THE FREEMAN
IDEAS ON LIBERTY

Thinking Carefully About Macroeconomics

by Steven Horwitz

Most people who believe in a free society have some knowledge of economics. After all, the case for economic freedom is usually the most difficult one to argue, and if one is going to defend the idea of freedom, one must be prepared to discuss economic issues. However, this strategy can sometimes face two differing problems.

The first is that economics is not a homogeneous entity—there are different schools of thought with different approaches to the subject matter and different policy conclusions that emerge from these approaches. Knowing some economics isn't enough. One must be careful about what it is one knows and what economics others might know. This point by itself suggests those who wish to make the case for the market need to be as aware as they can be about developments in economic theory and policy.

Even beyond the issue of policy, a second complication comes into play. There are a number of different theoretical arguments for the free market. It would be easy to simply dismiss these differences as irrelevant, since all seem to wind up with the same conclusion. However, some of those arguments may be better than others, and some may be more convincing to particular audiences. Here, too, it pays for defenders of the market to be as informed as possible about these differences and the various arguments each group presents.

What I would like to do in this essay is to lay out the Austrian school's approach to some fundamental issues in macroeconomics, and, in so doing, address both of the issues noted above: how does this approach differ from more interventionist schools of thought, and how does it differ from other market-oriented approaches?

Macroeconomics and Microeconomics

One of the issues that spans both of these questions is the relationship between macroeconomics and microeconomics. Prior to John Maynard Keynes in the 1930s, there was not really a distinct system of analysis known as "macroeconomics" which was concerned with establishing direct causal relationships among aggregates such as inflation, unemployment, and gross domestic product (GDP). Keynes was interested in determining the "level of output as a whole," and he argued that economists before him had ignored this crucial question. A great deal of Keynesian economics from the 1930s to the 1960s was solely concerned with these macroeconomic aggregates, never asking what the relationship between them and the choices made by individual persons and firms in the economy might be.

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An important accomplishment of economics in the 1960s was to begin to ask precisely this kind of question. Milton Friedman's work, in particular, sought to explain inflation and unemployment more in terms of the choices made by individuals who were smart enough not to be fooled consistently by government policy. Later developments of those themes have extended the assumption of individual rationality to the point where individuals in many recent models cannot *ever* be fooled by systematic government policies. The work of the so-called New Classical economists, such as recent Nobel Prize winner Robert Lucas, was important in reminding economists that people do not behave the same way no matter what policies governments adopt. If governments inflate, for example, individuals will have an incentive to recognize that inflation and take steps to neutralize its effects on themselves and their families or firms.

As important as these contributions are, they remained the victim of one central flaw. They were couched in terms of more and more abstract models that assumed that observed macroeconomic outcomes had to be the result of perfect utility- and profit-maximizing behavior by individuals and firms. The central assumption was that the economy was in equilibrium and that observed macroeconomic outcomes had to be compatible with microeconomic equilibrium. The problem with this strategy is that first, the conditions necessary for equilibrium to hold never exist in the real world, and second, it suggests that major macroeconomic difficulties (such as 25 percent unemployment during the Great Depression) are just the result of optimal decisions by individuals. Although it concluded from this analysis that government policies will be unable to improve on market outcomes, this strategy does shift the analyst's focus away from the role that government intervention might play in *causing* those outcomes.

Of course the Keynesians did not sit still for these developments. They recognized and accepted many of the counterarguments made by Friedman and the New Classicals. However, the general strategy of the so-called New Keynesians was to point out that various informational limitations and rigidities inherent in real-world markets prevent markets from achieving the equilibria that the New Classical models were built upon. As a result, argued the New Keynesians, government intervention might improve upon the free market by virtue of government's supposedly superior information and ability to take advantage of those rigidities and push the economy closer to that equilibrium. So New Keynesians share many of the same underlying assumptions as the New Classicals, they simply believe that in some (if not many) cases markets alone are unable to reach the equilibrium that the New Classicals believe they can.

An Alternative Perspective on Macroeconomics

It might surprise people who know a little bit about Austrian economics to read an essay about why macroeconomics matters. Austrians are presumed to reject the whole concept of macroeconomics as being inconsistent with the individualism that has long defined their approach. To the extent that macroeconomics is understood as only being about the direct relationships among economic aggregates, then it would be wise to reject such an approach. However, all economists are still interested in explaining phenomena such as unemployment, inflation, and economic growth and their effects, so we do need some way of analyzing those issues. As noted earlier, a sound approach to macroeconomics would insist that such explanations (and the effects of changes in aggregates) have to be understood in terms of the microeconomic choices made by individuals and firms.

One alternative way to explore these issues is to reject the equilibrium orientation of the major mainstream schools of thought and see what difference that might make in the analysis. Specifically, where these schools see market prices as equilibrium signals to perfectly rational actors (they

simply differ on how well prices perform this function), we might, by contrast, see market prices as *disequilibrium* signals that guide imperfectly informed individuals about what to do and how well they do it. For example, if you assume markets are always in equilibrium, then any given price is fully reflective of all of the knowledge and preferences of market actors. If so, then whatever results is optimal. This is how an equilibrium-oriented macroeconomics can shrug its shoulders at 25 percent unemployment. It's an equilibrium outcome, hence it is optimal.

If, however, we argue that equilibrium never actually exists, then the existing prices of goods and services in the market are not perfect reflections of people's preferences and correct knowledge, but rather indicate the imperfect information conveyed by individuals making choices in a complex economy. Prices then have multiple roles in the market. First, prices help to inform market actors about what choices they *might* make next. Suppose I make t-shirts. In deciding how to make my product I would want to know the prices of my various options for raw materials and labor in order to decide how much labor, what kind of shirt material, and what kind of dye or screening process I might use. Prices help to inform these decisions. Second, after having made my choices about inputs, I sell (or can't sell) my t-shirts at some price in the market. After the fact, the difference between the price I receive for my output and the combined prices of my inputs (including time), tells me whether what I have *already done* was the right thing to do.

These roles of prices are perhaps obvious. But when one assumes equilibrium, only the first role is emphasized and even then prices are assumed to be the right prices from the start. If one starts by assuming markets are always in disequilibrium, a third role for prices emerges. Our first two roles assumed that we already knew that we wanted to make t-shirts and that therefore we had some perception that a market for such t-shirts existed. But what makes such realizations occur? As Israel Kirzner's work has long emphasized, this recognition of previously unseen opportunities is known as entrepreneurship and it is essential to the discovery process of the market. This third role of prices is to alert us to such opportunities that would otherwise be missed. I might currently produce t-shirts, but in looking at various input prices and by imagining what price I might get if I began to produce shorts with cartoon characters or sports logos on them, I might be led to see an opportunity I would not have without prices. The disequilibrium prices of the market are central to alerting people to entrepreneurial opportunities.

Inflation

How does all of this relate to macroeconomics? What an alternative approach to macro might look for are the ways in which government policies, which are designed to affect broad aggregates like the price level or rate of unemployment, affect these individual disequilibrium prices and undermine their ability to lead to market coordination. Take inflation, for example. Mainstream discussions of inflation generally emphasize the problems created by variations in the *aggregate price level*. Inflation is bad because it is hard to, for example, write contracts if the parties cannot be sure of what the overall level of prices will be in the future. Alternately, inflation is bad because it means that sellers have to remark their prices more frequently, and these ongoing changes in prices require the use of resources that would otherwise go toward production directly. Although both of these are indeed problems caused by inflation, they seem relatively minor when compared with what a view that takes the market process seriously suggests.

Rather than worry about the overall level of prices, economists could instead look at the way in which inflation affects the individual prices in an economy. As excess supplies of money work their way through the market, they cause differential effects on prices. Some go up by a lot, some only by a little. These price effects divorce prices

from the underlying preferences of producers and consumers and in so doing *undermine all three informational roles of prices discussed above*. When the informational role of prices is damaged, economic coordination is more difficult and economic growth suffers as a result.[1] The real effects of a macroeconomic disturbance like inflation are the ways in which it undermines the *microeconomic coordination process* by disrupting price signals. If the analyst begins by assuming this coordination has already occurred, as do equilibrium models, then these effects of macroeconomic disturbances will be overlooked.

These price effects cause further effects throughout the economy. Of special interest is the way changes in the prices of consumer goods lead to distortions in input markets and the capital structure as they respond to the constantly changing signals coming from consumer goods. The changes in capital equipment or job training that result as firms react to the temporary effects of inflation are generally not completely reversible and thus involve economic waste. Once again, this perspective illuminates an aspect of macroeconomics not captured by mainstream approaches, including those, like Friedman's, which are sympathetic to economic freedom.

In addition, this approach differs from the New Keynesians because of this stress on the role of prices in stimulating entrepreneurial discoveries. The New Keynesian argument that governments can overcome information problems in markets is almost always put in terms of the information necessary for reaching equilibrium. Even if governments were capable of doing so (a dubious assumption at best), it still ignores the discovery role of prices. As market process economists have long stressed, achieving equilibrium is not the standard by which to judge a capitalist economy. Rather, the comparison is between what really-existing market competition can achieve in comparison to really-existing (not what get drawn up on a blackboard or computer) government intervention that suppresses the market.

Macroeconomics does indeed matter and it is important to understand both the mainstream and non-mainstream approaches to the subject. The differences between these approaches are important for how we understand macroeconomic phenomena, how we assess their costs, and what we might do to reduce those costs. Austrian-type arguments are not just one more weapon one can pick up along with those of other economists. They reflect a distinct perspective on political economy which needs to be understood both on its own terms and in comparison to other such perspectives. It is important for those who value freedom to be reasonably aware of these differences and their implications. □

1. I have discussed these issues in much more depth in my, "The Political Economy of Inflation: Public and Private Choices," *Durell Journal of Money and Banking*, 3 (4), November 1991; and also "Inflation" in Peter J. Boettke, ed., *The Edward Elgar Companion to Austrian Economics* (Aldershot, UK: Edward Elgar), 1994.

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Why Economists Need to Speak the Language of the Marketplace

James C. W. Ahiakpor

Ask a group of economists whether saving is necessary to promote investment and economic growth, and you will get a variety of responses. Some would claim that the answer depends on whether the economy is operating at "full employment," since outside of full employment their answer is no. Others would simply say no, it is rather investment which makes savings possible. A minority however would say definitely, without saving there can be nothing to invest. Indeed, a debate last summer among historians of economic thought on the internet well illustrates this amazing state of confusion among economists over an issue so fundamental as the primacy of saving to make investment possible. So how did economists get into this state of affairs?

Trace it to the publication of Keynes' *General Theory* (1936), in which he argues what is now called "The Paradox of Thrift." Keynes' claim is that saving at the national level is bad for an economy because when people decide to save more rather than consume, they deprive producers of market demand. As a result, production contracts, fewer people are hired, less income is generated, and the community becomes poorer. And with lower incomes, people will actually save less than they initially intended—so the argument goes. But a community in which people decide to consume more than save would create more demand for producers who will hire more workers, and thus create more income from which more savings will flow. And interest rates are not supposed to react to the changing desires of the public to save. Through this reasoning, Keynes believes he found "an explanation of the paradox of poverty in the midst of plenty," namely, the problem of wealthy communities making themselves poorer by their inclination to save.[1]

Keynes' argument defies sound logic, although many economics textbooks teach it as if it were valid. Even some of the few who cast doubt on the empirical validity of Keynes' claim, nevertheless insist that the proposition is theoretically sound.[2] Modern dissenters from Keynes' fallacy, especially Henry Hazlitt, have had little luck dissuading a majority of the academic economics community from teaching the doctrine that increased saving is a public vice.[3]

Some students who go on to fields such

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