Reply to Comment by Joseph T. Salerno

Gordon Tullock

The outstanding characteristic of the comment on which I comment is that we agree on the basic issue. My point was that the mechanism described by the Austrians would lead, not to unemployment, but to a shortage of labor and higher wages than would be justified without all of this additional capital in the market.

Professor Salerno refers to "higher prices for the services of labor and of the other relatively nonspecific inputs or 'convertible' capital goods." This is in complete accord with my view that the Austrian theory would tighten the labor market. It would increase bankruptcies and suicides by brokers, occasionally lead to incomplete factories, and cause a certain amount of transitional unemployment, particularly in the capital-goods industries, but it could not create the kind of massive unemployment we saw in 1929–33, 1937, or the only depression that he mentions, 1980–82.[1] Massive unemployment is what people mainly complain about with respect to depressions and, indeed, is usually regarded as the principle indicator of the depression. Ignoring it seems odd.

Apparently the Austrians use the word *depression* for something other than what ordinary people use it for. My critic says the business cycle is "a recurring qualitative sequence of abstract economic phenomena that can only be detected in the historical data by the application of theory." Thus, the word *depression* when used by the Austrians has a unique meaning. There is no reason why, of course, the Austrians should not use a special definition of a word, but they really should warn us.

Professor Salerno seems to be denouncing me for employing the word *depression* in the ordinary meaning rather than in the specialized Austrian usage. I regret to say that I must use it in this form because, to put it bluntly, I do not know the specialized Austrian meaning. The standard meaning of the word *depression* is a situation in which general conditions are very bad and, most importantly, there is very high unemployment.

Possibly we can compose our differences by agreeing that the Austrian theory of depressions does not help understanding what the ordinary citizen thinks of as depressions. It explains the Austrian-style "depression," which is (as Salerno quotes Mises) a "wavy outline of a cycle in the tangled confusion of events."

But, judging by Salerno's article, apparently there is at least one case in which the Austrian "depression" and the depression in its usual meaning coincide: the 1980–82 U.S. depression. Salerno and I agree that it was caused proximately by the Volcker Fed disinflating the economy.[2] Both of us would also agree that the previous inflation motivated Volcker to disinflate. I do not know whether he would agree with me that President Carter probably would have had a better chance of winning the 1980 election if this decision had not been made. Of course, not having had a previous inflation would also have been politically helpful.

I think that the decision to stop the inflation was politically rather than economically motivated. That seems to be my commentator's view also. Salerno refers to "highly unpopular double-digit inflation levels." There was no economic crisis in 1979 that required immediate action. Indeed, many countries have for long periods of time maintained rates of inflation that high or higher. Italy, of course, is a flourishing economy that has been operating with inflation rates like the United States experienced during the Carter years for quite a long time now.

Apparently Professor Salerno somehow feels that the malinvestment, after first increasing the demand for labor, puts the society in a situation where so much labor cannot be employed. This, in turn, seems to depend on a rather odd pattern of investment during the boom. There would not be more McDonald's going up. Instead there would be more research and capital investment in plants for making McDonald's eventually. Surely this is false. If the interest rate has been forced down and businessmen make the Austrian mistake of not realizing this is temporary,[3] the rate of growth of the capital-producing industry presumably would be higher than the rate of growth of the fixed-capital–using industries like McDonald's. Both should, however, grow. To quote a phrase much used in another connection: "A rising tide lifts all boats." The ratio of capital to labor in the consumer-goods industries would be higher.

In the original article, I used the analogy of a government that used tax money to subsidize investment and then suddenly stopped. I think this policy would be unwise. I do not think it would cause more than a little transitional unemployment, particularly in the capital-goods industry. It would be hard on the capitalist who had half-completed factories, but the additional capital would actually raise wages.

The Austrians and I agree on two things: neither of us likes inflation and neither likes depressions. Indeed, for the 1980–82 depression, both of us are monetarists and believe lowering the derivative of the money supply was the proximate cause. Historically, the lowering of the derivative of the money supply has not infrequently occurred as stabilization after a period of inflation. It has, however, on occasion occurred without such inflation and on other occasions after inflation that was not caused by the government. It should be kept in mind that history's first inflation occurred during the reign of Alexander the Great and was a gold inflation.[4]

The basic flaw in the Austrian's line of reasoning as I see it is the desire to argue that the inflation that they object to is the actual cause of the subsequent contraction. In a way, it becomes a moral tale. The wickedness of inflation carries a punishment, albeit the punishment falls more heavily on private citizens than on the government that caused it.

I would not deny that inflation is "wicked," but its main costs are the reductions in efficiency of the economy while the inflation is going on. It is possible to get out of an inflation without a depression. In fact, the more severe the inflation, the easier. It is also possible to have the reduction in the first derivative of the money supply without a preexisting inflation. It can go from zero to a negative number. Indeed, I would say that the 1929–33 experience was an example although I know that Rothbard argues that the 1920s was an inflationary period.

Depressions have been caused by many things. The termination of an inflation can cause a depression, but contraction of the money supply after a period of stability is at least equally dangerous. Frequently there are sins, either of omission or commission by governments, that either cause or aggravate depressions. Inflation is a "sin" that in the present-day world is normally the fault of government. It is inefficient, but its only connection with depressions is that incompetent governments may cause a depression while ineptly trying to stop it.

Notes

1. I follow the usual convention of using the term *depression* for only the down side of the trough.
2. This does not prove that Volcker is a monetarist.
3. Salerno does not answer this particular nit, but simply suggests I do wide reading.
4. Alexander spent the Persian emperor's gold reserve.