Why the Austrians Are Wrong about Depressions

Gordon Tullock

For many years, I have been critical of the Austrian theory of depressions and this led Walter Block to ask me to put my criticisms in print. Since in oral discussions, I am frequently accused of misrepresenting the theory, I asked him to give me a canonical version and he gave me the Rothbard pamphlet, "Economic Depressions: Causes and Cures."[1]

The pamphlet begins by presenting a Ricardian theory which is, of course, the foundation not only of the Austrian theory, but of most modern monetarist work. Rothbard, as I, thinks the Ricardian theory a major step forward, but incomplete. Our differences concern what should be added on to that theory. I shall not here attempt to derive a correct theory of depressions, but simply explain why I feel that the Austrian theory is not a serious contender for that honor.

Before turning to my main criticism, however, I would like to pick three nits. First, Rothbard never explains why the inflation that is part of his theory cannot simply be continued or even accelerated. I understand why Mises without our modern experience thought that it was impossible, but anyone familiar with the present world must realize that inflations can, at least, continue for very long periods of time and reach very high levels of monetary depreciation. As a personal item, I have lived through three hyperinflations and can testify that it is undeniably unpleasant, but not really a disaster.[2] It's the flu, not pneumonia.

The second nit has to do with Rothbard's apparent belief that business people never learn. One would think that business people might be misled in the first couple of runs of the Rothbard cycle and not anticipate that the low interest rate will later be raised. That they would continue unable to figure this out, however, seems unlikely. Normally, Rothbard and the other Austrians argue that entrepreneurs are well informed and make correct judgments. At the very least, one would assume that a well-informed business person interested in important matters concerned with the business would read Mises and Rothbard and, hence, anticipate the government's action.

My third nit deals with Rothbard's apparent belief that the depression and booms are cyclical. There are statistical tests that will detect cycles if they exist and these have been applied to the historic data. The result of the tests is a random walk rather than a cycle. Since Rothbard urges as one of the strong points of his theory explaining the cyclical nature of depressions and booms, this statistical finding would seem to be of considerable importance to him.

These are nits and not my major objection. My major objection, putting it quite bluntly, is that if the process that Rothbard describes did occur, there would be many corporate bankruptcies and business people jumping out of the windows of office buildings, but there would be only minor transitional unemployment. In fact, measured GNP would be higher as a result.

Suppose, then, the government forces down the rate of interest:

> For business men, seeing the rate of interest fall, react as they always would and must to such a change of market signals: they invest more in capital and producer's goods. Investments, particularly in lengthy and time consuming projects, which previously looked unprofitable now seem profitable, because of the fall of the interest charge. In short, businessmen react as they would react if savings had *genuinely* increased.[3]

This passage deserves a little analysis. First, it should be noted that if the business people are now building more factories than they were before, which is what Rothbard says, then, in fact, savings that are available for building factories must have increased. In fact, they have. What has happened is that the government by inflationary measures is transferring a certain amount of money from the general citizenry into the investment accounts and, hence, the money for building these additional factories is made available.

The second point that must be emphasized is his argument that investments in "lengthy and time consuming projects" are made. It should be noted here that Rothbard may possibly be confused by the Austrian theory of capital which involves a waiting time theory. In fact, most manufacturing processes take relatively little time. There are, of course, exceptions—building ships, large buildings, wine (if anyone is determined to let it reach its maximum market value), etc.—but mostly what takes the time is building the factory, not the actual production once the factory is completed. Austrians are quite correct in referring to this as a roundabout method of production, but one should not believe that because Henry Ford, shall we say, paid immense amounts of money in the 1920s mechanizing his factory, it actually took a long time for iron ore entering the River Rouge plant to be turned into a model T. The roundaboutness was building the steel mill and the assembly line and then depreciating it.

This matter is of some importance because the interest rate is of great

significance in deciding whether or not to build a new factory, buy an expensive machine, etc., but of very little significance in deciding how much to produce in an existing factory. In my own experience as member of the board of directors of a small company, we frequently discuss interest rates at great length when we are considering capital expenditures. I cannot recall the interest rate even being mentioned in any of our discussions of production matters.

Let us assume with Rothbard that, after a while, the government finds itself unable to keep the interest rate low and its shoots up again. Business people, to quote Rothbard, "had overinvested in capital goods and underinvested in consumer products."[4] I am not positive exactly how business people invest in consumer products. Walter Bloch suggests that this phrase "refers not only to retail inventories, but also to actual manufacture and also promotion of items of final consumption."[5] I shall accept that interpretation for what follows.

For our analysis, we shall assume that the interest rate which should have been 5 percent had been forced down to 3 percent although that seems a rather large cut granted the generally quite feeble instruments that governments have for lowering the interest rate. If they have not anticipated the later rise, some businesses will clearly go bankrupt, but let us go through a number of different possible situations.

First, a good deal of the productive capital will in fact have been inherited from the period before the government began to drive interest rates down. This is particularly true with such things as buildings and ships which are long and hard to produce, but it will also be true with much other equipment.[6] There is no reason why this machinery should be particularly damaged by what has happened, nor is there any reason to believe that there is too much of it under the current circumstances.

The second issue would be those new capital investments made during the period of the artificially depressed interest rate and that have been completed. Let us for this purpose consider only those capital investments that have been made in industries that produce consumer goods and leave the investments in industries producing capital goods until later.

Clearly, the businesspeople who made these investments will lose money; some of them will go into bankruptcy. But this is a sunk cost. There is no reason why this equipment should stop being used. Indeed, there is now more equipment of this sort than there would have been had the government not depressed the interest rate. Thus, the demand for labor to work with it will be higher than it would have been had these investments not been made.[7] What happens is that the products of these industries would have to be sold at a price that covered their operating cost but not their capital cost.

Bankruptcies again would occur, but we would anticipate that as a result of this additional capital equipment and additional production—together

with the fact that the material has to be sold at a price that does not cover capital cost (hence, a lower price than had originally been planned)—there should be higher living standards.

We must now consider those factories (factories designed for consumer products) that have not yet been finished when the interest rate rises. Whatever has already been built is once again a sunk cost, a cost that should be ignored in deciding whether or not the machinery or factory should be finished. Thus, if the interest rate went from 3 to 5 percent, most factories that are more than about 40 percent finished would still be completed. The same rule would apply to those special machines that take a long time to build. Once again, bankruptcies and loss of money would be expected, but the additional investment necessary to complete the machinery or the factory would be capable of paying 5 percent.[8]

Rothbard apparently believes that the 1920s was a long period of artificially depressed interest rates.[9] The overwhelming bulk of all capital investment caused by those low interest rates would have been completed by 1929 or, at least, brought close enough to completion so that even under the higher interest rates, finishing it off would be a profitable operation. The number of factories, apartment buildings, ships, etc. left incomplete because the operation had not gotten far enough along so that it was still profitable to complete them, would have been a fairly small part of the total new equipment acquired in the 1920s. Thus, once again, one would anticipate higher living standards and high employment.

But there would be those factories and machine tools that were less than 40 percent completed and, hence, for which production stopped. This brings us to the producer goods industries. The first thing to be said here is that the producer goods industries are always a fairly small part of the economy. In that small part, however, undeniably a Rothbard, Austrian type of depression would cause a cutback in production and laying off of personnel. Many factories, apartment buildings, and machine tools would be far enough along so that their completion would still be sensible with the new interest rates, and the cutback would not be total, but nevertheless it would be painful.

Note that new investment in equipment for the capital goods industries benefits from much the same effects as the new equipment investments anywhere else. That is, the equipment or factory that had been completed would now be available for production whenever prices rose above the current operating cost. Once again, an outburst of bankruptcies would be anticipated.

That producer goods industries are highly unstable, with booms and depressions that are much more severe than for the rest of the economy, is very well known.[10] Certainly, everybody in those industries knows it. If people in the capital goods industries failed to make their plans for the contingency of a very severe depression, one would be most surprised.[11] Under the circumstances, one might anticipate difficulties in these industries, but one

would also assume that everybody in such industries realized that it was a temporary phenomenon and it was only a question of sitting on your hands for a while. Further, one would also assume that the bulk of them had taken precautions against such readily predictable contingencies. After all, these industries are well known to be extremely unstable, and one would assume that both capitalists and skilled laborers who invest in acquiring a position in the industry would have done so with full knowledge of the situation.

The end result of all of this is that we would anticipate that in an Austrian-style depression, there would be a good deal of unemployment in the capital goods industries, but this is, after all, a small part of the total industrial picture. Of course, such industries would not be able to buy as much in the way of consumer goods as they would otherwise, and this would add to the fall in prices which would have to be absorbed by other industries. Indeed, it would increase the bankruptcy rate. Because of the size of the capital goods industries compared to the rest of the economy, however, the forcing down of prices in other industries made necessary by this unemployment would once again cause bankruptcies but not unemployment.

Consider another way of stimulating investment. Suppose that the government taxed consumer goods and used the money to subsidize investment. Suppose further that after a while, it stopped the subsidy. This is not good policy, but the net effect would be that production after the end of the subsidy would be higher than if no such subsidy had been offered. Indeed, we have a sort of example in the farm program. Among the many effects of this bit of government mismanagement, there has been an increase in farm capital above what would have occurred without the program. If the program were terminated tomorrow, there would be bankruptcies among farm owners, but both *hired* labor and consumers would benefit.

Looked at from the standpoint of ordinary employees in a nonproducer goods industry, the Austrian cycle would mean that their living standard was artificially depressed during the boom period, because funds that they would prefer to spend on consumption were being diverted to investment. During the depression however, their living standard would benefit, first, because with more capital goods, the demand for complementary services (mainly labor) is greater than it otherwise would be and, second, because prices for consumer goods are lower. Laborers would be exploiting the capitalists.

Notes

1. Although "Economic Depressions: Causes and Cures" appears on the cover of the pamphlet, the title page gives *Depressions: Their Cause and Cure.* Whatever the title, it is published by Constitutional Alliance, Inc., Lansing, Mich. (no date).

2. I was personally somewhat protected from them since I was an American diplomatic official.

3. Rothbard, p. 21.

4. P. 22.

5. Letter of 5 Jan., 1987.

6. The factory that I am associated with in Iowa is still using some machinery which is over twenty-five years old. This is probably typical.

7. Leftists might disagree. Capital-induced unemployment through labor-saving machines is part of their orthodoxy.

8. Under modern circumstances, prefabricated factory buildings do not really take very long to erect. Nor is the manufacture of most production equipment a long process. The roundaboutness of investment occurs in the depreciation.

9. Probably the largest single government action lowering interest rates was the rapid retirement of a sizable fraction of the war debt. For some reason, Austrians never mention it.

10. As a child in the machine tool center of Rockford, Illinois, who remembers the Great Depression, I can testify to this.

11. Here again, Rothbard appears to believe that one of the advantages of the Austrian theory of depressions is that it explains why the producer goods industries suffer more in depressions than other industries (p. 25). It does, but so far as I know, so do all other theories of depression except those highly abstract theories that do not look at interindustry impact. In any event, why they are particularly depressed in depressions and particularly booming in boom times is fairly obvious.