no physically independent contractors, and nothing to contractually agree upon. And "no": no rights can be derived "from behind a veil of ignorance," because no one lives behind such a thing, except epistemological zombies, and only a Rawlsian zombie ethic can be derived from behind it. Can rights emerge from tradition a la Hume or Burke? Of course, they always do. But the question of the factual emergence of rights has nothing to do with the question of whether or not what exists can be justified.

In his third objection, Osterfeld claims that I construct an alternative between either individual ownership or world community ownership but that such an alternative is not exhaustive. This is a misrepresentation. Nowhere do I say anything like this. In the section to which Osterfeld refers, I am concerned with explaining the entirely different alternative between property as defined in physical terms and as originating at definite points in time for definite individuals, and, on the other hand, property as defined in value terms and unspecific with respect to its time of origin, and the refutation



Professor Hoppe lectured on the Foundations of Austrian Analysis at The Second Annual Conference in Advanced Austrian Economics, held at Stanford University in June.

of the latter as absurd and self-contradictory. I do not at all rule out the possibility of ownership of "intermediate communities." However, to repeat, such ownership presupposes individual, private ownership. Collective ownership requires contracts, and contracts are only possible if there are already prior non-contractually acquired ownership claims: contracts are agreements between physically independent units, which are based on the mutual recognition of each contractor's private ownership claim to things acquired prior to the agreement, and which concern the transfer of these property titles from a specific prior to a specific later owner or owners.

Regarding Osterfeld's first objection, I did not write that the fundamental goals of political economy and political philosophy are "complementary" ones. What I said is that they are different. No one trying to answer "What is just?" is logically committed to insisting that his answer must also contribute to the greatest possible production of wealth (at least I don't contend anywhere that there is any such logical commitment!). Hence, it is no valid objection to my remarks on the relationship between political philosophy and economy that Hobbes, Rousseau and others suggest that political systems do not increase wealth but rather scarcity. Their claim that such systems are just cannot be made good, and as it turns out, the ethic which alone can be justified indeed helps maximize wealth production. This is a–fortunate–matter of fact. It does not change in the least the fact that political philosophy and political economy are concerned with completely separate issues.

This and only this has been my thesis: While political philosophers as such need not be concerned with the problem of alleviation of scarcity, political philosophy and economy have in common the fact that without scarcity neither discipline would make any sense; there would be no interpersonal conflict over anything, and hence no question as to what norms should be accepted as just in order to avoid such possible clashes! It is no stretching of the point to say that political philosophers have invariably been concerned with the assignment of rights of exclusive control over scarce goods. Such is the case when a Lockean proposes to accept the private property ethic, and no less when a Hobbesian suggests, instead, to make some person the supreme Fuehrer, whose commands everyone else must follow.

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New Palgrave: A Dictionary of Economics

Edited by John Eatwell, Murray Milgate, and Peter Newman

by Mark Thornton

The *New Palgrave* is the long-awaited update of *Palgrave's Dictionary of Political Economy* (edited by Henry Higgs, 1923-1926) which was itself an update of Robert Palgrave's *Dictionary of Political Economy* (1894-1899). The original dictionary was compiled to provide economists–who were becoming increasingly specialized–with a ready source of information that encompassed all the diverse areas within economics and included the leading figures, past and present, in those fields.

The four-volume update contains 1916 entries, 655 of which are biographical. The editors chose 927 contributors to compose the entries, most of whom are experts in their area or leading historians of thought. The four-volume set is 4,194 pages, leather-bound in half-calf, with gold leaf stamped on green and maroon. It is a truly impressive set for your library that weighs in at over 20 pounds! While both the production and content are of high quality, the quality of the contributions is uneven and the allocation of space presents some problems.

Although many leading Austrian economists are contributors it is certainly not flush or complete on "Austrian" topics. For example, praxeology is omitted and only discussed in Rothbard's spirited entry on "Ludwig von Mises."

An insight into the contributor selection process and the topics considered can be found in the contributions by the editors themselves. Among their contributions we find: "Keynesianism," "socially necessary technique," "Keynes's General Theory," "convexity," "duality," and "gauge functions." Two of the editors are card-carrying Keynesians while the third is an econometrician, so it is not difficult to see why Austrian economics did not fare better. The only mention of Austrian economics in the editors' 67 entries are in Milgate's short entries on William Smart and James Bonar. John Eatwell, formerly of Cambridge University, is now an economic advisor to the British Labour Party.

Some of the Austrian economists contributing to the *New Palgrave* are Israel Kirzner on "the Austrian school of economics" and "economic harmony" and "F. A. Hayek" (written with Roger Garrison). In addition to the entry on Ludwig von Mises, Murray Rothbard contributed entries on "catallactics," "Frank Fetter," "imputation," and "time preference." Other contributions of interest are: Bruce Caldwell on "positivism," Steve Hanke on "privatization," James Buchanan on "opportunity cost," and Paul J. McNulty on "competition: Austrian conceptions," while Marcello de Cecco wrote the contribution on the "gold standard."

The *New Palgrave* is any economist's friend, because it contains a listing of entries alphabetically, complete cross-references, a subject index (with a biographical list), a general index, a list of entries by author, a list of biographies and entries that were in the original but omitted from the *New Palgrave.*

Overall, the *New Palgrave* (Stockton Press, New York, 1987) is a handsome achievement and despite some minor flaws, a valuable research tool. If $650.00 is too high a price you can find it in the library near the old Palgrave (HB 61 .P17, 1923) listed under HB 61 .N49, 1987b. ■

The Theory of Free Banking

by George Selgin
Reviewed by Leland B. Yeager

George Selgin wrote his doctoral dissertation at New York University under the supervision of Lawrence H. White, who is well known for his research into the Scottish experience with free banking and British controversies over related topics. White now provides a foreword to a revised version of Selgin's dissertation. As he says, this book bears out John Hick's observation that the best work in monetary theory is topical, aimed at understanding a current monetary problem, and also is attuned to the evolution of institutions. The outstanding monetary problem of our time, White continues, is the failure of central banking to deliver macroeconomic stability as promised. The most noteworthy institutional developments of the recent past and foreseeable future are the partial deregulation and increasing competitiveness of banking and finance. Existing trends could conceivably culminate in the sort of free banking that Selgin analyzes.

American textbooks typically assume that a central bank monopolizes the issue of currency and that its liabilities constitute the reserves of the commercial banks, which must hold them in required minimum ratios against their own deposit liabilities. Selgin examines how private banks would operate if free from legal restrictions on their issues of banknotes and demand deposits but compelled by competitive forces to keep these liabilities redeemable in outside money (which might be gold or might be fiat money issued by a defunct central bank and now frozen in amount). He finds that economic forces would limit monetary expansion either by a single bank or by banks in the aggregate. He argues that a market feedback mechanism appropriately guides competitive banks but not a central bank in supplying money. A suitable mix of deposits and currency is also more readily attainable under free banking than under a system confining currency issue to a central bank.

Probably Selgin's most "provocative" analytical point (to adopt White's word) is that the economic limits to note and deposit issue expand when the public's demand for bank money grows. Even if the total stock of outside or reserve money were constant, banks could accommodate growth in the public's demand for notes and deposits, thereby maintaining equilibrium between the demand for and supply of money, since the reserve ratio required by prudence would sink appropriately (and since no reserves would be required by law).

It is marvelous indeed if Selgin really has discovered a system that automatically maintains monetary equilibrium, thereby avoiding episodes not only of too much money and consequent inflation and of too little money and consequent recession but also of alternating monetary imbalances and consequent stagflation. Just how does his analysis go?

To explain an accommodating decline in prudential reserve ratios, Selgin invokes economies of scale in reserve-holding, hinging in turn on the law of large numbers. Now, economies of scale are fairly credible in the sense that prudential reserve *ratios* decline somewhat as the scale of the money and banking system and of monetary transactions grows. It is downright counterintuitive, though, to suppose that prudential reserve ratios adjust downward *fully in inverse proportion* to the quantity of bank money against which reserves are to be held, so that a reserve stock of constant absolute size remains adequate. *Can* the reserve stock comfortably remain constant in an otherwise growing monetary system?

Unfortunately, the analysis becomes loose at just the crucial point. Selgin is vague about the nature of the supposed growth in the demand for bank money. Is it due to general economic growth? Or is it due, as he seems to suggest, to people's desire to hold more money than before in relation to their incomes and transactions (in other words, a fall in the desired velocity of money)? Selgin's analysis relies heavily on the dynamics of disequilibrium, even though the genuine issue is one of comparative statics, of what amounts of reserves are necessary to support monetary systems of alternative sizes. Putting the question into a growth context would not relax the necessary distinction between comparative statics and disequilibrium dynamics. Another ambiguity concerns whether Selgin envisions a decline in the price level to permit growth in the *real* quantity of money even given a fixed *nominal* stock of reserves. Appealing to that process would be neither new nor "provocative"; but to judge from a remark on page 79, that is *not* what he is doing. (However, a subsequent article, not yet published, does seem to leave an appeal to the price-level process open after all. In this book and other writings, furthermore, Selgin is skeptical of the criterion of price-level stability, especially in the face of productivity changes.)

Selgin could have reached the conclusion he wants–that reserve considerations need not inhibit accommodation of the supply of bank money to the demand for it–by a different route. Instead of arguing, dubiously, about a fully accommodating downward adjustment of reserve ratios, he could have argued that the question of reserves is a red herring in the first place. That would be true of the fully developed free-banking system he sketches out in parts of the book. The public uses bank-issued money exclusively; gold coins (the former outside and reserve money) have entirely disappeared from circulation. Gold no longer serves any monetary function beyond defining the unit of account (banknotes and deposits are denominated and prices expressed in grams, say, of gold.) Under such circumstances, the banks need take no precautions against any rise in the public's desired holdings of gold money as distinct from banknotes and deposits; those desired holdings are and remain zero. All the banks need to do, both individually and in the aggregate, is to keep the quantity of their outstanding notes and deposits no greater than the quantity the public desires to hold at the defined gold size of the money unit. The banks merely need to keep their money scarce enough (and sufficiently backed by sound assets, including liquid assets) so that a one-gram note is always worth one gram of gold. Clearinghouse balances among banks would probably be settled not in gold itself but in gold-gram-worths of liquid securities. An individual bank would probably redeem its notes and deposits over the counter in the notes of rival banks. Even if an occasional customer did demand redemption in actual gold (bullion, since gold coins would have become obsolete), appreciable reserves of actual gold would still not be necessary (keeping some of its assets in liquid form would suffice). The bank could always send a clerk to the bullion market to buy the necessary gold, which would be no problem, since a prudently managed bank would always have kept its money scarce enough to be fully worth the amounts of gold denominating it. In effect the bank would simply be sparing its customer the trouble of going to the market and buying the gold himself.

I reached this interpretation of Selgin's fully developed free-banking system on realizing that it is the same, with one exception, as the "BFH system" that Robert Greenfield and I described in the *Journal of Money, Credit, and Banking,* August 1983. Under the BFH system the unit of account is defined as the value of a comprehensive bundle of goods and services. Under Selgin's system, that bundle contains only one commodity, gold (or, which is another possibility he mentions, a formerly issued fiat money whose quantity is now frozen). Whether his system would have the durability and the desirable macroeconomic properties of the BFH system is a separate question, left aside here.

Correspondence with him suggests that Selgin does not accept my interpretation, and perhaps I am mistaken in seeing flaws in his analysis of reserves. In any case, I have enjoyed grappling with his ideas. And he does deal in ideas, in refreshing contrast with being bogged down in models or statistical calculations that either ignore institutions or take no thought of alternatives to existing ones.

Selgin has written an ambitious work. It surveys a wide range of literature. It mentions many historical episodes that suggest further research projects (for example, Australia's shift from competitive banknote issue to government domination shortly before World War I). It not only employs theory to explore alternative institutions but also enriches the theory itself. As Lawrence White says in his foreword, Selgin's ideas hold out hope of uniting economists who propose different monetary reforms along private-enterprise lines. (Selgin acknowledges drawing inspiration from one reformer, Nobel laureate F. A. Hayek, who already gave up advocating return to a gold standard of the historical type several decades ago.)

For fellowships and other assistance, Selgin thanks various persons and organizations, including the Institute for Humane Studies and the Ludwig von Mises Institute of Auburn University. It must gratify them to have helped create this important advance in understanding what the free market can offer.

Leland Yeager is Ludwig von Mises Professor of Economics at Auburn University and a member of the Editorial Board of the *Review of Austrian Economics.* ■

NOTES & TRANSITIONS

Dr. Robert McGee, associate professor at Seton Hall University has been named editor of the *Mid-Atlantic Journal of Business.* This is a general business journal but Dr. McGee is interested in incorporating the Austrian approach to economic analysis in both articles and book reviews. For more information write: Robert McGee, Editor, *Mid-Atlantic Journal of Business*, Seton Hall University, South Orange, New Jersey 07079.

Professor Lawrence White will be joining the economics faculty as an assistant professor of economics at the University of Georgia in the fall.

Professor George A. Selgin will join the economics department of Hong Kong University as an assistant professor of economics in the fall. During the recent spring term Professor Selgin conducted a series of three lectures at the Mises Institute's Fertig Center in Fairfax, Virginia. The lectures were as follows: Free Banking in Foochow, China; L. Albert Hahn: Precursor of Keynesianism and Monetarism; and The Price Level, Productivity, and Macroeconomic Stability.

Professor Randall Holcombe, professor of economics at Auburn University and adjunct scholar of the Mises Institute has accepted a position at Florida State University where he will help develop a political science center.

Richard Ebeling has been appointed the Ludwig von Mises Assistant Professor of Economics at Hillsdale College. Professor Ebeling is currently at the University of Dallas and will begin his new position in the fall of 1988.

A session entitled "Austrian Monetary Theory" was organized by Roger Garrison at the annual meeting of the Southwestern Social Science Association, held in Houston, Texas. Papers were presented by Peter Lewin ("Hayek's Monetary Theory: Then and Now"), Richard Ebeling ("The Monetary Theory of Ludwig von Mises"), and Mark Thornton ("Monetary Factors and the Redistribution of Income in the 1920s"). Discussants included Robert Formani (University of Dallas), Larry Sechrest (University of Texas at

Arlington), and Parth Shah (Ludwig von Mises Institute and Auburn University).

Professor Richard Wagner of Florida State University has accepted a new position at the Public Choice Center at George Mason University in Fairfax, Virginia. Dr. Wagner will begin his new assignment in the fall of 1988.

The first issue of the *Loyola Journal of Economics* was published in February of this year. The *LJE* is a student publication devoted to publishing Austrian and free market economics at Loyola University in New Orleans. The staff includes Mari Bari, David Ingel, Eric Eckholdt, Bill Bethea. The faculty advisor is Deborah Walker. Correspondence can be addressed to: Mari Bari, Editor, *Loyola Journal of Economics*, Loyola University/College of Business, 6363 St. Charles Ave., Box 15, New Orleans, Louisiana 70118, (504) 865-3544.

Jeffrey Herbener, assistant professor of economics at Washington-Jefferson College, organized a session on Austrian methodology and teaching at the annual meeting of the Association for Private Enterprise Education in Cleveland; Mises fellow Jeff Tucker was one of the discussants.

Professor Leland Yeager, Ludwig von Mises Professor of Economics at Auburn University, gave the second biannual lecture at the Public Choice Center at George Mason University. The lecture was given April 4th on the topic of the Virginia School.

In April the Mises Institutes's Lawrence Fertig Center held a reception and open-house to officially open the student center. The reception was held in connection with the Institute's conference on taxation.

The Bureau of Business Research at the University of Nebraska-Lincoln has published a translation of Friedrich von Wieser's *Das Gesetz der Macht (The Law of Power)* from 1926. The translation was done by W. E. Kuhn, with an introduction by Warren J. Samuels. Wieser, the "black sheep" of the Austrian family, wrote *The Law of Power* at the end of his career. It represents the culmination of Wieser's interest in sociology, power, and the great man thesis of history. It also represents a somewhat radical departure from his early work in the Austrian school.

The Pacific Institute has just published *Advertising and the Market Process: A Modern Economic View.* The book was written by Robert Ekelund of Auburn University and David Saurman of San Jose State University. The book critiques mainstream theories of advertising, develops Neo-Austrian and "new neoclassical view" theories of the role of advertising in the market process, and provides illustrations of the results of advertising and advertising restrictions. The introduction was written by Israel Kirzner of New York University.

Gower Publishers has just published Eamonn Butler's book entitled *Ludwig von Mises: Fountainhead of the Modern Microeconomic Revolution.* The book examines Mises's theory of microeconomics, the foundations of Austrian economics and demonstrates why the work of von Mises is attracting growing numbers of economists.

Note: With this issue the "Notes & Transitions" column will become a regular feature of the *Austrian Economics Newsletter*. The function of this column is to gather together news that is of interest to Austrian economists and other interested persons, i.e., personnel changes, conferences, new publications, significant research, special lectures, translations, etc. If you have information or an item that would be of interest to readers of the *AEN*, please send it to: Mark Thornton, Editor, Mises Institute, Auburn University, Auburn, Alabama, 36849.

Upcoming Institute Events

August 13-19, 1988: "Introductory Instructional Conference in Austrian Economics" at Dartmouth College, Hanover, New Hampshire.

October 15-16, 1988: "Marxism vs. Austrian Economics: Yesterday and Today" in New York City.

For more information, please write or call: Pat Heckman, Mises Institute, Auburn University, Auburn, Alabama 36849, (205) 826-2500.

(Continued from page 1)

output and diminish inequality generally—no longer wander as intellectual outcasts, beyond consideration in civilized quarters.

W. H. Hutt was a classical political economist who brilliantly applied and extended economic theory in a variety of contexts. True, Hutt's pen was not always facile, he had a penchant for peculiar terminology, and his contributions were not error-free. Yet each work displays his fearless courage, unswerving dedication to the pursuit of truth and the power of simple economic theory in the hands of a master. Bill Hutt, a man of courage and scholarly integrity, is gone but his ideas live on.

Morgan Reynolds is professor of economics at Texas A & M University and an editorial board member of the *Review of Austrian Economics*. He is also the editor of *W. H. Hutt: An Economist for the Long Run* (1986), which is available from Regnery Gateway, 950 North Shore Drive, Lake Bluff, Illinois 60044 ($7.95, plus $3.25 postage and handling). ■

Selected Contributions of Professor W. H. Hutt

Books

The Theory of Collective Bargaining (London: Staples, 1930; 2nd edition, 1977, Institute of Economic Affairs; 2nd edition, 1977, Cato Institute. Translated into Spanish by Cesar A. Gomez, *La Contraticion Collectiva* (Madrid: Union Editorial, 1976).

Economists and the Public (London: Kegan Paul, 1936).

The Theory of Idle Resources (London: Jonathan Cape, 1939; 2nd edition, 1977, Liberty Press).

Plan for Reconstruction (London: Kegan Paul, 1943).

Keynesianism —Retrospect and Prospect (Chicago: Regnery, 1963).

The Economics of the Colour Bar (London: Deutsch, 1964).

Neo-Keynesian and Academic Freedom (Tokyo: Toyo Keizai, 1966).

Politically Impossible. . . ? (London: Institute of Economic Affairs, 1971). Translated into Spanish by Juan Rincon Jurado, *El Economista y la Politica* (Madrid: Union Editorial, 1975).

The Strike-Threat System (New Rochelle, N.Y.: Arlington House, 1973).

A Rehabilitation of Say's Law (Athens, Ohio: Ohio University Press, 1975).

Individual Freedom, a collection of works edited by Svetozar Pejovich and David Klingaman, (Westport, Conn.: Greenwood Press, 1975).

The Keynesian Episode: A Reassessment (Indianapolis, Ind.: Liberty Press, 1979).

Articles

"The Factory System of the Early Nineteenth Century," *Economica* (March 1926); reprinted in *Capitalism and the Historians*, ed. F. A. Hayek, 1954.

"The Effects of Immigration on Earnings," *The Journal of the Economic Society of South Africa* Vol. III part 2: No. 6 (Fall 1930); originally read to the Cape Town Branch of the Economics Society of South Africa.

"The Significance of State Interference with Interest Rates," *S.A.J.E.* (December 1933).

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"Logistical Issues in the Study of Industrial Legislation," *S.A.J.E.* (March 1935).

"The Nature of Aggressive Selling," *Economica* (August 1935).

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"Privacy and Private Enterprise," *S.A.J.E.* (December 1939).

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"Economic Institutions and the New Socialism," *Economica* (November 1940).

"Distributive Justice," *S.A.J.E.* (September 1941).

A review of "The Economics of Democratic Socialism," *Economica* (1941).

"War Demand, Entrepreneurship and the Distributive Problem," *Economica* (November 1941).

"The Price Factor and Reconstruction," with R. Leslie, *S.A.J.E.* (December 1941).

"The Sanctions for Privacy Under Private Enterprise," *Economica* (August 1942).

"The Concept of Waste," *S.A.J.E.* (March 1943).

"The Minimum Wage: A Major Cause of Poverty," *Austrian Economics Newsletter* (Fall 1987).

"Public Works and Reconstruction," *S.A.J.E.* (September 1943).

"Plan for Economic Research in the Union," *S.A.J.E.* (June 1944); reprinted as a pamphlet by the South African Association of Scientific Workers.

"Two Studies in the Statistics of Russia," *S.A.J.E.* (March 1945).

"Full Employment and the Future of Industry," *S.A.J.E.* (September 1945).

"Further Aspects of Russian Statistics," *S.A.J.E.* (December 1945).

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"The Notion of Money and Constant Value," *S.A.J.E.* (September 1953); and (December 1953).

"The Significance of Price Flexibility," *S.A.J.E.* (March 1954); reprinted in *The Critics of Keynesian Economics*, ed. Henry Hazlitt, 1960.

"The Yield on Money Held," in *On Freedom and Free Enterprise*, ed. Mary Sennholz (Princeton: Van Nostrand, 1956).

"New Light on Wicksell," *S.A.J.E.* (March 1959).

"The Critics of the Classical Tradition," *S.A.J.E.* (June 1964).

"Keynesian Revisions," S.A.J.E. (June 1965); reprinted in *Rampart Journal* (Winter 1965).

"South Africa's Salvation in Classical Liberalism," *Il Politico* (No. 4, 1965); revised for *Studies in Economics and Economic History*, ed. Marcelle Kooy (London: Macmillan, 1972; Durham, N.C.: Duke University Press, 1972).

"Unanimity versus Non-Discrimination (as Criterion for Constitutional Validity)," *S.A.J.E.* (June 1966).

"Misgivings and Casuistry on Strike," *Modern Age* (Fall 1968).

"Economics of Immigration," in *Economic Issues in Immigration*, ed. Sir Arnold Plant (London: Institute of Economic Affairs, 1970).

"Reflections on the Keynesian Episode," in *Toward Liberty*, vol. II (Menlo Park, Calif.: Institute for Humane Studies, 1971).

"Poverty in Mexico," a review of *Labor Legislation from an Economic Point of View*, by Gustavo R. Velasco, *Modern Age* (Fall 1974).

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"The Face and Mask of Unionism," *Journal of Labor Research* (Summer 1983).

"The Power of Labor Unions," in *The Unfinished Agenda: Essays on the Political Economy of Governmental Policy in Honour of Arthur Seldon*, ed. Martin J. Anderson (London: Institute of Economics Affairs, 1985).

"The Principle of Social Justice," in *W. H. Hutt: An Economist for the Long Run*, ed. Morgan O. Reynolds (Chicago: Regnery Gateway, 1986).

"Apartheid in the Republic of South Africa–A Proposal," in *Apartheid–Capitalism or Socialism* (London: Institute of Economic Affairs, 1986).

"Trade Unions: The Private Use of Coercive Power," *Review of Austrian Economics* vol. III (Fall, 1988).