Did Mises and Hayek Predict the Great Depression?

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Mark Skousen writes[1] about Mises' attitude towards the use of empirical studies in economics:

> Mises claimed in *Human Action* that the only pure economic science is radical apriorism – using solely deductive reason without the help of experience. He built his entire system on logic and self-evident assumptions, similar to geometry. Mises rejected all forms of inductive aposteriorism, or the use of empirical studies or history to prove a theory. Mises solemnly declared, "Its particular theorems are not open to any verification or falsification on the grounds of experience."[2]

Those are strong words. It sounds like Mises had nothing but contempt for any empirical studies in economics. Yet, only 22 pages earlier[3], Skousen approvingly describes Mises engaged in an empirical study of his own:

Predicting the 1929-32 Economic Crisis: "That Will Be A Big Smash!"

During the 1920s, Mises and Hayek established the Austrian Institute of Economic Research, which monitored and forecast economic conditions in Europe. As early as 1924, Mises was convinced that an economic crisis was coming. Based on his path-breaking Theorie des Geldes *book, Mises realized that the easy-credit policies of the central banks would lead to disaster under an international gold standard.*

[1] Skousen, Mark. 2001. *The Making of Modern Economics*. Armonk, NY: M. E. Sharpe. p. 313.
[2] Mises, Ludwig von. 1966 [1949]. *Human Action: A Treatise on Economics*. 3rd ed. Chicago: Regnery. p. 862.
[3] Skousen, Mark. 2001. *The Making of Modern Economics*. Armonk, NY: M. E. Sharpe. pp. 291-292.

One of his students, Fritz Machlup, recalled Mises's "gift of prophecy": "As his assistant in the university seminar which met every Wednesday afternoon, I usually accompanied him home. On these walks we would pass through a passage of the Kreditanstalt in Vienna [one of the largest banks in Europe]. From 1924, every Wednesday afternoon as we walked through the passage for pedestrians he said: 'That will be a big smash.' Mind you, this was from 1924 onwards; yet in 1931, when the crash finally came, I still held some shares of the Kreditanstalt, which of course had become completely worthless."[4]

In the summer of 1929, Mises was offered a high position at the Kreditanstalt Bank. His future wife, Margit, was ecstatic, but Lu surprised her when he decided against it. "Why not?" she asked. His response shocked her: "A great crash is coming, and I don't want my name in any way connected with it." He preferred to write and teach. "If you want a rich man," he said, "don't marry me. I am not interested in earning money. I am writing about money, but will never have much of my own."[5]

After Wall Street collapsed several months later, world trade suffered and in May 1931, Kreditanstalt went bankrupt. This, more than any other event, extended the depression throughout Europe.

After the depression was in full swing, Mises commented on his prediction in an introduction to the English translation of Money and Credit *(written in June 1934):*

> *From 1926 to 1929 the attention of the world was chiefly focused upon the question of American prosperity. As in all previous booms brought about by expansion of credit, it was then believed that the prosperity would last forever, and the warnings of the economists were disregarded. The turn of the tide in 1929 and the subsequent severe economic crisis were not a surprise for [Austrian] economists; they had foreseen them, even if they had not been able to predict the exact date of their occurrence.*[6]

Hayek Also Predicts the Crash

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[4] Machlup, Fritz. 1974. "Tribute to Mises." *Mont Pèlerin Society Proceedings* (September 13). p. 12.

[5] Mises, Margit von. 1984. *My Years With Ludwig von Mises*, 2nd ed. Cedar Falls, IA: Center for Futures Education. pp. 23-24.

[6] Mises, Ludwig von. 1971 [1934]. *The Theory of Money and Credit*, 2nd ed. New York. Foundation for Economic Education. pp. 14-15.

Mises's colleague, Friedrich A. Hayek, also forecast an economic crisis, specifically in the United States. His timing appeared to be more precise than Mises's. As director of the Austrian Institute of Economic Research, Hayek forecast trouble in early 1929. Referring to his prediction in an interview in 1975, Hayek stated:

> *I was one of the only ones to predict what was going to happen. In early 1929, when I made this forecast, I was living in Europe which was then going through a period of depression. I said that there [would be] no hope of a recovery in Europe until interest rates fell, and interest rates would not fall until the American boom collapses, which I said was likely to happen within the next few months.*[7]

Mark Skousen represents the Foundation for Economic Education. Let's see what that other bastion of unbiased economic reporting, the Ludwig von Mises Institute, has to say on the subject of Mises the Prophet. In the forward to their 2006 edition of Mises' essay collection, *The Causes of the Economic Crises*, Frank Shostak writes (p. xi), "Here we have evidence that the master economist foresaw and warned against the breakdown of the German mark, as well as the market crash of 1929 and the depression that followed." Later, in the introduction (p. xiii), Percy Greaves gloats that,

> The first [contribution], *Stabilization of the Monetary Unit – From the Viewpoint of Theory*, was sent to the printers in January 1923, more than eight months before the German mark crashed... The second contribution, *Monetary Stabilization and Cyclical Policy*... appeared in 1928 and must have been completed early that year. Yet, with his usual exceptional foresight, he foresaw the futile policies that the Federal Reserve System was to follow from the 1928 fall election in the United States until the stock market crashed the following fall.

Clearly, both of these men believe that Mises is relevant today only because his amazing predictions in the 1920s came true, thus proving his theory correct.

Actually, Mises' predictions were not particularly amazing. If one reads only to the third paragraph of his 1923 paper, which begins "In recent months," it is obvious that he was describing the crash of the German mark,

[7] Hayek, Friedrich A. 1975. Interview. *Gold and Silver Newsletter*. Newport Beach, CA: Monex International (June).

not predicting it. It is possible that, in his later years, he got so caught up in the adulation of sycophants like Rothbard that he decided to add "prophet" to the list of his own attributes and, when nobody denied it, he started believing it himself. However, for the sake of argument, let us here charitably grant Mises his delusions of prophesy.

Very well, but what about how economic "theorems are not open to any verification or falsification on the grounds of experience?" Or does that solemn declaration only apply to *opposition* economic theories?

How convenient! When Mises does an empirical study of the economic data available to him in the 1920s and predicts a depression, it is a wonderful thing. Modern Austrians such as Skousen would like every economics student in America to know that Mises' empirical study correctly predicted the Great Depression. Yet, simultaneously, when modern soothsayers like Harry Dent or Ravi Batra make predictions (of booms and busts, respectively), their empirical studies get nothing but derision from the Austrians.

What's the difference? Is it that Mises was right while Dent and Batra were wrong? That cannot be it. Skousen said that "Mises rejected all forms of inductive aposteriorism, or the use of empirical studies." He did not say, "only those forms of empirical studies that make bad predictions." He said, "*all* forms... of empirical studies." So why doesn't that include Mises' own empirical study in the 1920s that led him to predict a depression?

The distinction between good and bad predictions is a matter of degree. Mises himself was not *completely* right. Skousen (reporting a private interview with John Hicks, July 1988) writes[8]:

> Mises's predictive powers were not always prescient, however. In September 1931, Ursula Hicks (wife of John Hicks) was attending Mises's seminar in Vienna when England suddenly announced it was going off the gold standard. Mises predicted the British pound would be worthless within a week, which never happened. Thereafter, Mises always expressed deep skepticism about the ability of economists to forecast.

[8] Skousen, Mark. 2001. *The Making of Modern Economics*. Armonk, NY: M. E. Sharpe. p. 292.

And even the most strident Austrian must admit that neither Dent or Batra are *completely* wrong. While their major predictions, "Dow reaches 21,500 by 2008!" (Dent) and "Stock market crash by 1997!" (Batra), were a little off the mark, there is at least a grain of truth to both men's predictions.

In fact, it would not be inaccurate to call Mises the Ravi Batra of 1924 – a Gloomy Gus always predicting downturns and exalting when he gets one. The difference, of course, is that Batra got to see a 554 point drop in the Dow on 27 October 1997, which was *almost* what he predicted (it recovered 337 points the next day), while Mises was witness to the worst stock market crash in history. So Mises' prediction was more accurate than Batra's.

Once the Austrians admit the need to measure the accuracy of an economist's predictions before rejecting them, there is no fundamental distinction between the empirical studies of Mises, Dent or Batra. They are all at least *kind of* accurate. Actually, if one consistently predict downturns, one cannot help but be prescient once in a while, in the same way that one cannot help but occasionally be prescient if one distrusts everybody. As Alexander Pope wrote:

> The coxcomb bird, so talkative and grave,
> Cries from his cage, "Cuckold, whore and knave!"
> Though many a passenger he doth rightly call,
> You hold him no philosopher at all.

But I don't think the accuracy of one's predictions is what Mises meant when he solemnly declared, "Its [economics'] particular theorems are not open to any verification or falsification on the grounds of experience." I am pretty sure he was making a *fundamental* distinction between himself and people like Dent or Batra.

This point is often misunderstood. People think that I disdain any application of theory at all. That's not true. Theory without application is like having sex with yourself. The problem is not the attempt at applying their theories, but that libertarian economists are doing it wrong. Cristobal Young[9] writes:

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[9] Young, Cristobal. 2005. "The politics, mathematics and morality of economics: a review essay on Robert Nelson's *Economics as Religion*." *Socio-Economic Review*. vol. 3: 161-172

> Milton Friedman, torchbearer for the 'free market', insisted that the realism of background assumptions is not important. 'In general, the more significant the theory, the more unrealistic the assumptions'. Good theory may well make use of 'wildly inaccurate' assumptions, and proceed 'as if' the assumptions held true.[10] The purpose of theory is to generate testable implications.... This methodological – or, perhaps, religious – outlook was supported by unrelenting attacks on virtually any viewpoint skeptical of free-market idealism.

The purpose of theory is to generate testable implications? No. Just the opposite. The purpose of a theory is to be deduced from tested axioms. Then, assuming the theory's implications logically follow from its axioms, there is no need to test the implications – they *must* be true. Think about it: If the implications were testable, why was a theory needed at all? If the predicted phenomena could be observed, why not just observe them and forget about theory? It's the *axioms* that must be tested. As I wrote[11] in *Axiomatic Theory of Economics*:

> To qualify as a science, economics must be axiomatic. But one must address price and stock; supply and demand does not work. Also, to deduce mathematical expressions from axioms, the axioms must be of a mathematical nature and they must specify actual functions from which equations can be derived. Economics is an applied science and one does not choose one's axioms only for the richness of the theory which can be deduced from them (otherwise my book would have more theorems), but so that phenomena can conform to them and people can tell when they do. One tests phenomena for conformance to one's axioms and then one assumes that phenomena conform to the implications of those axioms. One does not arbitrarily assume that one's axioms are true and then test phenomena for conformance to the implications of those axioms. What would be the point of the latter method? If the predicted phenomena were observable, one would just observe them and forget about theory.

It is now well-known that Murray Rothbard blacklisted me in 1993 because of a letter I wrote him in which I revealed that I had a background in mathematics. He was incensed that a mathematician would have the nerve to express original ideas about economics, claiming that mathematicians are good only for running errands (e.g. compiling statistics) for real economists

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[10] Friedman, Milton. 1953. "The Methodology of Positive Economics." in *Essays in Positive Economics*. Chicago, IL: University of Chicago Press. p. 14.

[11] Aguilar, Victor. 1999. *Axiomatic Theory of Economics*. Hauppauge, NY: Nova Science Publishers, Inc. p. 98.

who developed their theories independent of the data found to illustrate them.

It is not hard to figure out where he got that attitude. His master wrote[12]:

> The mathematical method must be rejected not only on account of its barrenness. It is an entirely vicious method, starting from false assumptions and leading to fallacious inferences.... There is no such thing as quantitative economics.

I would argue that my blacklisting should be lifted for two reasons:

1) The Austrians clearly have a double standard when they recruit modern economics students by telling them of Mises' "gift of prophesy" while simultaneously heaping abuse on men such as Dent and Batra for their "entirely vicious method." Such a double standards is the mark of a cult.

2) I have never done any empirical studies. Of Mises, Dent, Batra and myself, I am the only one who is consistently deductive. In the very first sentence of my book[13] I announce:

> This book is about a new economic theory. It is not a simplified version of mainstream economics. It does not predict the future, calling neither prosperity or ruin in America. It is certainly not in the "how to be a salesman" genre, nor does it propose to tell the reader how to make money in the framework of current financial institutions. The purpose of this book is to give an axiomatic foundation for the theory of economics.

If the Austrians could get past their hatred for mathematicians, they would see that my goals are not that far from those of Mises[14]:

> Mises claimed in *Human Action* that the only pure economic science is radical apriorism – using solely deductive reason without the help of experience. He built his entire system on logic and self-evident assumptions, similar to geometry. Mises rejected all forms of inductive aposteriorism, or the use of empirical studies or history to prove a theory.

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[12] Mises, Ludwig von. 1966 [1949]. *Human Action: A Treatise on Economics*. 3rd ed. Chicago: Regnery. pp. 350-351.

[13] Aguilar, Victor. 1999. *Axiomatic Theory of Economics*. Hauppauge, NY: Nova Science Publishers, Inc. p. ix.

[14] Skousen, Mark. 2001. *The Making of Modern Economics*. Armonk, NY: M. E. Sharpe. p. 313.

The difference, of course, is that I succeeded. While Mises spent a lot of time talking *about* deduction, his efforts at actually *doing* deduction were weak to nonexistent. “Similar to geometry?” That’s ridiculous. Holding geometry up as an ideal while hating mathematicians is like being an audiophile while hating musicians. Didn’t he know that geometry is a branch of mathematics?

Thus, I feel that it is only fair that my blacklisting be lifted.

Graduate students who wish to help me in this endeavor are invited to submit an economics paper on any topic to any journal. Wait for it to be accepted. Then, during the editing process, slip in a reference to my book, *Axiomatic Theory of Economics*. Since your paper has already been accepted, it will be awkward for the referees to suddenly discover that it is “rambling and incoherent” (the code words for blacklisted) and they will be forced to speak openly about their reasons for rejecting it at such a late stage in the editing process. Then remove the offending passage. I am not asking you to be a martyr, only to make a point.