Episode 619: Rothbard's Depression Analysis: More Relevant Than Ever

Guest: Antony Mueller

WOODS: We're talking today about an article of yours and I'm linking to it at TomWoods.com/619, which is the show notes page for today, and it's about how Rothbard's depression theory is more relevant than ever. Now, I have talked quite a bit on this show about Austrian business cycle theory, which is more or less Rothbard's theory, and oftentimes the guests and I just kind of take for granted that the listeners already know what Austrian business cycle theory is, but that's probably not the best approach for us to have taken. So why don't we at least begin this conversation with at least a basic overview of what is it that makes Rothbard so different from other economists, is the way he looked at the causes and cures of depressions.

MUELLER: Well the major difference and the deep difference is that Rothbard and the Austrians have a strong laissez-faire position. They say — and this is sometimes hard to convey to most people — that the best way to deal when a recession begins is simply to start nothing. While nowadays, since the Great Depression is different from the myth that there was no intervention, we have an interventionist tradition and as soon as the slightest signal appears, there could be an economic downturn, we hear all kinds of measures that need to be taken to prevent a deeper downturn. In fact, these activities have more prolonged, or deepened the recessions, and the last one since 2008 is an example of that. Now when we try to explain the Rothbardian or the Austrian approach, this is very difficult to say, well, we just do nothing. Why shouldn't we do nothing? That's the big problem because, I mean, when there's a problem it's always easy, what do we have to do? Now, when someone says — it's like in medicine, when some doctor says, well, it's best to do nothing, that needs more explanation than those that are in favor of an active policy.

WOODS: Right.

MUELLER: Now, in this respect my paper's a contribution, why we shouldn't do anything.

WOODS: All right, so what would be then — of the things that people might propose that we would do, let's list those and then think about what it is, what would be the main reason that Rothbard would say that every one of them would be a bad idea. And then we can talk about your own particular contributions here. So for example, fiscal and monetary stimulus are often recommended. What's wrong with those approaches? It seems like what we need is another burst of economic activity, and surely these forms of stimulus would give us that activity. What's wrong with that?

MUELLER: Well, let's put it in simple terms and compare a recession as a signal for the economy that the capital structure is moving in the wrong way. Let's compare to a person who is going on some way to some place, and then after a short distance he notes that he has gone the wrong way. The right reaction is now to go back and choose the right way. And this is symbolic of what happens in recessions, fluctuations; the entrepreneurs notice, or those that are in certain areas, that represent wrong investments, that they have to move back, and this of course has elements of a recession to stop investment, to reconsider investment, and so on.

Now, let's assume this person now gets all kinds of incentives in this way from the government to move on. Well you can move on this way, go on this way. The truth is that by this impulse, by this stimuli to move in to the wrong direction, the misstructure of the economy increases and is not being recused. Of course, as long as let's say the person moves on, the economy moves on, there is economic activity. There is employment and so on. Yeah, but we are doing the wrong things, and that is the point of the Rothbardian approach that I would like to bring over which usually is not very much discussed in this kind of way, why shouldn't we do anything?

WOODS: Well, let me take a minute, if you wouldn't mind, to give an analogy that I recently used on an episode of the other podcast I do, *Contra Krugman*. Just to make sure people understand what we mean when we say that something is unsustainable or we're doing the wrong thing. Mises gives this wonderful allegory of the master builder who's building some home or something according to a blueprint that would require more physical resources than actually exist. So if he continues building according to this blueprint he's just making more and more errors. He's pouring time and resources into something that can never be finished.

And the analogy to the economy is that entrepreneurs have been misled by the central bank's intervention into thinking that more investment projects are possible to be completed than can possibly be completed. So yes, we can stimulate further activity in that direction but we don't want to go in that direction, the same way we don't want the master builder to continue going in his direction according to that blueprint. The blueprint is faulty. He shouldn't be building according to that blueprint. So that's what we mean when we say we're doing the wrong thing, we're on the wrong path. So yes, obviously we could stimulate activity but activity in the abstract is not what we want. We want productive activity in the interest of producing according to consumer preferences and resource availability. Have I got it?

MUELLER: Yes. We want to do the right thing, and we want to have an economic structure that is working in the long run, that is sustainable, as one can say. There is one additional aspect to this, that at least for me, took some time to find out reading also Rothbard's *Man, Economy and State*. The function of the capitalist in his view is not just the entrepreneurial function that we were talking about, but also the function of the capitalist. The function of the capitalist is to maintain this immense capital structure.

Now, to maintain this capital structure we need resources. A simple way to name this is savings. Our savings depend on our production by itself. Now, the point to note is that we can overextend the capital structure so that the savings we have available are not sufficient to maintain this extended structure. I always use another example to make this clear to the layperson. Let's say we have a normal income, we're normal guys, regular guys. And we have a super rich uncle who gives us a Ferrari. Now, at the first moment, that is a great thing. We are rich, so to speak; we feel wealthy; we can impress everybody. But now comes the point, can we maintain? Now, a Ferrari for one is not a capital good, but just to compare, we just aren't rich enough to maintain an item such as a Ferrari, because only the regular repair costs a fortune.

And this happens all of the time in the economies, particularly — and that's maybe why I hit on that because I live in Brazil — in the poorer economies, where it's more obvious to see, like Brazil, Argentina or some other semi or emerging economy, where large government projects are launched to develop the country, to create infrastructure. And then one notices they cannot maintain it. The saving is just not enough, because spending, as the Keynesians say, of course spending creates sharps, creates economic activity. But spending has all of the other effects that we all know. Every spending is also cost. When I spend something I have costs, and when I spend too much I have too much costs, and when I produce, let's say, a house — let's say this example of Mises with the master builder — it's like a person with a regular income would just get a house that is too large for him or her to maintain. That is the main point, and it fits very well, and that's why I have created this model. This fits perfectly well with the so-called neoclassical growth model. That's the interesting point to bring it over to the mainstream, so to speak.

WOODS: Okay so here's where I'd like you in layman's terms and as simply as possible to explain for us the basic neoclassical growth model. And then let's see how it can possibly be fit together with the Austrian view of the business cycle.

MUELLER: This model goes back to the '50s, and its elements basically are that the output is characterized with an economy by diminishing marginal returns, and only technical progress can make economic growth continue. Now, when we look away from technical growth, because it does not even happen all of the time — there are periods especially in developing countries where there is not much technical progress going on. They have to import know-how and so on. Now, with this output, our income is determined, and our income determines the savings we can generate.

However, as the output is subject to diminishing marginal returns, the costs of capital maintenance are linear. They continue more or less with the same margin. They do not return. They do not diminish and probably also not increase so we can say they are linear. So there's a point where more capital that we invest renders less income, but to maintain this additional capital we have to use as much resources to maintain as before. And this is the collapse between the return and the costs.

Let's put it this way, also an example: a carriage and a horse. So you have the capital, which is the horse and one person. And then you put on two horses or three horses or four horses, and one notes that with each horse we have an additional output, but each additional horse will contribute less to the production. And if you mention that we have six horses in front of a small cart, so we can see that this sixth horse will produce relatively little, but this sixth or fifth or seventh horse costs as much to maintain as the first and the second that are very productive. They need the same food; they need the same attainment. So there you have a clash and you rarely see a carriage with four or five horses. Lets say it's a small carriage, so there's a relationship between capital and production and maintenance of this capital. That is the point that I want to bring over.

And this is mainstream in this respect for the neoclassical growth theory, and it fits perfectly well to what Rothbard said, because he said we have to reduce capital, we have to liquidate capital, which always is cited as a joke, as you know, in the popular press or by Krugman and so on, so we are the liquidationists that want to liquidate capital. But what is it, what does it mean? It means we have too many horses.

WOODS: Right. That's a good analogy, too many horses leading a carriage leading a carriage. You don't want to have six horses. They're consuming too much, and you don't even need six horses to do the job.

MUELLER: Yes, exactly.

WOODS: Very interesting analogy. All right so TomWoods.com/619 is going to have that, and you've got a full graphical representation, and it will be useful also I think for the many college students I have who listen in and who are taking economics in school and who are going to be encountering a lot of the concepts you just talked about —

MUELLER: That would be great to have this audience. That's the main point I want to bring over to this group of people.

WOODS: Yeah, so they can see how there can be an Austrian take on what it is that they're — they're not just learning stuff that's completely preposterous and can't be — I mean, this is a way that we can speak to the mainstream. Is that the way you were thinking about it?

MUELLER: Yes, that is the main objective. I think it is very important and the time is really ripe nowadays, because we have made great advancement in the Austrian school, and the mainstream is more open for alternative use. And of course your show is extremely helpful because of the audience that includes many students, particularly in the area of the social sciences and economics.

WOODS: Before I let you go, I do want to ask you, even though we did talk about Brazil some time ago, if you could just say a little something about Brazil, because for a long time Brazil, whether you know it or not, in the rest of the world, Brazil was being held up as a wonderful example of a prospering economy that had a healthy — and by healthy they mean large — public sector. And this goes to show that stupid idiots like me are all wrong because look at the great success that Brazil is having. What is the real truth of that?

MUELLER: Well, actually Brazil is a good case for this model. You have this large sector, you have many public investments, and Brazil has always tried to industrialize and to have a huge infrastructure, but there have always been setbacks, grave setbacks, terrible setbacks. This happened, for example, in the '80s, and a similar episode happened in the recent time when the new government came in to power in early 2000 and had again this prospect of now we are overtaking Great Britain — that was really the talk — with huge investments and by a strange idea that is even stranger when we think about the Rothbardian model, because here they have the dominance of the post-Keynesians, while in the rest of the world they're more in the new Keynesians. In power here are the post-Keynesians that also believe that one can, let's say, grow the economy through consumption. So there was a gigantic consumption splurge initiated by the public sector.

WOODS: And how would you describe the condition of Brazil right now? Here we're talking in early 2016.

MUELLER: Well, there is also a political crisis, because with this huge public sector, which has companies, a lot of public companies, there is a bonanza for corruption, and now a new generation has grown up with that in the legal departments and so on that seem not to accept that anymore, and there are severe investigations in the corruption scandal and the impeachment process against the current president. So these are also political facts, but ironically, somewhat ironically I would say, as the Brazilian economy tanks right now in a severe way, we simply see the result of the policies that were implemented before the current recession. But it can also be a very interesting experiment because of the political mess right now, the government is pretty paralyzed and largely unable to implement new government programs against the recession. So by a strange coincident, the government is practically forced to do nothing, to have a hands-off approach. So we have two very interesting experiments right now going on, and that the Brazilian economy was on the wrong path could easily be seen by the Austrians already for or five years ago.

WOODS: Well, it will be interesting obviously to see what happens in the future and for that obviously I'm going to turn to you, because I — no, I guess I do know some people in Brazil, but none quite as well as you, so I'm glad to get a little bit of confirmation of what I suspected was going on in Brazil and also to talk a little bit about your article on Rothbard business cycle theory and the mainstream. Again, this is all available at TomWoods.com/619. Well, Professor Mueller, I appreciate your time today and perhaps we'll talk to you again one of these days soon.

MUELLER: Thank you very much, Tom, was a pleasure.