BUSINESS CYCLE THEORY

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INTRODUCTION

Economics is a branch of the science of praxeology, which is the study of human action involving choice. "It [economics] concerns the activities of man in the satisfying of human wants."[1] It is not a part of economics to make judgement on what wants are better or in the community interest. "Economics in its basic tenets is amoral . . . It applies as well to dope peddling as to food production."[2]

All economic theory must stem from deductive reasoning. "Theory cannot emerge, Phoenix-like, from a cauldron of statistics; neither can statistics be used to test an economic theory."[3] Statistics can tell you what is happening, but they can never tell you *why* it is happening. "For statistics and history are useless in economics unless accompanied by a basic *deductive* understanding of the facts . . . "[4] (His underline)

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[1]Don Paarlberg, "*Great Myths of Economics*," New York, The American Library, Inc. © 1968, p. 109.

[2]*Ibid*.

[3]Murray Rothbard, "*America's Great Depression*," Kansas City, Sheed and Ward, Inc., © 1975, p. 4.

[4]Henry Hazlitt, "*Economics in One Lesson*," New York, Manor Books, Inc., March, 1974, p. 37.

AUSTRIAN ECONOMICS

Austrian economics is called that because its founders were all Austrians; not necessarily because it was put into practice by the Austrian government. It was founded in the 1800's by Carl Menger, followed by Friedrich von Wieser, and Engen von Bohm-Bawerk. Their books were in German and did not have much effect on economics until it was revived by Ludwig von Mises in the 1900's.

What distinguishes the Austrians the most is their radical subjectivity. People value a commodity because of the want it will satisfy or the want that will be satisfied by its exchange for other goods. "Whether a diamond was found accidentally or was obtained from a diamond pit with the employment of a thousand days of labor is completely irrevelant for its value."[5] Value cannot be measured; while one can say one values one commodity over another, one cannot put that value on an index which applies to everyone.

There are three basic propositions dealing with value:

1) The value of goods is measured by the importance of the want whose satisfaction is dependent upon the possession of the goods.

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[5] Carl Menger, "Principles of Economics," New York, New York University Press, 1981, p. 146.

2) Which satisfaction is the dependent one can be determined very simply and infallibly by considering which want would be unsatisfied if the goods whose value is to be determined were not in possession.

3) And again, it is evident that the dependent satisfaction is not that satisfaction for the purpose of which the goods are actually used, but it is the least important of all the satisfactions which the total possessions of the individual can procure.[6]

This last point is the basis of the concept of marginal utility which the Austrians discovered. Marginal utility states that a man values a commodity that he possesses, not for the want it satisfies but for the least satisfaction it can fulfill. For example, a peasant owns three sacks of grain; A) to feed his family, B) to seed his field, and C) to fatten his poultry. If sack A was destroyed by fire, the peasant would not starve; he would merely shift the loss to his final utility, or sack C.[7] He does not necessarily have to possess the commodity that fills his least satisfaction. If a person's coat is stolen in the middle of winter and he has to buy a new one for $20, then he will have $20 less to spend. So, while the coat satisfied an important want, he suffered only the least important want

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[6]Eugen von Bohm-Bawerk, "<u>The Austrian Economists,</u>" in "Shorter Classics of Eugen von Bohm-Bawerk", Illinois Libertarian Press, © 1962, p. 7.

[7]<u>Ibid.</u>, p. 7-8.

that the $20 would have satisfied.[8]

The cost of producing goods is determined by their selling price. An entrepreneur will only bid for capital to the point where he believes it will be recovered by his selling price. "No one supposes that copper is dear because the stock of mining companies is high, but obviously the value of the mines and the stock is high when and because copper is dear."[9] This is more obvious in some cases than others, but it is always true. If a businessman is selling a product at a price higher than the market calls for, it is not because his costs are so high but because he didn't foresee the demand correctly when he bid them up.

The rate of interest is determined by people's time-preference for future goods as opposed to present goods. The lower a man's time-preference the more he will save and invest. The higher his time-preference the more he will consume. He has no other choices than consumption or saving and investment, which are the same thing. The rate of interest goes down as this capital pool increases. All loans to the capital goods industries (higher order of production) must come out of this pool. Any attempt to lower the rate of interest without changing people's time-preference will result in mal-investment

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[8]Eugen von Bohm-Bawerk, "The Austrian Economists," in "Shorter Classics of Eugen von Bohm-Bawerk," Illinois Libertarian Press, © 1962, p. 9.

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[9]Ibid., p. 12.

because people's time-preference is still in the lower orders of production (consumer goods industries). If the rate of interest went down because of a true change in time-preference, then there would be no harm because the capital came out of the lower order of production (consumption).[10] "To refrain from consuming one's whole product, to save some of it, and then invest it in the building of machines and the training of men - this is how economic development occurs."[11] How the economy is affected by making loans out of other than this pool (inflation), will be discussed later.

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[10]Murray Rothbard, "America's Great Depression", Kansas City, Sheed and Ward, Inc., © 1975, pp. 17-21. form

[11]Don Paarlberg, "Great Myths of Economics", New York, The New American Library, Inc., © 1968, p. 75. form

BUSINESS CYCLES

A lot of the things considered as cycles are merely fluctuations and there is no use trying to explain them with theory. Cycles cannot be set off by a "depression in the auto industry" or a "depression in housing". If one business is losing money, then there is an equal rise in another business, and no depression will be set off.[12]

So how does one know if the economic changes being considered are really a depression or not? The first characteristic of depressions is the cluster of errors. Almost all businessmen will be found to have made serious errors in forecasting. And they will all be revealed at the same time. The entrepreneur's business is forecasting future conditions. The better he is at it the more profit he makes. So why do they all make such drastic mistakes, and all at once? A second characteristic is the fact that capital goods industries are hit the hardest in a depression and expand the most during a boom. These variances are much wider than in consumer goods industries. A final characteristic is an increase in the quantity of money in circulation.[13]

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[12]Murray Rothbard, "America's Great Depression", Kansas City, Sheed and Ward, Inc., © 1975, pp. 12-21.

[13]Ibid., pp. 16-17.

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The cause of these things is not in the depression but in the preceeding boom. The government, to lower the rate of interest, to cover its debt, or whatever, will print paper money for the banks to loan. This makes it appear as though people's time-preference had lowered and the money is used by the capital goods industries to bid capital away from the consumer goods industries. There is no increase in the amount of capital, though; it is only redistributed to companies which would not have otherwise gotten it.[14] "This expansion distorts the structure of investment and production causing excessive investments in unsound projects in the capital goods industries".[15]

Eventually, the banks will be forced to deflate because of a drain of gold to foreign banks (this will be discussed later). When this happens the entrepreneurs will find out too late that time-preference had not changed and their investments have been in error. The error has been made and the depression must run its course. It is too late to prevent it.[16]

The depression is the readjustment process. The mal-investments caused by the inflation must be liquidated before the economy can return to normal. Any attempt to fight the depression will only prolong it and increase the misery. "The recession

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[14]Murray Rothbard, "America's Great Depression," Kansas City, Sheed and Ward, Inc., © 1975, pp. 18-21. form

[15]*Ibid.*, Introduction to 3rd Editions.

[16]*Ibid.*, pp. 17-21.

period of business cycles then becomes inevitable, for the recession is the necessary corrective process by which the market liquidates the unsound investments of the boom and redirects resources from the capital goods to the consumer goods industries."[17]

If one were to sit down and think of ways to slow the readjustment and delay recovery, one's list would probably include these things:* use a fn. rather than asterisk

1. Prevent or delay liquidation.
2. Inflate further.
3. Keep wage rates up.
4. Keep prices up.
5. Stimulate consumption and discourage saving.
6. Subsidize unemployment.

In fact these are the exact things the government carries in its "anti-depression policy."[18]

It is sometimes argued that, since the depression started when inflation stopped, why not continue the inflation? For one thing, the drain of gold would eventually force the banks to stop inflating and then the depression would be worse. If they inflated despite this, eventually the people would lose confi-

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[17]Murray Rothbard, "America's Great Depression," Kansas City, Sheed and Ward, Inc., © 1975, Introduction to 3rd edition.

*Several of these apply to features of depressions that have not been mentioned.

[18]Rothbard, pp. 25-29.

dence in money and the country would enter hyperinflation, which is worse than any depression.[19]

While the depression is born in the boom, the next boom is not born in the previous depression. It comes because governments are naturally inflationary and will be as long as they are not threatened by a drain of gold.[20]

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[19] Murray Rothbard, "America's Great Depression," Kansas City, Sheed and Ward, Inc., © 1975, pp. 25-29.

[20] *Ibid.*, pp. 36-37.

BANKING

Banks can issue more claims to gold than they actually own because everyone won't redeem them at the same time. If they did, the bank would be in trouble, but as long as they have confidence in the bank then they won't all redeem their claims at once. The only reason people would have to get gold would be for business dealings with foreigners who are not customers of the bank.[21] "The bank of issue may therefore assume that its money substitutes will remain in circulation until the necessity of dealing with persons outside its circle of customers forces holders to redeem them."[22]

It is usually assumed that, with free banking, the banks could inflate until the currency is worthless. This is not true. If a bank lowered its interest rate below other banks, the customers of those other banks would take out loans from that bank, redeem their claims for gold, and use this gold to pay off loans from their own bank. They would be paying off a high interest loan by borrowing at a low interest rate. Since banks are "inherently bankrupt institutions", they will do every-

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[21] Ludwig von Mises, "The Theory of Money and Credit," New York, The Foundation for Economic Education, Inc., 1971, pp. 319-338.

[22] *Ibid.*, p. 320.

thing they can to avoid losing gold.[23]

Since banks will always be trying to increase profits by lowering their interest rate, why don't they create a worldwide cartel to keep everyone's interest rate low and at the same level? Aside from the organization required for this, there will always be a maverick that does not lower his interest rate, no matter what pressure is brought against him. This is because the reward of having all one's outstanding loans paid with gold far outweighs the increase in business done because of the lower interest rate. This is especially true when everyone else's interest rate is as low, wiping out any competitive edge such as a low interest rate would have in a free market.[24]

So, why is there such a tendency to nationalize the banks? This is because the government's "sound money policy" is not aimed at sound money but at inflation. Only by bringing all the banks under one roof can the government bring the rate of interest down to a point where it can afford to pay off its debts. In this way, the rate of interest is limited only by foreign banks not under the government's control.[25]

The government will resort to this method of financing its debts whenever public opinion will not stand for a direct tax to

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[23]Ludwig von Mises, "The Theory of Money and Credit," New York, The Foundation for Economic Education, Inc., 1971, pp. 319-338. form

[24]Ibid. ~~pp. 319-338.~~

[25]Ibid., ~~pp. 319-338~~.

pay for unpopular projects (or at least projects which would become unpopular if their true cost was disclosed).[26] "Inflation is a form of taxation, since the government can create new money out of thin air and use it to bid away resources from private individuals, who are barred by heavy penalty from similar 'counterfeiting'."[27]

And so, in summary, "Inflation drives capital out of the country and distorts the pattern of investment."[28]

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[26]Ludwig von Mises, "The Theory of Money and Credit," New York, The Foundation for Economic Education, Inc., 1971, pp. 319-338.

[27]Murray Rothbard, "America's Great Depression," Kansas City, Sheed and Ward, Inc., ©1975, p. 29.

[28]Don Paarlberg, "Great Myths of Economics," New York, The American Library, Inc. © 1968, p. 75.

CONCLUSION

"Essentially - and stripped of the jargon, the equations, and the graphs - the economic Establishment held all during this period that if the economy is seen to be sliding into recession, the government need only to step on the monetary gas - to pump in money and spending into the economy - in order to eliminate recessions. And, on the contrary, if the economy was becoming inflationary, all the government need do is step on the fiscal and monetary brake - take money and spending out of the economy - in order to eliminate inflation."[29]

This quotation points out the tendency to consider the business cycle as originating in and caused by the free market. "Only the unlikely adoption of sound economic policy could lead the public to pin the responsibility where it belongs; on the government itself."[30]

"In times of breakdown, mere tinkering reforms are not enough; we must take the radical step of getting the government out of the economic picture, of separating government completely from the money supply and the economy, and advancing toward a

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[29]Murray Rothbard, "America's Great Depression," Kansas City, Sheed and Ward, Inc., © 1975, Introduction to 3rd edition. form

[30]Ibid., Introduction to 3rd edition.

truly free and unhampered market and enterprise economy."[31]

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[31] Murray Rothbard, "America's Great Depression," Kansas City, Sheed and Ward, Inc., © 1975, Introduction to 3rd edition.

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