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Austrian Economics

An Introductory Overview

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Agenda

- Introduction
- Human Action
- Goods, value, and price
- Entrepreneurship and market processes
- Money
- Production, capital, and interest
- Business cycles and crises
- Epistemology and applications

- **Introduction**
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- “Austrian” Economics?
 - » Methodenstreit with German Historical School
 - ⇒ **Pronounced pro-theory approach in economics**

- Cradle of modern economic thinking
 - » Marginal revolution, concept of opportunity costs
 - » Subjectivist theory of value
 - » Methodological individualism
 - ⇒ **Next significant stage of economics after the classics**

- Criticism of homo oeconomicus and Neoclassics
 - » Over-simplistic assumptions (economic core is assumed away)
 - » “Pure-and-perfect competition” as model without true competition (e.g. problem of representative firms)
 - » Problematic macro-micro-dichotomy
 - ⇒ **Economics as a social science, comprehensive view on entrepreneurs**

- Praxeology: Economics as the science of human action
- Catallactics: Science of human inter-action (market exchange)
- Aprioristic analytic framework
 - » Set of fundamental claims describing economic/social reality
 - » Strictly deductive logic as ultimate proof only
(vs. eclecticism and data-driven “empirically evidence-based” work)
 - » Focus on pattern prediction
- Liberalism as a social philosophy
 - » Search for laws driving voluntary social cooperation
 - » Evolutionary view on institutions (trial-and-error), “spontaneous order”
 - » Contractual society as benchmark for human interaction

- Production and value theory
 - » Production in time-consuming stages, no uniform production function
 - » Process of value imputation in a modern complex economy
- Theory of money and credit
 - » Money vs. money substitutes; monetary regression theorem
 - » Currency competition, private money production
- Pure theory of interest and capital
 - » Time preference and interest
 - » Capital as a structured stock of non-permanent means (path-dependency)
- Monetary theory of the business cycle
 - » Non-neutrality of money
 - » Credit creation and banking crises

Major topics (2/2)

- Exploding overproduction/excess saving theories
 - » No limits to “growth” (division of labor/capital accumulation)

- Evolutionary emergence of social institutions
 - » Human discovery vs. human design

- Impossibility theorem of economic calculation under socialism
 - » Role of private property for price mechanism

- Precursors: Juan de Mariana (1512-1577), Richard Cantillon (1680-1734), A.R.J. Turgot (1727-1781), Jean-Baptiste Say (1767-1832), Frédéric Bastiat (1801-1850)
- **Founder: Carl Menger (1840-1921)**
- Eugen v. Böhm-Bawerk (1851-1914), Friedrich v. Wieser (1851-1926), Frank A. Fetter (1863-1949)
- **Ludwig v. Mises (1881-1973)**
- **Friedrich A. v. Hayek (1899-1992)**, Ludwig Lachmann (1906-1990), Henry Hazlitt (1894-1993), Wilhem Röpke (1899-1966)
- Murray N. Rothbard (1926-1995), Israel M. Kirzner (*1930), George Reisman (*1937)
- Roger W. Garrison (*1944), Joseph T. Salerno (*????), Hans-Hermann Hoppe (*1949), Jesús Huerta de Soto (* 1956), George A. Selgin (*1957), Guido Hülsmann (*1966)
- Thomas Mayer, Rahim Taghizadegan, Philipp Bagus, ...

Ludwig von Mises Institute: www.mises.org

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Man acts.

Implications of “human action” (1/2)

- Purposeful conduct: Aiming at reducing uneasiness
 - » The human actor “wants to substitute a state of affairs that suits him better for one that suits him less”. (Mises)
 - » Human beings as universal entrepreneurs (explorers, not decision automata)
 - » Action: decision making + search for means

- Individuals act ...
 - » ... but not in isolation (society formed by voluntary interaction)
 - » ... groups/aggregates do not (anti-collectivist approach)

- Preferences as ranks only
 - » Chosen ends are strictly subjective
 - » Making choices on means (no discussion of ends)
 - » No room for interpersonal comparison of utility (no social planner)

Implications of “human action” (2/2)

- Diminishing marginal utility
 - » Follows from praxeological approach (outcome, not an assumption)
 - » Not a psychological/physiological phenomenon

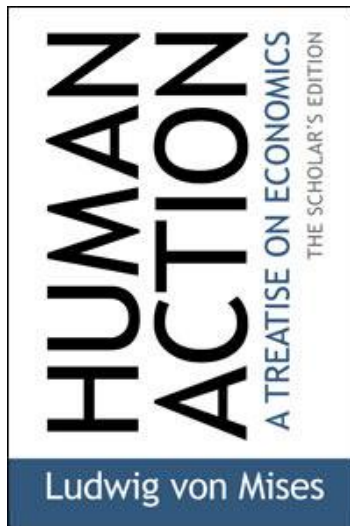
- Action in time
 - » Dynamic disequilibrium approach
 - » Evenly rotating economy as a state of non-action (thought experiment only)

- Uncertainty: Limited and distributed knowledge
 - » Action as speculation based on subjective judgments
 - » Knowledge: Local, fragmentary, non-centralizable
 - » Prices as universal information carriers
(The Use of Knowledge in Society, Hayek 1945)

Ludwig von Mises (1881 – 1973)

Nationalökonomie – Theorie des Handelns und Wirtschaftens (1940)

Human Action (1949)



<http://mises.org/document/3250>

- General method
 - » Individuals as point of departure for economic analysis
 - » Explaining social processes via inter-actions of involved persons
 - » Aggregates are constructivist pseudo-entities, no facts

- Individuals ...
 - » ... are diverse
 - » ... have exogenous preferences
 - » ... are capable of acting on their own
 - » ... follow their vested interest (\neq egocentric, selfish)

- Subjectivism
 - » Individual preferences
 - » No scientific inter-subjective comparisons of utility

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Nature of (economic) goods

- Human need
- +
- Causal connection to satisfy such a need
- +
- Human knowledge of this causal connection
- +
- Sufficient command of the thing



Carl Menger (1840 – 1921)

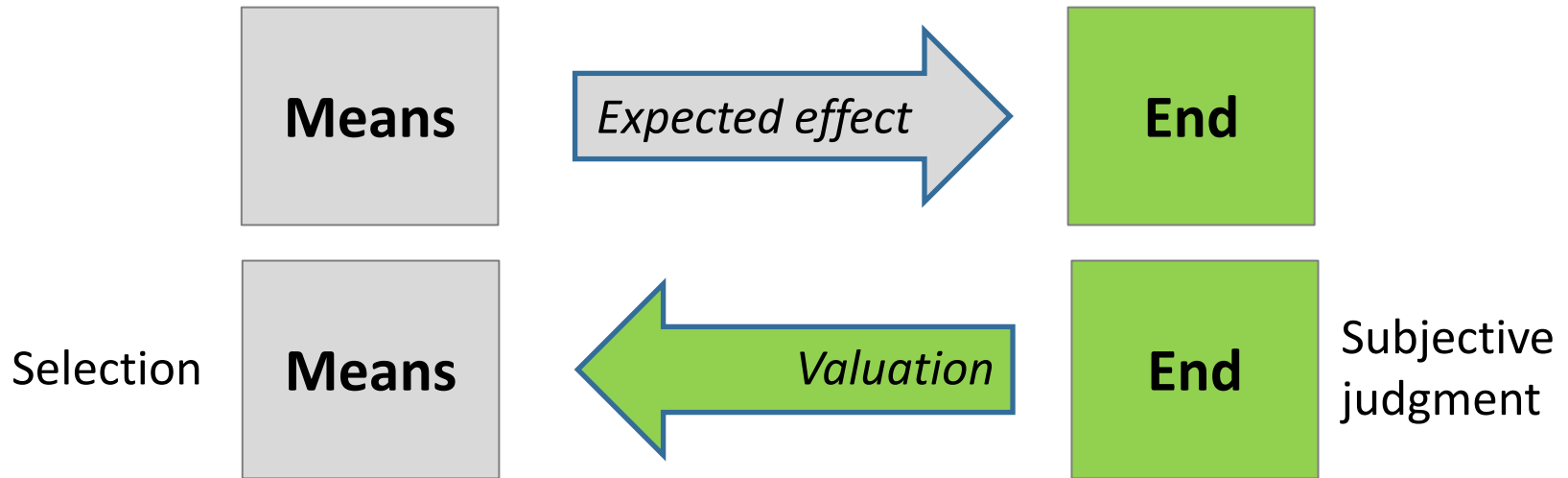
Grundsätze der Volkswirtschaftslehre (1871)

Principles of Economics (1976)

⇒ **Subjectivist theory of the good**

- » Good-character depends on human judgment
- » Quality/value not an objective property of the good

Means, ends, and valuation



- Reverse value imputation
 - » The end may not „sanctify“ the means, but it **values** it!
 - Limited knowledge
 - » Action under uncertainty (= speculation)
 - Rationality
 - » Humans do not purposefully act against their aims
- ⇒ **Final purpose of economic activity: Consumption goods**

Marginalism and subjectivist theory of value

- Solving the value paradoxon
 - » Subjectivism
 - » Marginalism

- Marginal principle \neq infinitesimal analysis
 - » Relevant units matter!

- Subjectivist theory of value
 - » Value = opportunity cost
 - » Trilateral relation between human actor and 2 options
 - » Exploding classical labor theory of value

- Violence (military campaigns, robber barons)
- Discrimination (Sex, Nationality, Age, ...)
- Greyhound racing („First come, first served“)
- Communism („Each according to his/her need“)
- Egalitarianism („Each the same“)

- **Market (competitive exchange mechanism)**
 - » **Property rights**
 - » **Voluntary exchange**
 - ⇒ „Each according to his/her preferences *and* performance for others“
(ability-to-pay resulting from market income = valuation by others)

The market signal system: Profits, Losses, Bankruptcy

■ Profits

- » Revenues (value creation) > Costs (value destruction)
- » Net creation of value
- ⇒ Agent stays in the game, activity can be expanded

■ Losses

- » Revenues < Costs
- » Net destruction of value
- ⇒ Yellow card (warning): activity should be reduced/modified

■ Bankruptcy

- » Revenues << Costs
- » Net value destruction ongoing/at large scale
- ⇒ Red card (sending-off): activity must stop (reallocation of resources)

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- Disequilibrium approach
 - » Menger/Hayek vs. Walras/Marshall tradition
 - » homo agens (HA) vs. homo oeconomicus (HO)

- Role of entrepreneurs
 - » Uncertainty: speculation, search, and discovery (HA as explorer)
 - » Universal arbitrageurs: investment as intertemporal arbitrage

- Dynamics and time
 - » Permanent adjustment process rather than sequence of equilibria
 - » Market system as feedback mechanism (ex-ante and ex-post prices)
 - » Time cannot pass without modifying knowledge (Hoppe)

Market process view (2/2)

- Prices as knowledge surrogates
 - » Deficiency of monetary calculation:
Distorted price structures vs. price level movements
 - » Non-neutrality of money (Cantillon effects)

- Competition
 - » Striving for better consumer satisfaction
 - » “Perfect” competition = no competition

⇒ Leaving the “evenly rotating economy” behind

- One economic process
 - » Micro level: Economic mechanisms and individual decisions
 - » Macro level
 - Mismatches on micro level show up as „imbalances“
 - Universal drivers (permeating into all micro markets)

⇒ Macroeconomics: Evidence for systematic misallocation of resources?
- Universal (= pervasive) drivers
 - » Money (medium of exchange)
 - » Interest (price of time)
 - » Capital (means for intertemporal coordination)
 - » Labor (most universal production factor)
 - » Constitutional framework (regulations, policy)

⇒ **Systemic micro disruptions as macro symptoms**

- Risks of macroeconomic misperceptions
 - » Aggregating/averaging the problems away (e.g. aggregate production function approach)
 - » Losing touch with microeconomic principles (e.g. key role of price mechanism)
 - » Over-interpreting national accounts concepts (e.g. identities tell nothing about causality or interdependency)
 - » Ignoring production structures (netting out intermediate consumption)

- Language (terminology) and reasoning (theory)
 - » Words can be misleading
 - » Wording matters

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- **Money emerged by evolutionary learning**
 - » Enabling indirect exchange
 - » Dramatically widening the division of labor

- **Money = medium of exchange**
 - » Pre-monetary value (regression theorem, Mises 1912)
 - » Homogenous, permanent, reversibly divisible
 - ⇒ Precious metals emerged as best-suited candidates

- **Money is a product of the market**
 - » Private money production prior to state monopoly (Menger 1892), contrary to the “State theory of money” (Knapp 1921, Peacock 2013)
 - » Standardization reduce transaction cost even further
 - » Governments can act as standard setters for monetary units ...
 - » ... but historically acted primarily as counterfeiters

■ Legal privilege

- » Granted to the banking industry only
- » Deposit vs. loan contracts (Huerta de Soto 2012) (safekeeping vs. temporary transfer of availability)
- » Borderline between liquidity provision (deposits) and capital provision (loans) becomes legally and economically indistinct
- ⇒ Interplay of central bank and commercial banks:
Money production as a Public-Private-Partnership (Seignorage sharing)

■ Genuine banking

- » Deposit services (100 percent reserve requirement) subject to charges
- » Credit intermediation (bringing savers and investors together) including risk assessment, volume (and maturity?) transformation

■ Macroeconomic consequences

- » Credit and money creation out of thin air
- » Drives a wedge between ex ante saving and credit/investment
- » Non-neutrality of money (Cantillon effect)
- » Key mechanism in monetary business cycle theory (Hayek 1932)

■ Macroeconomic benefits?

- » Two economies distinguished only by their quantities of money: Which one is better of? (Mints 1950)
- » Deflation – a case for monetary expansion? (Hülsmann 2008)
 - Deflation as a side-effect of crises (provoked by what?)
 - Deflation as the flip-side of increasing productivity
- » Commodity money: Cost reduction, freeing resources for final use (Wicksell 1935, Selgin 1988)
- » Fiat money: Risk transfer to private banks (but: moral hazard)

Debt-backed money creation: Self-reference

- Money (means of payment) backed by ...
- ... securities (promises of future payments)



- Possibility of banks-runs due to fractional-reserve banking
 - » Central bank as “Lender of Last Resort” for liquidity support only
 - » Solvent, but illiquid banks (Bagehot 1873)
 - ⇒ Creeping process of expanding role as LoLR (concept dilution)

- Collateral risks infect stability of payment systems
 - » Central bank as bail-out agency? ⇒ only seemingly
 - » Ring-fencing financial stability by central supervision?
 - ⇒ Promoting monocultures of risk assessment/regulatory overkill

- Technically unlimited money creation capacity
 - » But: Too much money is no money (hyperinflations)
 - » And: Financing illusion of the money press
(monetization as implicit taxation)
 - ⇒ Technical feasibility ≠ economic effectiveness

Monetary policy: The all-purpose weapon?

- Generic target: Provision of a means of exchange
 - Other targets
 - » Government financing
 - » Debt-monetization
 - » Boosting employment
 - » Business-cycle stabilization
 - » Systemic financial stability
 - Monetary policy
 - ⇒ **Potential conflicts**
 - ⇒ **Room for excessive rent-seeking**
 - ⇒ **High risk of sacrificing the (most abstract, general) generic target for (more simplistic, partisan) non-generic targets**
- } What about Tinbergen?

Monetary policy: Overloaded!



Source: FAZ, 26. Oktober 2011, p. 11

■ Unknown monetary territory

- » World-wide (JP, USA, GB, EMU):
drastically increased monetary base unseen in peacetime before
- » Threat of solving fiscal burdens at the expense of money users
- ⇒ Search for alternatives (demand side)

■ Technological trends

- » Cash will disappear very soon (10 years?, 15 years?)
- » Enhanced electronic payments infrastructures
 - Internet-based services as a layer above traditional banking systems
 - Cash-like ubiquitous and permanently available virtual wallets (necessary for money as a network good)
 - Vast opportunities for data mining
- ⇒ Ability and incentives: new players (supply side)

⇒ **Potential demand and lower barriers-to-entry**

■ Forthcoming situation

- » Increasing potential demand for less costly medium of exchange
- » Full-fledged infrastructure for switching the reserve medium
- ⇒ Lower barriers-to-entry for private money production
(back to the roots: denationalization/re-privatization of money)

■ What private money?

- » Reserve medium: fiat money or commodity money
- » Pure cyber money (BitCoin etc.): contrary to regression theorem, no backstop, highly exposed to fraud due to incentives and intransparency
- » Virtual wallets make precious metals fully fungible
- » Come-back of gold (strong suck-in effects)
- » Free banking and reputation building: 100-percent-money?
(maximum degree of transparency, ETF-like situation)
- ⇒ **Private money services as management of gold reserves**

The search for alternatives (2/2)

- **Transition process**
 - » Gradual, not a 1-0-decision (experimental phase)
 - » Remonetization of gold and the gold price: positive feedback loop
 - » From the start a globally accepted means of payment
 - » Reverse of Gresham's law (= Thier's law) applies
 - **Regulatory preconditions**
 - » None, only full protection by existing civil laws (deposit laws)
 - **Governmental response?**
 - » Repeated prohibition of monetary gold (New Deal 2.0)?
 - » Compulsory state-issued currency for public-private-payments?
 - » Safe sites for the gold base of global money providers?
- ⇒ **Consequence: End of monetary policy**

Two monetary perspectives

- The optimistic (utopian?) view
 - » Emergence of (parallel) hard currencies
 - » Transition to 100-percent money
 - » Restoration of market principles (accountability)
 - » Separation of money and credit
 - ⇒ **Stable global means of exchange**

- The pessimistic (realistic?) view
 - » Devaluation spirals, currency wars
 - » Wealth taxes, financial repression, hyperinflation
 - » Interventionist regulatory overkill
 - » Disruption of financial stability
 - ⇒ **Economic chaos**

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“Final aggregate demand”: No demand and not all of it is final

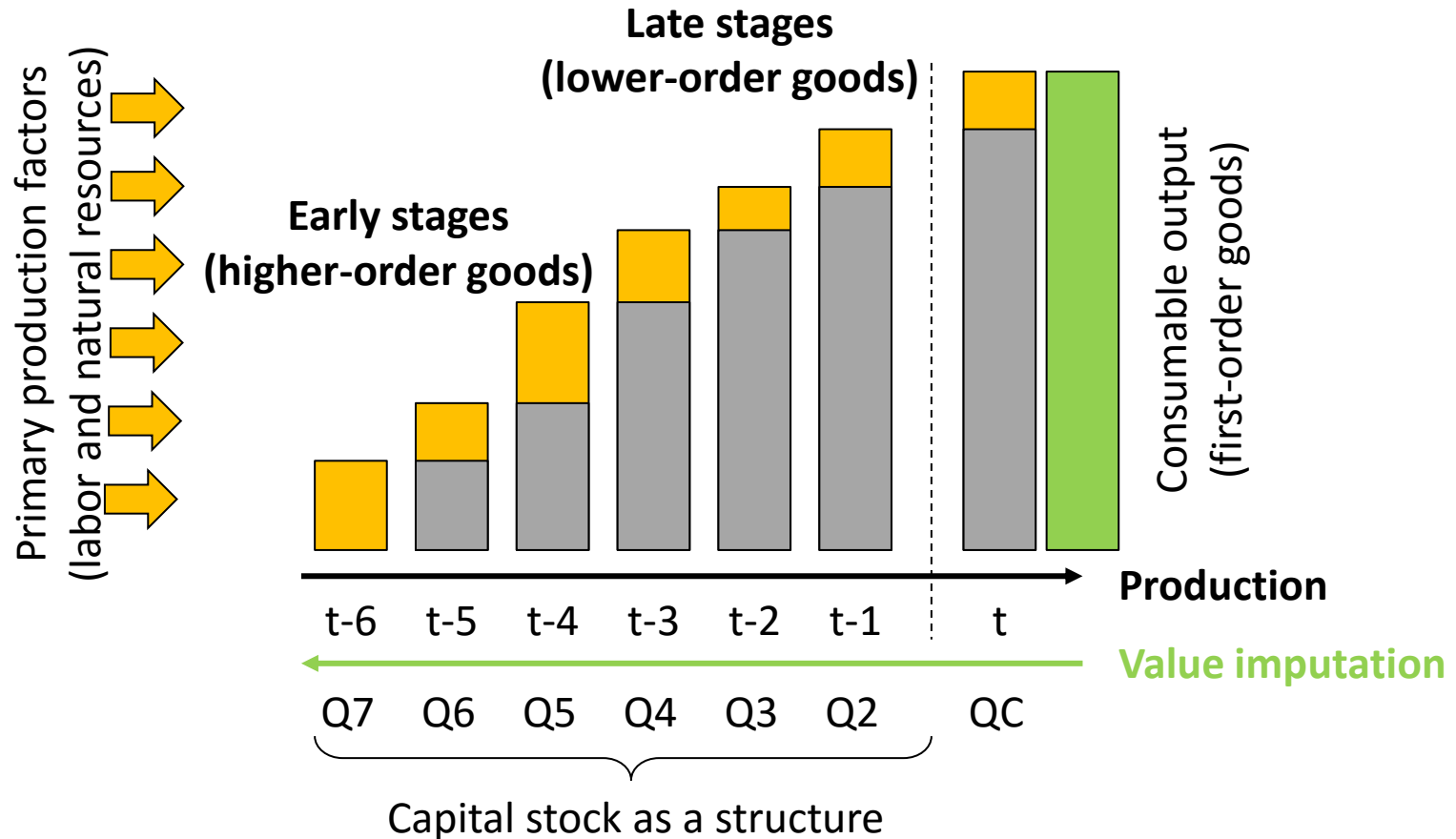
Goods and services account

Source/Input (not: supply) for period t Use/Output (not: demand)

Intermediate consumption (production structure)	Intermediate consumption (production structure)
Domestic value-added	Final consumption (exclusive source of value)
	Domestic capital formation
	Capital formation abroad
Imports	Exports

**„Final“ use of domestic production
(only with respect to period t)**

Production as a time consuming, multi-stage process



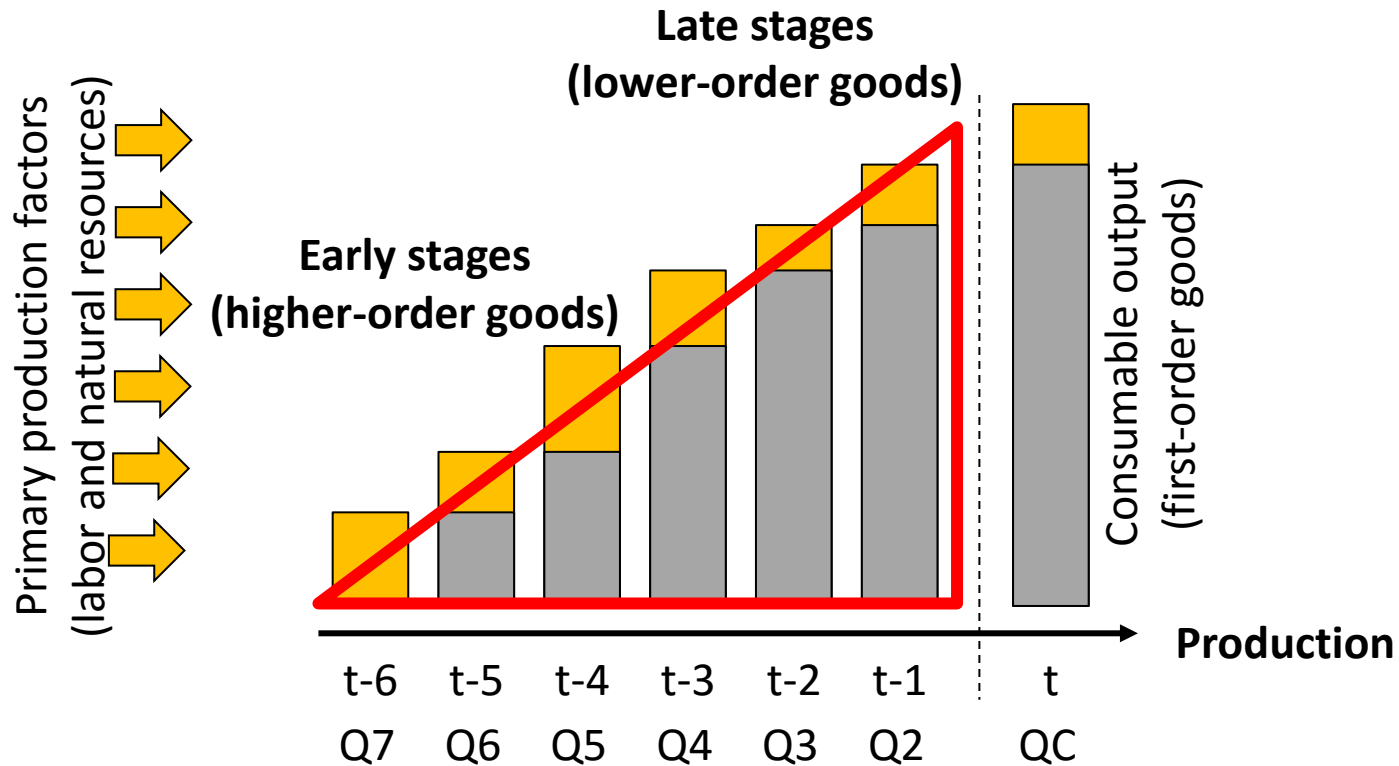
⇒ **Capital formation: intertemporal intermediate consumption**

- Capital as intentionally produced productive means ...
 - » ... not a disembodied abstraction or homogenous aggregate
 - » ... nor a self-perpetuating (“Knightian”) fund

 - Structure of heterogeneous goods
 - » Limited convertibility and recombination losses
 - » Capital as a structural pattern (Lachmann)

 - Value dimension:
 - » Ability to allow individuals to more readily realize their plans rather than physical characteristics or physical history
 - » “Unfinished entrepreneurial plans” (Kirzner): Capital goods to be assessed in light of their usefulness to those plans
- ⇒ **Missing link between micro and macro level (Skousen)**

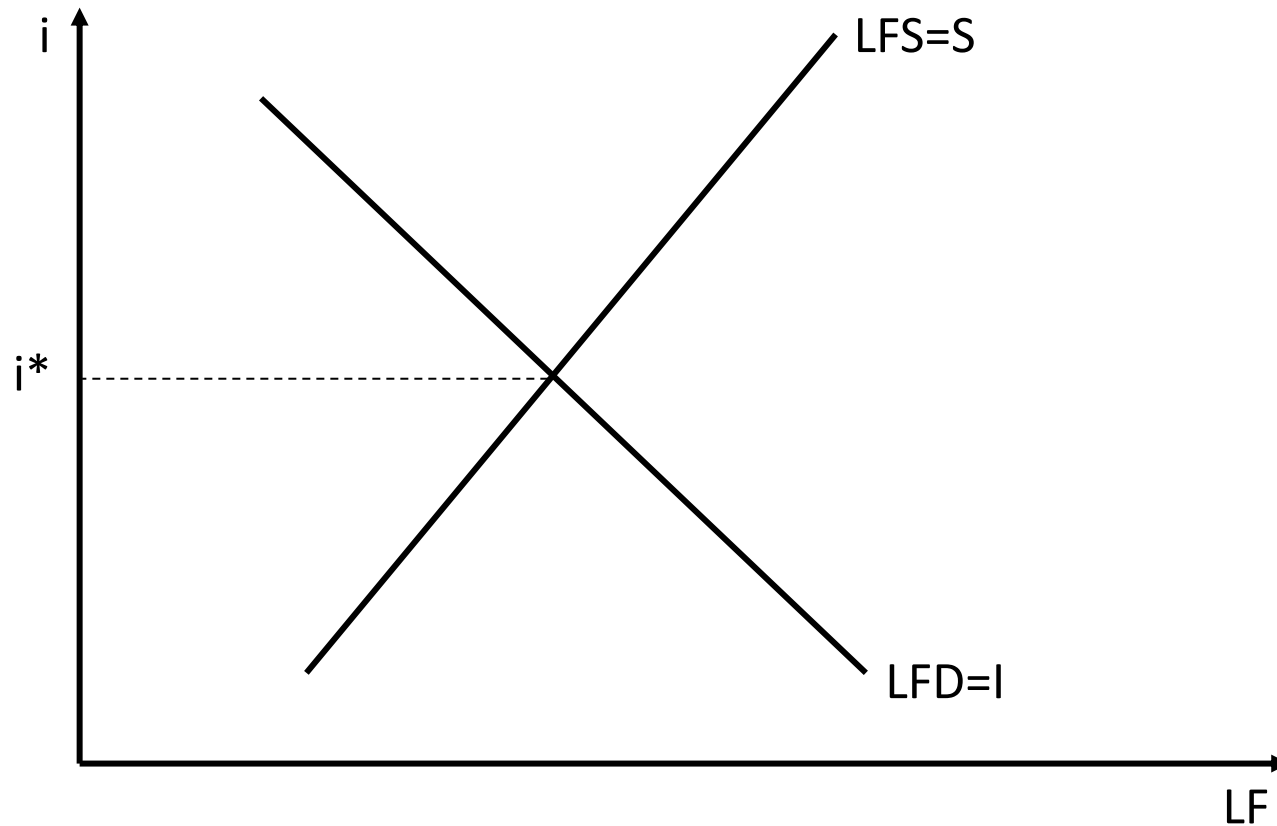
Production: The Hayekian triangle



⇒ Number of production stages/shape of the Hayekian triangle?

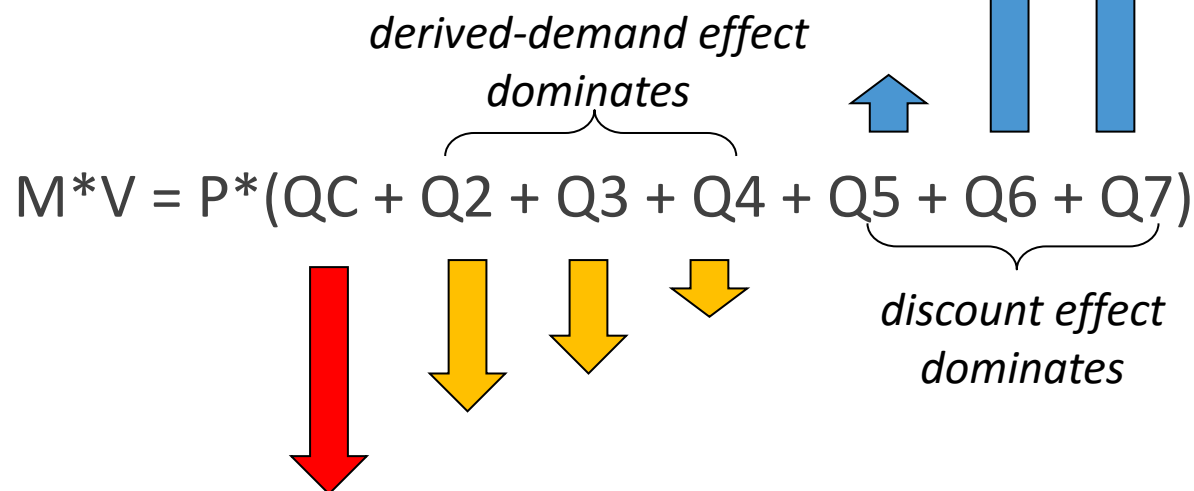
- Interest as a value phenomenon
 - » Expression of time preference
 - » Price of future goods relative to present goods
 - » Discount rate interwoven in the entire price system
 - Capitalization theory (Fetter): Interest vs. price of capital
 - » Productivity of capital reflects in price of capital goods
 - » Valuation of reproducible capital pushed backward to primary factors
 - » Price of capital = present value of future income streams
 - Interest and “roundaboutness of production”
 - » Capital-intensity increases labor productivity via natural forces
 - » Choice of more roundabout production schemes depends on time preference
- ⇒ **Pure time preference = market rate of interest?**

Interest rate and market for loanable funds



- Saving

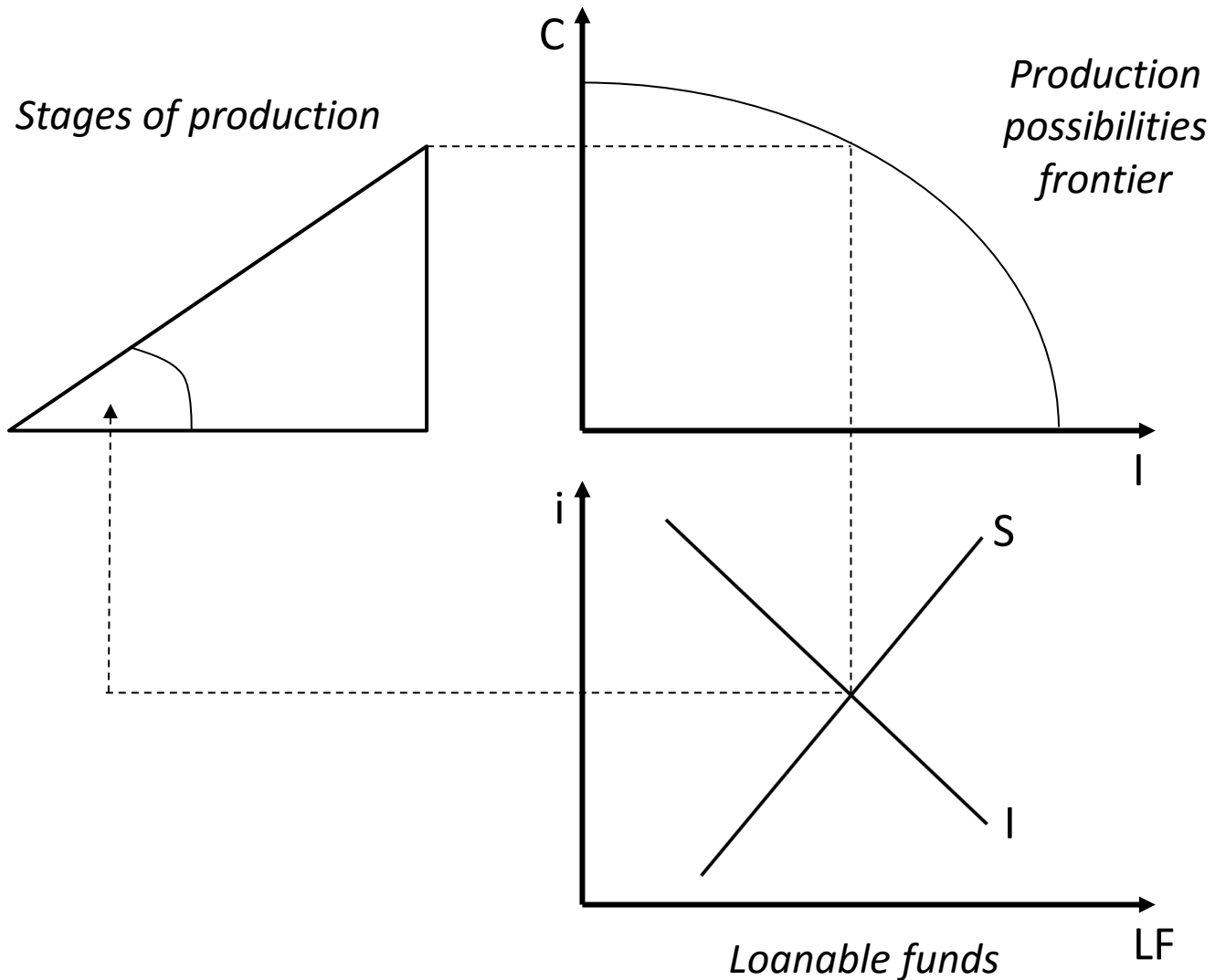
- » Saving up for something: Future demand, not a leakage
- » Derived-demand and discount effect



- Investment: Stage pattern matters (not volume alone)

⇒ Entrepreneurial challenge: bringing capital structure in line with pure time preference (intertemporal arbitrage)

Capital-based macroeconomic framework (Garrison)



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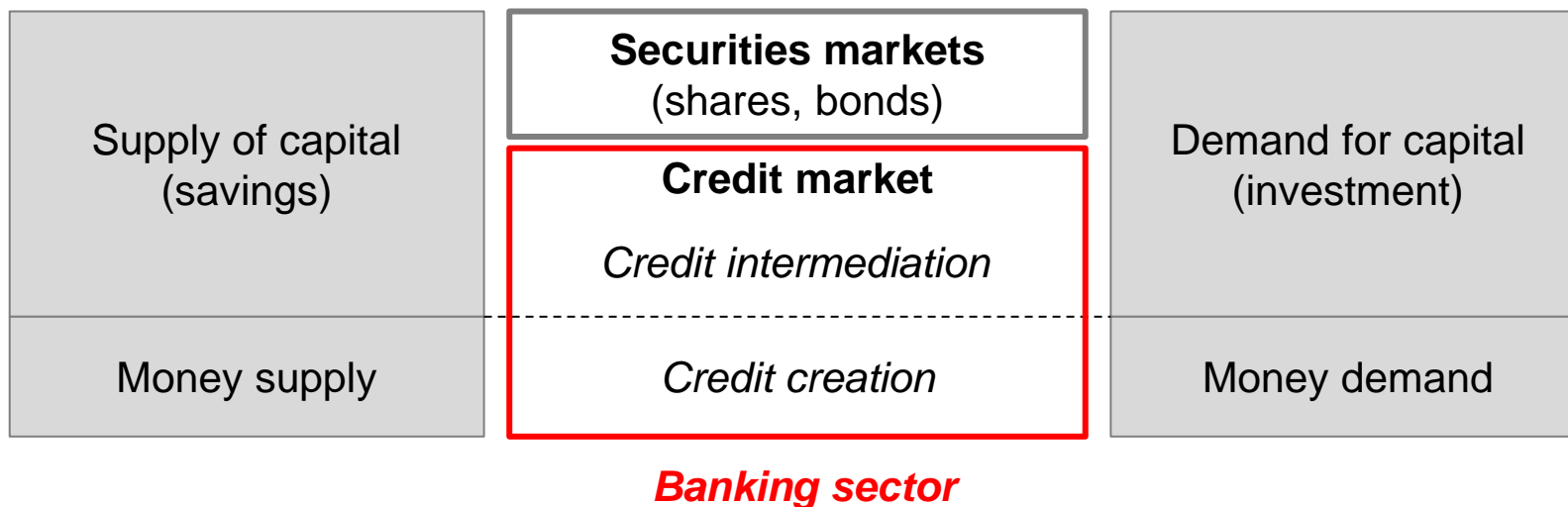
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- Financial crisis
 - » Flipside of capital stock distortion
 - » Systematic investment failures due to excessive credit creation

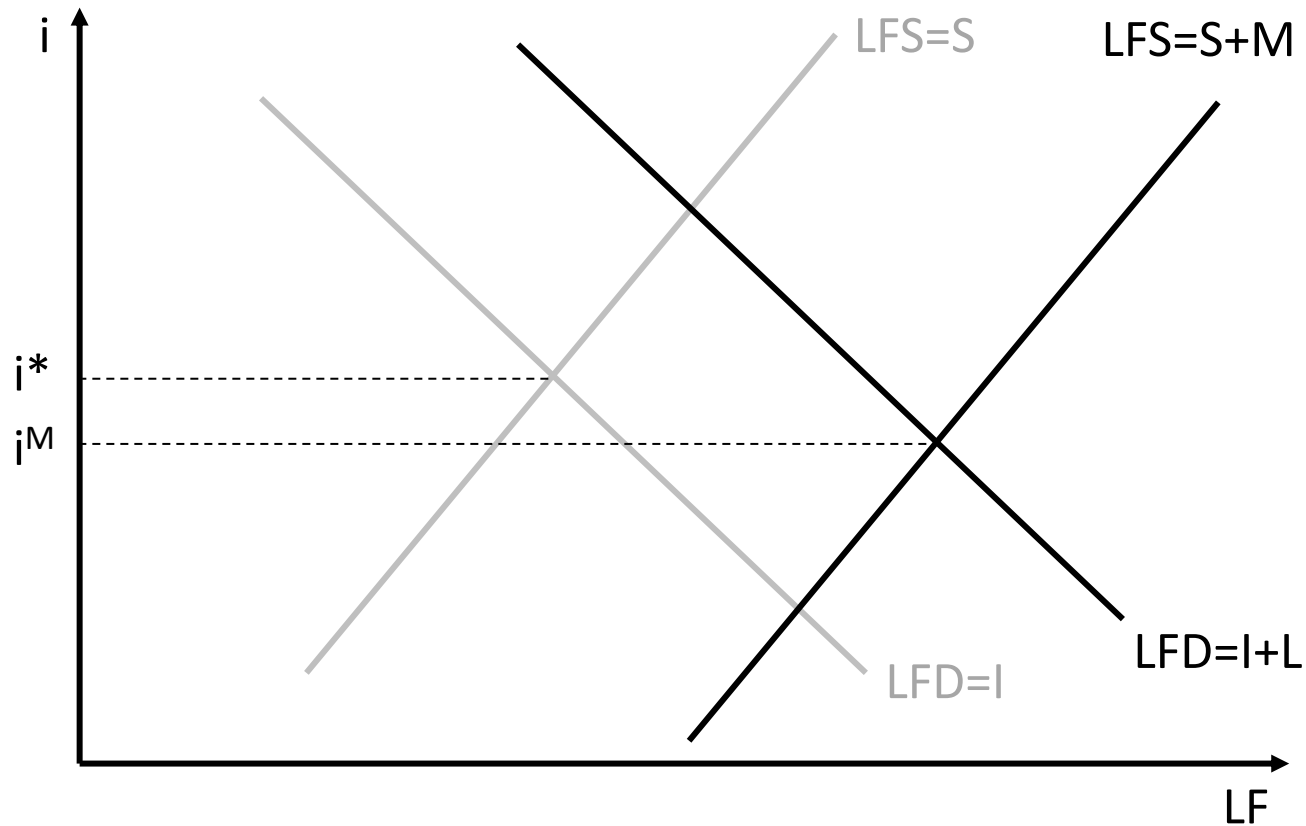
- Non-neutrality of money
 - » Cantillon effects
 - » “Capital gives money time to cause trouble” (Garrison)

- Monetary policy
 - » Interest rate: Key economic variable in the capitalist system manipulated by central banks

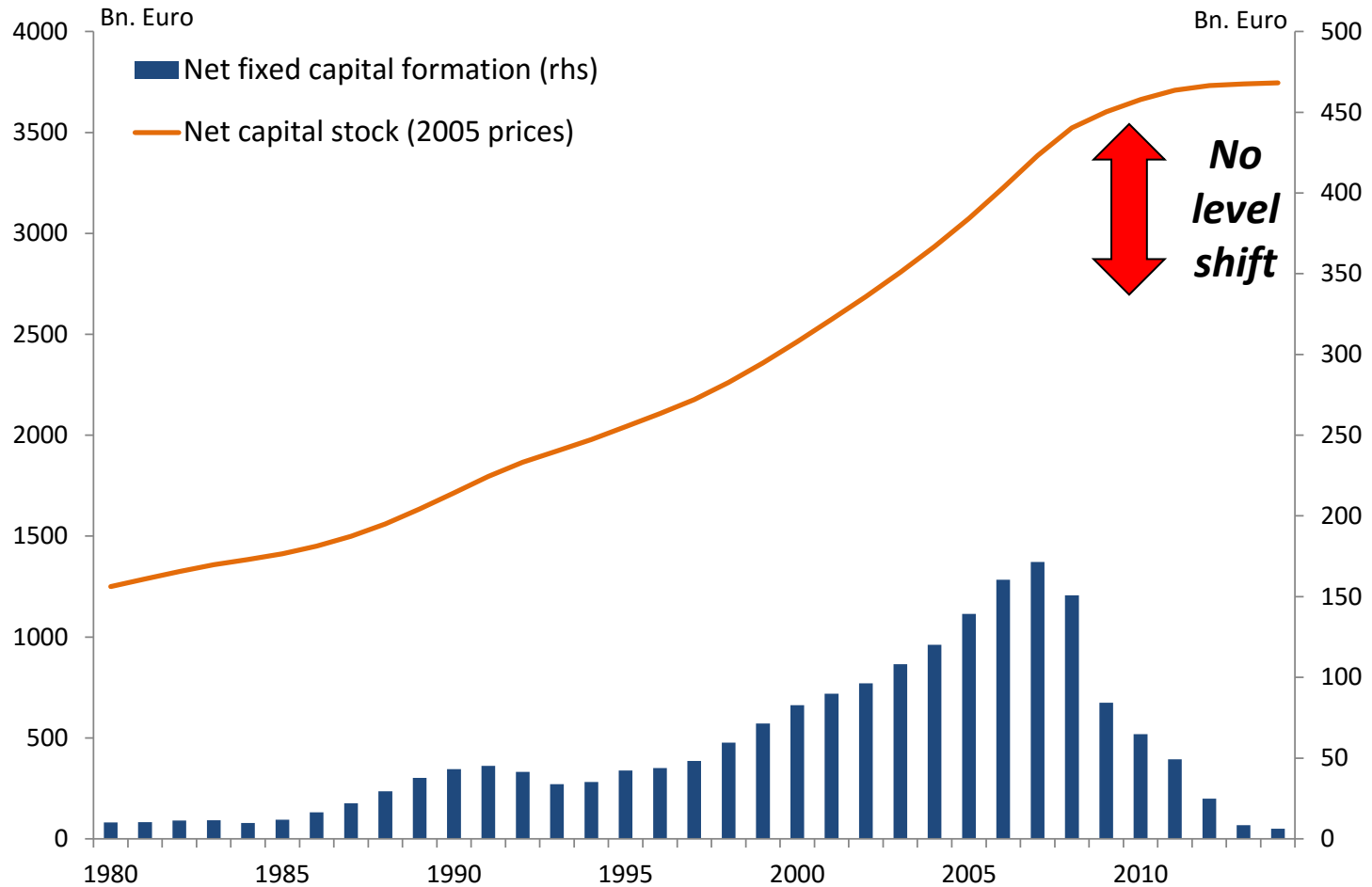
- Credit creation vs. credit intermediation
 - » Forced savings vs. voluntary savings



Interest rate and monetary policy

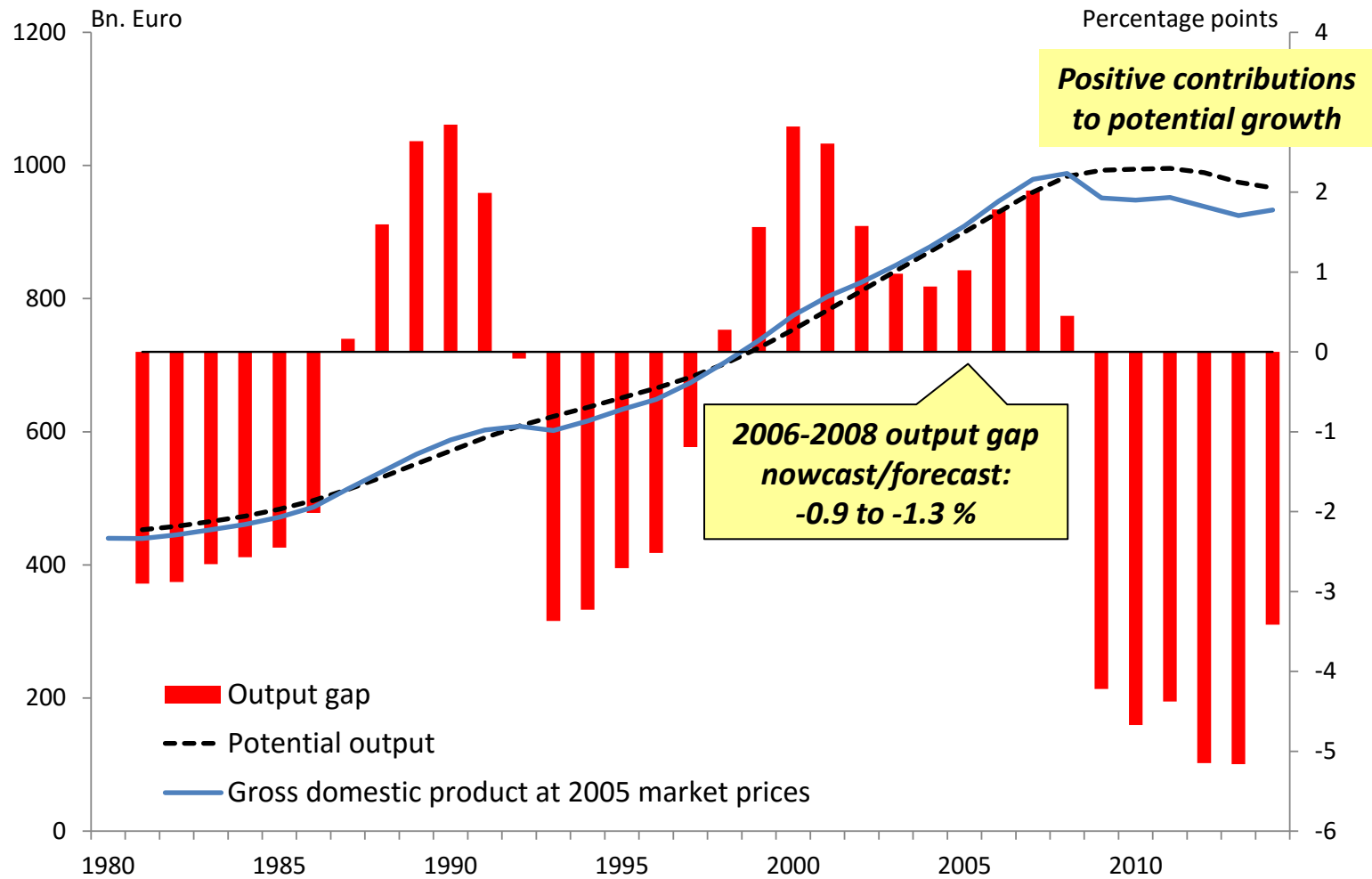


Value of the Spanish capital stock?



Source: AMECO Database.

Spain: Invisible “ghost estates”



Source: European Commission, AMECO and CIRCA databases.

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- Natural sciences vs. social sciences
- Principle of causality
- Praxeology
 - » Science of human action
 - » Aprioristic (motives for human action cannot be observed)
 - » Deductive approach
- Economics
 - » Division of labor and social cooperation
 - » not „*Volkswirtschaftslehre*“ or „*Nationalökonomik*“
- Theory vs. history

- Potential production/output gap estimations
 - » Disaggregated approaches (marketable production possibilities)
 - » Market revaluations compared to national accounting data
- Capital stock distortions as flipside of financial crisis
 - » Repairing intertemporal coordination problems
 - » New light on “austerity” debate
- The global monetary system
 - » Scenario of globalizing monetary policy (multilateral swap agreements)
 - » Global money and free banking 2.0
- International macroeconomic imbalances
 - » Imbalance \neq disequilibrium
 - » Current account vs. financial account (capital vs. trade flows)

- Global macroeconomic imbalances: The savings glut debate
 - » Negative natural interest rates ahead?
 - » Need for more public debt to fill the global “investment gap”?
- Global business cycle and regional/national impact
 - » Top/down: Economic activity within countries derived from global dynamics
 - » National specialization and impact of capital restructuring
- Global division of labor and international trade:
 - » What about unilateral free trade?
- Social cohesion
 - » Harmony of interest between rich and poor and between capitalists and wage-earners under free markets?

- Peace, economic freedom, and the welfare state
 - » Is interventionism a source of social conflict?

- Profit motive, wealth, and inequality
 - » Is individual success in the free market a cause of anyone's impoverishment?

- Radical reform proposals and pattern prediction
 - » Refuting socialism in the absence of self-declared socialist regimes without apriorism?

- Key research and policy question:
Evidence for hampered market coordination processes?
 - » Coordination efficiency vs. macroeconomic management
 - » Important role of intertemporal coordination (capital and interest)
 - » Path-dependency of economic activity via capital allocation

- Beyond the demand-side vs. supply-side controversy
 - » Coordinationist macroeconomics is not a cheerleader for growth
 - » Intermediary step to linking macroeconomics and well-being
 - Overcoming the production-biased view
(production serves consumption, not vice versa)
 - Putting consumers/households back in the center
 - Value theory remains key pillar
(whether preferences are exogenous or endogenous)

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