

# The Free Market

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## Understanding the Austrian Theory of the Business Cycle

by Mark Skousen

One of the highlights of my professional career occurred recently when I had the opportunity to talk with Professor F. A. Hayek at his vacation home in the Austrian Alps. It was an unforgettable experience. Since the death of Ludwig von Mises in 1973, Professor Hayek has been the acknowledged dean of the "Austrian" school of economics, which teaches individualism, laissez-faire economics, and the gold standard. He is now 86 years old, but sharp and alert, and still working hard on a number of projects.

Professor Hayek is the oldest living member of the Austrian school, which began in Vienna with Carl Menger in the 1870s, and continued with Eugen Bohm-Bawerk, Ludwig von Mises, and Murray N. Rothbard, among others. In 1974, Professor Hayek won the Nobel Prize in Economics for his work on the Mises-Hayek theory of the business cycle.

Of all the many contributions of the "Austrians," their theory of the business cycle is one of the most valuable. Economists and Wall Street analysts have known for decades that the markets are highly volatile. There is a business cycle in national output, interest rates, and inflation, creating bull and bear markets in stocks, bonds, gold, and so on. And Austrian theory is the only satisfactory explanation of this business cycle.

The first thing to understand is that the principal source of economic disruption and the business cycle is irresponsible government policy. The business cycle, inflation, and high nominal interest rates are not caused by the free market, but by government's monetary and fiscal policies.

Without government intervention, the free-market economy would reflect:

- 1) Stable interest rates, probably in the 2%-3% range, as in the 1950s.
- 2) No inflation. In fact, historically, average prices have tended to decline slightly with a free market and gold standard.
- 3) Low unemployment. No minimum wage laws and forced collective bargaining, which keep wages artificially high during a recession.

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Mark Skousen at the Institute's conference on "Man, Economy, and Liberty" (see p. 2).

## A Trip to Poland

by Murray N. Rothbard

This March, I spent a fascinating week at a conference at a hotel in Mrogowo, in the lake country of northern Poland (formerly East Prussia). The conference, a broad-ranging symposium on "Economics and Social Change," was hosted by the Institute of Sociology at the University of Warsaw, and sponsored by a group of English conservative and free-market scholars.

Even though economically, as one of the Western participants noted, Poland is a "giant slum," its countryside, small towns, and cities in evident and grim decay, this gallant nation is intellectually the freest in the Eastern bloc. There is no other country in the Soviet orbit at which a conference of this sort could possibly be held.

The only restriction was that the announced titles of the

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## From the President

### Genesis of a Birthday Party

by Llewellyn H. Rockwell, Jr.

More than 250 people gathered in New York City on March 1st for a surprise 60th birthday party for Professor Murray N. Rothbard. It was a great evening, preceded by an impressive academic conference on his work. (Audio and video tapes of both the dinner-roast and the conference are available from the Institute.)

Godfather to the whole event was Robert D. Kephart. Austrian economics is the sole school of economic thought to give full credit to the entrepreneur. Bob Kephart is not only a very successful entrepreneur in business, he fulfills the same role in ideas.

Bob was also responsible for the publication of *Murray N. Rothbard: A Scholar in Defense of Freedom*, a bibliography lovingly compiled by libertarian scholar Carl Watner, with a long introductory essay by philosopher David Gordon.

As David Gordon notes, looking over Murray Rothbard's incredible output, one could easily think there must be several scholars of the same name. Bob Kephart thought that this amazing fecundity should be compiled for students and faculty, and through his generous contributions, he made it possible.

**SPECIAL OFFER:** If you would like a copy of this fascinating bibliography and bibliographical essay—important for anyone interested in Austrian economics or the other disciplines related to liberty—just mark a capital “B” on the enclosed form and enclose \$2.00. The normal price for this 72-page monograph is \$5.00, but through Bob Kephart, we are able to offer it for this low price, which includes postage and handling.

Murray N. Rothbard, who has taught at New York's Polytechnic University for 20 years, has been offered the prestigious S.J. Hall Chair in Economics at the University of Nevada, and he will begin teaching there this fall. With Professor Roger Arnold already there, and Professor Hans Hoppe joining the faculty as well, Nevada will be another important center for scholarship in Austrian economics. ■

### Participants in “Man, Economy, and Liberty: A Conference in Honor of Murray N. Rothbard”

*Dom Armentano, University of Hartford:* “Monopoly Theory and Policy: A Rothbardian Perspective”

*Walter Block, Fraser Institute:* “Fractional Reserve Banking: An Interdisciplinary Perspective”

*Arthur Ekirch, State University of New York at Albany:* “A Utopia for Liberty: Individual Freedom in Austin Tappan Wright's *Islandia*”

*Williamson Evers, Stanford University:* “The Rothbardian Political Economy”

*Roger Garrison, Auburn University:* “Professor Rothbard and Austrian Interest-Rate Theory”

*David Gordon, Bowling Green State University:* “In Defense of Rights”

*M.E. Grenander, State University of New York at Albany:* “Murray Rothbard and Methodological Individualism: Scientific Validation in Roger Sperry's Mind/Brain Research”

*Randall G. Holcombe, Auburn University:* “The Role of Government”

*Hans-Hermann Hoppe, University of Nevada at Las Vegas:* “From the Economics of Laissez-Faire to Libertarian Ethics”

*Sheldon Richman, Institute for Humane Studies:* “Commentator on Our Times: A Quest for the Historical Rothbard”

*James Sadowsky, Fordham University:* “Rothbard's Contributions to Philosophy”

*Joseph Salerno, Pace University:* “Rothbard's Contributions to the Theory of the Firm”

*Mark Skousen, Rollins College:* “Rothbard and Austrian Business Cycle Theory”

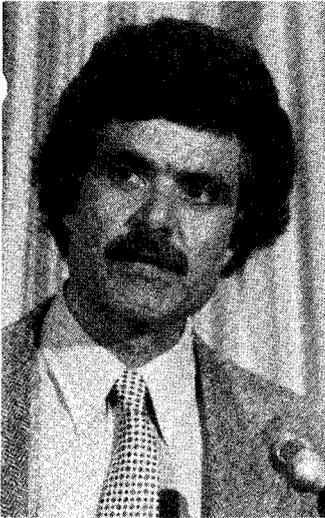
### Murray N. Rothbard: A Scholar In Defense of Freedom

a bibliographical essay by David Gordon  
with a bibliography compiled by Carl Watner  
and annotated by David Gordon

The Ludwig von Mises Institute

## Scenes From the Rothbard Conference and Dinner

(All photos in this issue courtesy of David Jarrett.)



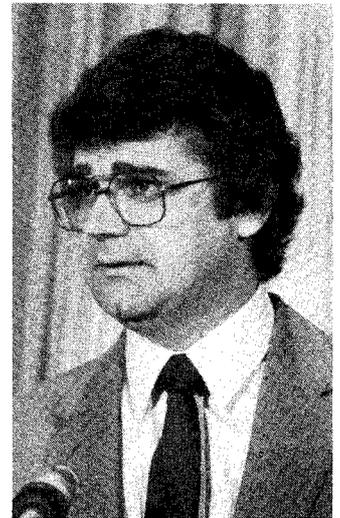
*Dominick J. Armentano  
of the University of Hartford*



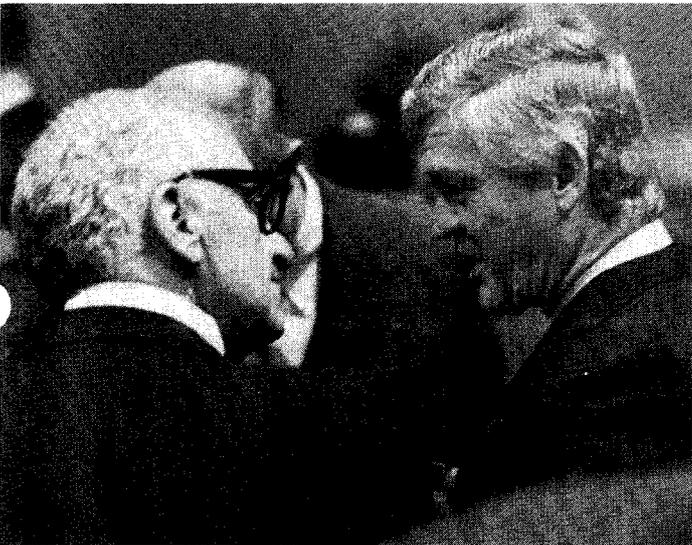
*Hans Hermann Hoppe  
of the University of Nevada*



*Randall G. Holcombe  
of Auburn University*



*Roger Garrison  
of Auburn University*



*Murray N. Rothbard and Robert D. Kephart*



*Margit von Mises and Robert D. Kephart*



*(left to right) Williamson Evers of Stanford University, Sheldon Richman of the Institute for Humane Studies, Arthur Ekirch of the State University of New York at Albany, Walter Block of the Fraser Institute, and Murray N. Rothbard, during one of the conference's panels.*

**Rothbard** . . . continued from page 1

papers had to be ideologically neutral. But, once the conference ran that particular gauntlet, and the meeting was approved by the authorities, anyone could—and did—say whatever they wished. (In my case, I bowdlerized the title of my paper, “Concepts of the Role of Intellectuals in Social Change Towards Laissez-Faire,” by discreetly omitting the last three words, although the actual content of the talk remained the same.)

The first paper of the meeting was delivered by Professor Antony Flew, a distinguished English philosopher, who likes nothing better than to deliver—with intelligence and wit—zingers at the Left. Flew pulled no punches, pointing out the importance and necessity of property rights and the free market. The fascinating thing was that no Polish eyebrow was raised, and no Polish scholar reacted in horror. Quite the contrary. And it was enormously inspiring to see everyone of the twenty-odd Polish scholars denouncing the government, even though it was obvious to everyone of us that there was a government agent listening intently to the proceedings. (The agent—the travel guide and director of the trip—was obviously highly intelligent, and aware of what was going on.)

The Poles ranged from libertarian to middle-of-the-road to dissident Marxist, but it was markedly evident that not one of them had any use whatsoever for the Communist regime. In addition to being opposed to Communism, none of the Polish scholars at the meeting had much use for any government. One told me, “of course, any act of government is done for the power and wealth of the government officials, and not for the ‘public interest,’ ‘common good,’ ‘general welfare,’ or any other reasons offered.”

“Yes,” I said, “but the government’s propaganda always says that they perform these actions for the common good, etc.” The Polish professor looked at me quizzically: “Who believes government propaganda?” I replied that, “unfortunately, in the United States, most people believe government propaganda.” He was incredulous.

The Polish scholars all knew English very well, a virtue that unfortunately we Westerners couldn’t begin to reciprocate. One amusing culture gap was the Polish waiters in our hotel (what passes for a “luxury hotel” in Poland is roughly equivalent to a low-end interstate motel in the U.S.) having to deal with the “kids” of the conference, two young English scholars who are insistent vegetarians. Poland is a land with a very high meat consumption per capita (the Communists never collectivised agriculture), but where meat is now rationed, and it was beyond the comprehension of the Polish waiters that two young privileged Westerners would keep calling for “more vegetables” while turning down top-grade beef and pork. Fortunately,

there was always a Polish professor nearby who could serve as interpreter for these outlandish requests.

The most moving moment of the meeting came at the banquet on the final night, when the English sociologist who directed the conference, after thanking our Polish hosts, raised a glass and offered a heartfelt toast to “a free, sovereign, and Catholic Poland.” Everyone of us understood his intent, and everyone in that room, Protestants and unbelievers included, raised a glass and drank with fervor. Including the government agent. ■

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Dr. Rothbard—S.J. Hall Distinguished Professor of Economics at the University of Nevada—is vice president for academic affairs of the Ludwig von Mises Institute.

**Skousen** . . . continued from page 1

- 4) High savings rate. Contrary to standard Keynesian doctrine, high personal savings rates are good for economic growth.
- 5) Economic growth without recessions or depressions.

But as long as government is ubiquitous, and controls the supply of money, it will appear that “capitalism” is inherently unstable, as the Marxists say. Only the wise student of history and economic science knows that government policy, not the free market, is responsible for economic instability.

The key to understanding the economic cycle is what the Austrians call the “structure of production.” Unlike the Keynesians and Monetarists, the Austrians look at the economy not as a whole, but as a collection of individual parts—not “macroeconomics,” but “microeconomics.”

The easiest way to understand the “structure of production” is to see how the economy exists at a single moment, as if a snapshot were taken. If the whole economy were suddenly frozen, what would you see? You would see some products and services completed, such as cars coming off the assembly line ready to sell to consumers. Other products would be half finished, and still others would be just starting production.

In other words, there is an order to the production of goods and services in an economy. The “higher” order or stages of production are “capital goods,” which include tools, machinery, raw materials, trucks, and other goods necessary to produce final consumer goods, which include automobiles, food, clothing, and so on.

This distinction is very important in understanding the inflationary boom-bust cycle. As the Austrians point out, the central bank (the Federal Reserve) expands the money supply in a way that affects certain industries more than others. Historically, because the Fed expands the money

supply primarily through the credit markets, the capital-goods investor has been more affected than the consumer-goods market.

There are essentially four states to the business cycle:

*First, the inflationary boom.* The Fed expands the money supply by purchasing Treasury securities from banks. Profits in capital-intensive industries tend to rise, and because the stock market is highly capital-intensive, the stock market goes through a bull market. However, at the later stages of the inflationary boom, consumer prices start catching up, the stock market loses its luster, and the bull market ends. Also, at the end of the inflationary cycle, gold and silver and other inflation hedges move up sharply.

*Second, the credit crunch.* Once consumer prices start rising sharply, and interest rates start edging up, the Fed usually puts on the brakes and causes a credit crunch. Interest rates rise rapidly as capital industries scramble for funds to escape bankruptcy.

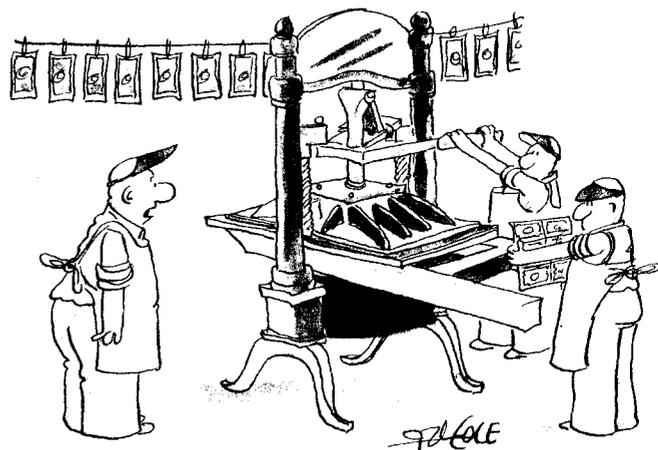
*Third, recession.* Production of capital goods falls more sharply than consumer goods. Gross National Product declines, and stocks continue to fall. Interest rates start dropping as demand for credit declines. Prices for commodities and capital goods tend to fall more sharply than consumer goods, which sometimes continue to rise ("inflationary recession").

*Fourth, economic recovery.* The recession in capital goods ends as the economy returns to stability.

The Austrians are the only school with satisfactory answers to two questions facing economics today: 1) how it is possible to have low inflation in the face of double-digit increases in the money supply, and 2) inflationary recession.

The "low-inflation" environment continues, despite 10% annual increases in the money supply, because of the previous "malinvestments" in the capital goods industries. When companies are on their backs, it requires a greater increase in credit than the previous cycle to achieve a return to previous levels of economic prosperity. After the economy has gone through a major recession and the inflationary psychology has been broken, the government must expand the money supply at a higher rate than the previous cycle in order to achieve the same level of economic activity and price inflation. Note, however, that under President Reagan, the money supply has grown at the same rate as under President Carter, but not more—therefore, we would expect, under Austrian theory, the inflation rate to fall below the double-digit rates of the 1970s. Indeed it has.

I believe the money supply must expand at a 15% to 20% annual rate in order to rekindle double-digit price inflation this time around. So far it hasn't happened, although lately



"Money is just too undependable, boys — we're switching to gift certificates."

M1 has been growing at a 14% rate. At some point, of course, price inflation will catch up, but it's too early to tell when this will happen.

During the inflationary stage of the business cycle, production and prices for capital goods and raw commodities tend to rise much more than for final consumer goods. Only at the later stages of the inflationary boom do consumer goods (as measured by the Consumer Price Index) begin to rise.

Look, for example, at the production of automobiles. During an inflationary boom, the price of iron, steel, aluminum, and other producer goods used in building cars may increase substantially, perhaps doubling in value. But the price of an automobile in the showroom may increase only 5% to 10%.

During a recession, just the opposite occurs. Prices for producers' goods and raw commodities drop sharply, compared to consumer goods. In the case of cars, steel may fall sharply in price. Meanwhile, the price of finished cars may fall only slightly, or, as has occurred recently, continue to rise.

Thus, consumer goods always tend to rise in a recession relative to capital goods. If you look at the statistics of any recession, you'll note that the raw commodities price index and the wholesale price index fell by a greater amount than consumer prices. Consumer prices also tended to fall, but not by the same amount. In other words, consumer prices rose in relation to wholesale and commodity prices.

The relationship still holds even today during a recession, except that now in absolute terms, consumer prices are rising instead of falling. This is because the magnitude of monetary inflation is much greater than in past cycles. So, relative to capital goods, all recessions are "inflationary recessions." It's just that such a relationship didn't become

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obvious until the Consumer Price Index continued to rise in the 1973-1975 recession and the 1980-1981 recession.

If you want to learn more about this aspect of Austrian economics, I recommend the following books, all available from the Institute: *What Has Government Done to Our Money?*, by Murray N. Rothbard (\$3), *America's Great Depression* also by Rothbard (\$18), *An Introduction to Austrian Economics* by Thomas C. Taylor (\$3), and *The Austrian Theory of the Trade Cycle* by Ludwig von Mises and others (\$3); shipping charge: \$2.25 with each order.

All show that the only way that we can escape from the business cycle is through the establishment of sound money (i.e., a gold standard and no central bank) and the free market. If we are ever able to do so, the Austrian school of economics will deserve the credit. ■

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Dr. Mark Skousen, an adjunct scholar of the Mises Institute, teaches economics and finance at Rollins College in Florida. He is also an internationally renowned financial advisor, best-selling author, and editor of the influential *Forecasts and Strategies* investment newsletter. If you would like a free copy, write: *Forecasts & Strategies*, Phillips Publishing, Inc., 7811 Montrose Road, Potomac, MD 20854.

## A Trip to Nicaragua

by Jeffrey Tucker

The government-caused chaos in the Nicaraguan economy would probably be familiar to anyone who's been to a socialist dictatorship. But this was my first visit to such a place. Not to my surprise, nothing I saw conflicted with Ludwig von Mises' predictions about the socialist commonwealth.

An economy is most efficient when the State takes no role, and therefore market participants can rely on certain givens. For instance, before making an entrepreneurial decision, it is useful to know that any profit you make will not be confiscated the following day. It would also be useful to know that your prices won't be controlled, that your supply of raw goods will not be cut off, that the markets in which you sell your products will not be declared illegal, and that your entire business will not be taken over by the State.

The same applies to the consumer. Before you buy a portable radio, you want reasonable assurance that batteries and replacement parts will be available at a later date. You might also want to know that the government won't later decide it needs your radio, or that owning a radio that gets foreign radio stations is an indication of subversive tendencies.

Thanks to the government's Marxist ideology, entrepreneurs and consumers in Nicaragua have no such assurances. But the economy is not totalitarian yet, although it is moving in that direction. And it is seeing that movement that makes the country such an interesting (and horrifying) study for an Austrian economist.

The State claims to have a "mixed economy," but it is confiscating private property and hindering it in a multitude of ways. The government may nationalize a restaurant and then put it under the control of someone politically reliable who can then keep, say, 40% of the profits. This was the case at the hotel in which I stayed, for instance. But the property stays private only so long as the politicians approve. And private title without control means little, as when farmers own their own land, but can sell their produce only to the State at controlled prices.

Enrique Belanos, president of COSIP, a highly respected free market group, told me that "The State not only orders you what, when, how much, and where to produce, it also controls the raw materials. All financing is in the hands of the State. All production is bought by the State. And wages and salaries are set by the State for all Nicaraguans. All wages and salaries are pigeon-holed in 28 categories. It's not a minimum wage—we had that before. But then I was able to pay more, and provide incentives for production. Now I cannot." Belanos has been jailed twice for the crime of trying to provide his employees with incentives.

How is the businessman supposed to survive?

"The art . . . of the businessman right now involves being able to negotiate with the Ministry of Commerce the price of your products. So you make no decisions. We have become the government's commissars in our own businesses. And this is what they call the mixed economy."

The Nicaraguan economy is currently in an inflationary depression. The annual rate of price inflation, as measured by the black (i.e., free) market dollar-to-cordoba exchange rate, is somewhere in the area of 400%.

And there is a wide discrepancy between the government's exchange rates and the market's. The week I was there, the official exchange ratio was 880 cordobas to the dollar. But on the black market, the ratio was 2000 cordobas to the dollar.

Although it's illegal, everybody would rather take dollars than Nicaraguan government money. Said one man of the cordobas, "that's not real money." (Eventually, thanks to the Federal Reserve, he may find out dollars aren't either, but in the meantime, of course, the dollar functions as a much more efficient store of value than the cordoba.)

Over 50% of Nicaragua's GNP, according to the government, is contributed by the government, but that figure is highly questionable considering the size of the under-

ground economy and governments' propensity to lie. But everybody in the country agrees they are worse off economically since the revolution, even though no one has anything good to say about the Somoza dictatorship which, among other crimes, brought the Sandinistas to power.

Consider the case of *La Prensa*, the newspaper that has always enjoyed the widest readership of any newspaper in Nicaragua. As the only opposition paper left, it represents a threat to the government. The Sandinistas could throw all the employees in jail and padlock the front door of the building, but then it couldn't say that there's freedom of the press in Nicaragua. Instead the politicians use economic controls to do their dirty work.

After the revolution, the government put price controls on Nicaraguan newspapers, including the government's own. As with all price controls, firms suffer losses because as income remains the same, production costs rise with the general price level. *La Prensa* is being hit very hard while the government papers receive massive subsidies to make up their losses.

The government also censors *La Prensa*. In addition to its intrinsic evil, the censorship also cuts consumer demand for *La Prensa*. The editorial staff submits the content of the paper to the government in the morning, but the bureaucrats wait until late afternoon to return their version. The paper is radically different when it comes back, and always much shorter. Sometimes even Dictator Daniel Ortega's own speeches are altered when the party line changes.

The government also censors non-political articles that are too interesting (a deliberate attempt to make the paper boring) and even vocabulary, deleting the word "rebel" and substituting "counter-revolutionary."

By the time *La Prensa* can print and distribute that day's edition, it is 10:00 pm. The news is old by then, and distribution is hampered by government controls as well.

*La Prensa* is operating now on savings and small donations, but they are running thin. And the owners, writers, and editors and the newspaper receive death threats and have government troops quartered in their houses.

In every country where there's food to eat, you know that the market is still operating in some fashion. Even Marxists know that total collectivisation of agriculture brings starvation. And in Managua, at the Eastern Market, small farmers of fruits and vegetables can sell their goods at free-market prices. Prices fluctuate according to supply and demand, and it's packed every day.

But there is no such market for such things as auto parts. If something major goes wrong, and cannot be fixed by local mechanics, the car becomes junk metal. (Only government officials and foreign diplomats have new cars.)

If your car is still running, you are limited to 10 gallons of gas a month, unless you have pull with the bureaucrats in charge of rationing. Favored people get extra allocations.

Nicaraguans who can afford to are sending their children out of the country while there is still time. As one lady told me, "We don't want our kids drafted into the army or brainwashed in Marxism-Leninism."

A government grocery store I visited in Managua symbolized the failure of central planning. Although very large, it carried few items. But these were strung out to make it appear filled with goods. There were some fruits and vegetables, but no meat in the large refrigerated section, which had been shut down.

Not everything was in short supply, however. One aisle had forty feet of water glasses, all exactly alike. Another was filled with thousands of cans of Soviet sardines. While one Nicaraguan I asked said he had finally gotten used to eating Soviet sardines, clearly the supply was larger than the demand.

Is experiencing Nicaragua first-hand enough to make a case against socialism? One would certainly think so. But not with Gary Merrill, the minor actor who was once married to Bette Davis.

I ran into Merrill at the government bookstore in the lobby of Managua's Intercontinental Hotel, where he was buying a copy of *Barricada*, the government organ. It had, he said, "more truth than the *New York Times*."

"Are you a Marxist?" I asked.

"Well, I really don't know. All I know is that this works."

"How do you know?"

"My God, have you tried the buffet in the hotel? All those fruits and things? It's great! This is a beautiful government. A pure government. The people who run it are the most honest in the world. Just like Jesus."

Was Gary Merrill an isolated case? Sadly, no. There was a cantina just down the street filled with similar types. They hang out there for hours at a time, endlessly discussing socialism while pausing occasionally to point out some of the large portraits on the wall to a newcomer.

"There's Marx," one pundit said. "He laid the foundations of scientific socialism, with help, of course, from his close friend Engels; that's his picture there." Another interrupted, "and there's Sandino, the great opponent of American imperialism; and over there: Khadafy, a victim of the same."

They quaffed glass after glass of a disgusting mixture of beer and water, although one of the few products in plentiful supply was a tasty Nicaraguan beer called *Tonya*. Maybe

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**Tucker** . . . continued from page 7

drinking watered-down beer was a form of penance for the revolution.

Then I ran into another American who was helping the government with "some engineering projects." In an attempt to talk about something other than politics, I told her about a movie I had seen the night before at a local theater.

"The movies around here are pretty bad," she said, "but you have to understand why. You see, those North American movie companies take all the movies that bomb there and sell them here at outrageous prices. That's how American film companies make all those obscene profits."

This intense woman was entirely consumed by revolutionary politics. I wondered if she thought about anything else, and remembered Oscar Wilde's quip: "The trouble with socialism is that it takes too many evenings."

More apropos is Paul Hollander's book on *Political Pilgrims*, in which he discussed this phenomenon of Westerners going to Marxist countries and returning full of praise for the failures of central planning. They developed, he notes, a "capacity for . . . selective perception and . . . selective moral indignation." Mangnus Enzensberger, the radical German social critic, said a decade ago that these people "let themselves be politically blackmailed, morally bribed, and theoretically blinded."

But the best commentary on this subject comes from Ludwig von Mises in his book *The Anti-Capitalistic Mentality*. In a comment that seems particularly relevant to Nicaragua, Mises wrote that "no intelligent man could fail to recognize that what the socialists, communists, and planners were aiming at was the most radical abolition of individuals' freedom and the establishment of government omnipotence. Yet the immense majority of the socialist intellectuals were convinced that in fighting for socialism they were fighting for freedom. They called themselves left-wingers and democrats, and nowadays they are even claiming for themselves the epithet 'liberal.'"

He calls the kind of people I talked to in Nicaragua "outcasts" who practice "self-chosen segregation" from reality. Their attraction to socialism can be traced to their own "deficiencies." "They console themselves and try to convince other people that the cause of their failure is not their own inferiority but the injustice of society's economic organization."

According to Mises, the forces of "self-deceit" and "frus-

trated ambition" in the anti-capitalistic mentality are so strong that sometimes nothing can shake their religious faith in State planning. Pathetically, the example of American Sandinistas in Nicaragua illustrates this truth. ■

Jeffrey Tucker, a Mises Institute Ron Paul Fellow in economics at the graduate school of the University of Houston, recently spent a week in Managua, Nicaragua.



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