THE AUSTRIAN SCHOOL OF ECONOMICS AND MARKET INSTABILITY

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Abstract: *Market equilibrium is an illusion. The economic reality shows us that the main characteristic of the markets is the state of instability.*

The complexity of the phenomenon and the strong implications engendered by the economic fluctuations in the macro system, justify the rich scientific research activity of the main schools of economic thought to explain it. The Austrian school of economic thought has one of the most realistic analyses of the factors who generate the market instability.

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INTRODUCTION

During the past 20 years, the Austrian economic school saw a major revival upon, its principles and values. Mainly, this is due to the commitment and tenacity of Rothbard, Kirzner and Lachmann to save and develop the ideas inherited from Mises and Hayek. This work has received contributions from a new generation of Austrian economists such as Vaughn, Langlois, Rizzo, O'Driscoll and Garrison who were involved in the spreading and grounding the liberal doctrine. Strongly anchored in the economic theory of Carl Menger from "Principle of Economics" and built on the visionary principle of Eugen von Bohm-Bawerk's on capital and interest, the attitude of the Austrian School towards economic cycle and market instability is at the same time profound and multisectoral extended. Austrian School studies the nature of the economic crisis, highlighting variables such as time, money, and capital structure and coordination failures.

"It's not about just the two macroeconomic variables, time and money, says Garrison, but also focuses on issues of coordination. Focusing on the capital structure heterogeneity we can offer a theory that not only takes seriously the existence of capital and capitalists but allows an integration of economic growth theory with the cyclical fluctuations one by removing the distinction between micro and macro analysis" (Snowdon, Vane and Wynarczyk, 1996, p. 353).

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The Austrian vision on markets does not impose a clear dichotomy between the actions of factors and may also explain the structural instability. The market is seen as a multi-sectorial entity based on a network. Factors which act combined to create instability are, from the point of view of the Austrian economists, the structure of the property, as the foundation of the economy and of the vector "of human action" and Government intervention that distort the normal flows of the economy and, as well, structural intervention upon interest rate to produce structural instabilities by over sizing some sectors over others.

1. PRIVATE PROPERTY, ENTREPRENEURS AND "SHOCK" THERAPY RESTRUCTURATION

In an attempt to identify the entrepreneurial elements of the market, Mises shows for the first time, an appropriate methodology for this social science: "economics, as Say understood it, is not based on a table of raw statistics. It was based instead on general facts, deeply rooted in human nature and the world... and the implications derived from these facts so widely rooted in human nature and the natural law (Rothbard, 1995, p. 12).

This is the method of praxeology. It wants to explain any phenomena of society deriving its ultimate causes from the human action. In a broad sense, entrepreneurial activity coincides with human activity. On a small lever, purely economic, an entrepreneur is a person who acts in the changing conditions of the markets. Its function is to achieve its objectives in the context of events and circumstances which cannot be associated with probability functions. Mises's entrepreneur does not act in an economy with a state of balance, but rather in an unstable environment, tense up by the lure of profit. From here, the Austrian economists identify the optimal framework in which human action is developing, being dominated by the private property, the only concept able to motivate and generate profit.

The most obvious failure of socialism has been the inability to create wealth. The absence of private property and voluntary contacts between members of society has completely removed the ability of entrepreneurs to take the uncertainty of social production.

To provide the possibility of expressing the creative energies of the entrepreneurs, Austrian school recommends a massive removal of State property from the productive structure of an economy. The main structural factor of instability in an economy is the dominance of public property in preference to those. This will open the "Pandora's box" of massive state intervention in the economy and a waste of resources (Rothbard, 1995, p. 54). The essence of the transformation consists in creating a structure of property rights, to support the functioning of a viable economic entity or a market based economy.

The restructuring requires the passing of ownership of labour, land and capital in the hands of individuals. How each person is naturally his owner, it is necessary to complete a removal of restrictions and Government interventions, enabling each person to conclude contracts and to associate with others freely.

Reaffirming the institution of private property will significantly reduce the size of Government and reduce the production and supply of goods by the State, as well as the massive bureaucracy. Instead of the State apparatus will be specialized entrepreneurs; which will pay close attention to market signals and not complying with a central plan. They will provide the highest revenue to the original owners of land, labour and capital. This voluntary method of creating entrepreneurial capital, by the virtue of their association with the free market, is the only one that eliminates the structural tension of the goods production and services and ensures that, through free market competition, prices will never be artificially changed the Government's economic decisions.

Austrian ideas in terms of the transformation of the economy through systemic privatization of the enterprise environment were retrieved and brought together in a set of economic policies during the 1980s, known as followers of the "Washington consensus". The phrase was coined by the American economist John Wiliamson and designates a convergence of concepts on the path of economic restructuring. Also called "shock therapy", the reform plan can be summarized in three fundamental concepts: deregulation, privatization and liberalization.

Price liberalization is necessary in order to achieve efficient allocation of resources and eliminate consumer goods shortages. Abandoning control of interest rates, exchange rates and external trade is imperative to stimulate exports, attract foreign capital and avoid over-lending to State enterprises could be measures aimed at Deregulation. Deregulation measures aims to replace administrative measures by limiting state interventionism in the economy.

In spite of solid arguments, "shock therapy" was rather the exception than the rule of structural transformation. Criticism has come from followers of the ' gradualist approach ', being influenced by the neo-institutionalism theory and the study of socio-biological systems. The main thesis of this approach is that institutions create rules of the game, generates and creates economic incentives to businesses behaviours. In the early 1990s, the gradualists felt that the old institutions, including centralized planning agencies, must be maintained until, gradually, will be replaced by new institutions built by the virtue of change. Their idea was that the partial privatization should be privileged, in a process step by step, enterprise by enterprise, because in that way they would become more efficient.

Broadly, gradualists criticized the Austrian privatization perspective, by shock, due to the following aspects: the impossibility of eliminating the State and its institutions in the economy, dramatic lowering of the output, substantially reducing the living standards and the blatant inequality of income distribution (Işan, 2002, p. 43).

In fact, these taunts to "shock therapy" are nothing more than signs of structural instability caused by inheritance and maintaining old institutions and their functioning in a so-called competitive system between public firms and „young entrepreneurship".

Hayek, referring to the British liberal tradition, emphasizes the importance of the State in these moments of transformation. Hayek argued in this regard that "it is not a form of magic, but the evolution of well constructed institutions, where rules and principles for reconciling the conflict of interests and reaching compromise in terms of benefits, is the key that has successfully channelled individual efforts towards socially beneficial goals" (von Hayek, 1964, p. 138). The wisdom and success of the transformation of an economy, based on planning, to a private one led by entrepreneurial instinct and gain, depends on the role that State institutions will play in creating and securing property rights, the legal and institutional framework which provides the manifestation of the spirit of enterprise.

In terms of reducing the output, gradualist theory believes that could be avoided through effective management of public enterprises. John Williamson, a partisan of the radical liberal measures, views the situation from a different angle (Işan, 2002, p. 44):

- Statistical data from the socialist period are less feasible because they are known to have inclination toward exaggeration due to Communist regimes;

- Industrial production structure in ex-socialist countries were largely ineffective, heavy industries with outdated technology and products, unaffected by the pressure of international competition did not have appropriate quality,

- Many businesses, unexposed to market harshness, were totally ineffective and produced negative added value;

- Value of GDP was distorted.

From this point of view, the reduction of production in the case of shock therapy is a positive result because the resources released from inefficient industries will be able to be used in new industries, where private businesses are profitable.

In the same logic, we can analyze the hypothesis of massive unemployment, in the case of radical liberal interventions. Over employment in socialist regimes was not an effective use of labour, but a phenomenon of "disguised unemployment". Creation of jobs has to be a function correlated with the demand of the market and not an artificial indicator of a central plan or a method of attracting voters. The expression of a strong structural unemployment is just the result of disparity and lack of realism of the old structures.

If we were to summarize the two approaches, we could say that the first one, with its liberal views, seeks the reduction of interventionism, while the second is pointing its look upon the government for solving the problems of the economy. The first is based on the free market potential to produce positive economic results, while the second one emphasizes the inability of markets to bring prosperity and stability, encouraging the control in order to avoid shortfalls of the economy.

2. THE EXPANSION OF LOANS AND INSTABILITY OF THE AUSTRIAN MARKET

The instability theory is centred on the market that offer the disproportion between consumer goods and capital, in an integrated manner, to show how a "disorder" of one of them generates effects upon each other and on the economic system itself.

In explaining country's instability, the Austrian school's theory is built on three elements presented separately before. The first step was the revitalization of Ricardian analysis which shows that the expansion of credits used by the Government and the banking system will lead to a rise in prices, followed by a leak in the amount of gold out of the country - the economic contraction. The second element of Mises's pyramid was the analysis of capital and interest presented by Bohm-Bawerk.

It started from the time when preference determined the rate of profit in business, pointing out that in fact the normal profit rate is the interest rate. The normal rate of profit is determined by the different time preference rates. Analysis of capital and productive structure of Bohm-Bawerk was taken away by Mises. The capital, which looked like a complex network that has a time dimension, was analyzed by Mises in a manner where the aggregate money and the price level are no longer regarded as separate variables from the rest of the economy. The third pillar of Mises's theory is the reviewing of Wicksel's theory, which demonstrated that differences between the natural rate of interest (the interest rate in the absence of expansionist bank credit intervention) and the rate actually charged, affects the price and production system.

For the Austrians, it is not so much the size of the money supply, as well as the way they are making their way into the economy and affect all real variables as well as the final output. This effect of Cantillon distribution highlights the insertion of money in the economy and stresses that money neutrality hypothesis is a utopia, because money always matters and is not neutral in their impact on the real economy. Mises argued that "the extra money finds its way to the pockets of all individuals; not every individual receives the same amount and not everyone reacts in the same way" (von Mises, 1990, p. 54). Money affects the real economy by changing relative prices and time structure of production. Machlup observes that while "additional money causes instability .... Real phenomena form it ".

In explaining economic instability, Mises made the distinction between actual credits (commodity credit) which are transfers of savings in the hands of the one who saved initially in the hands of entrepreneurs who intend to use these funds in the production process and the loan of circulation (circulation credit) granted by banks, which is how Mises said "an increasing amount of money substitute. We can say that they are accepted and spent by the public as if they were their own money. Credit movement increases the purchasing power of the borrowers, they entered the market with a request that does not exist in the absence of newly created deposits, inducing a new trend of increasing prices of goods and salaries"(von Mises, 1933, p. 28). If the amount of credit is limited strictly to the amount of capital accumulated in savings, the moving credit amount depends mainly on the bank financial management if it can be extended beyond the limits of the deposit.

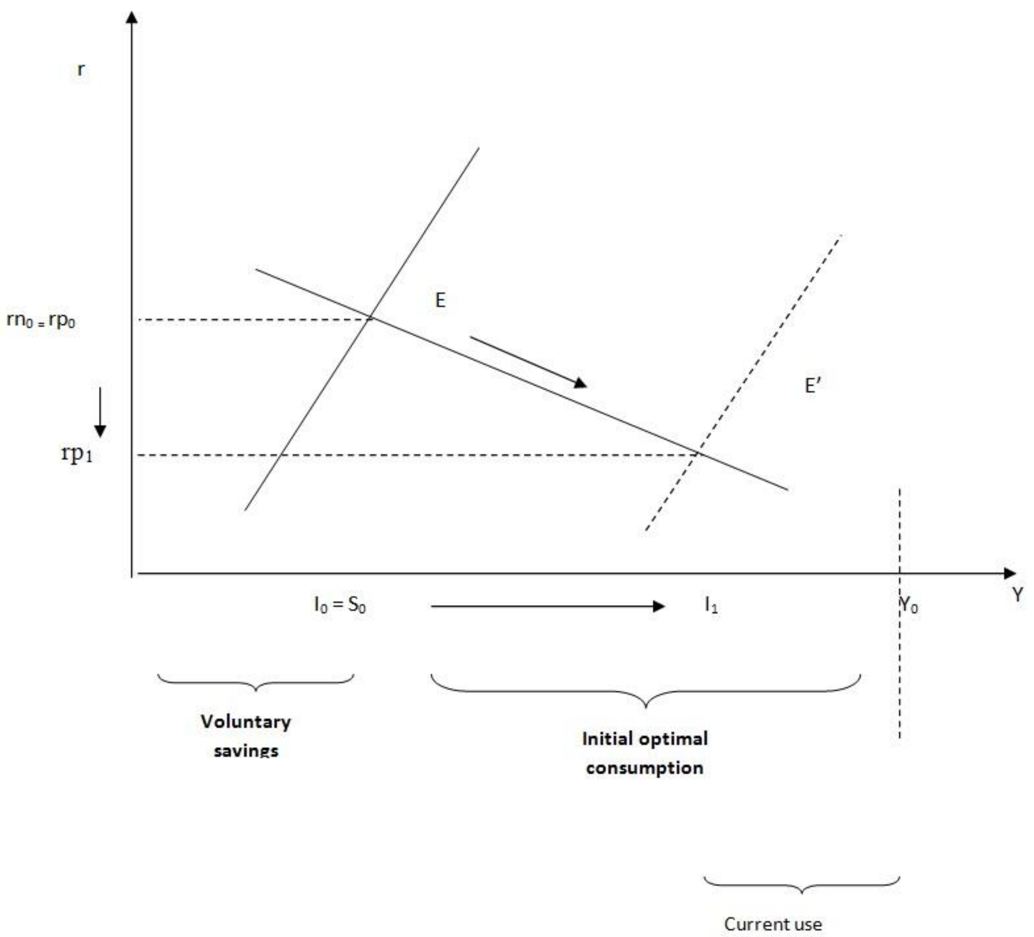
The results of government interference in the market will always be misleading. The inevitable trend of increasing prices and wages is not the only consequence of the credit expansion. It has a powerful effect on the level of interest rate, which has a tendency to descend below the level that would be achieved in an unaltered loan funds market. The expansion of credit is today the main tool of cheap money policies. The interest rate is a market phenomenon, not the product of some unscrupulous exploiters, "the settlement of future goods by comparisons with present goods is a permanent class of human actions, which cannot be abolished by bureaucratic measures" (von Mises, 1933, p. 35). In a free economy, the market determines prices, wages and interest rates. This is the element that keeps the entrepreneurial activities oriented towards production, where they can meet the wishes of consumers in the most appropriate manner and at the lowest expense.

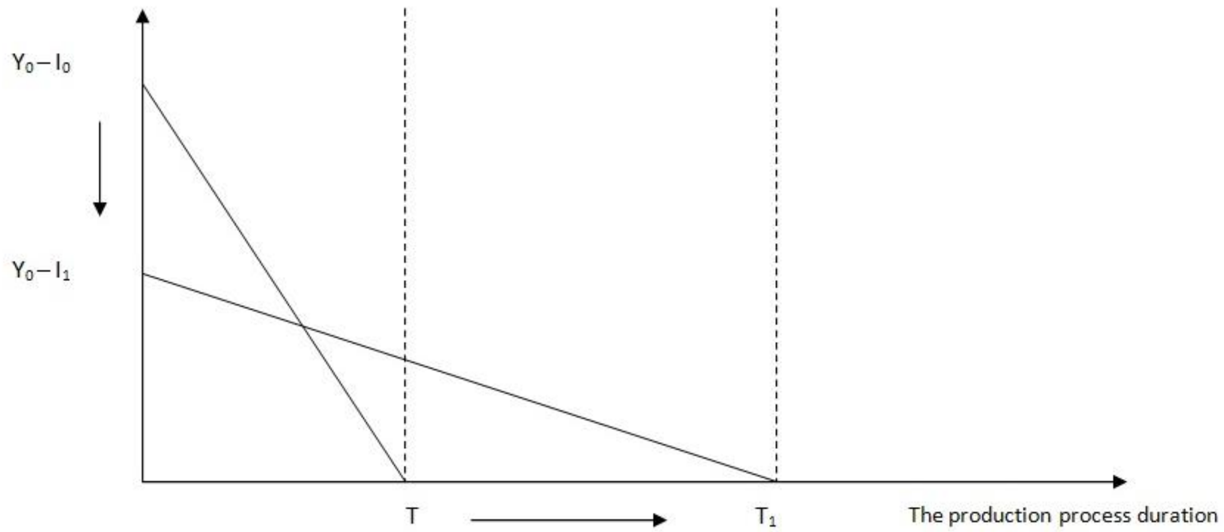
Government intervention on the lending activity, by manipulating the amount of money in the economy, generates a disproportion between the production of capital goods and consumer goods. The following chart presents a simplified picture of the effects which the difference between the natural rate of interest and a market one, affected by credit expansion, has on the structure and time of production.

Artificial reduction of the interest rate, below the natural rate, is called by Hayek as the trigger of "capitulation". This is the main factor of the cyclical developments in the economy and the main culprit of market variables instability.

In Hayek's view, an expansionist credit policy induces in economy an artificial feeling of optimism, of well-being illusion. Many of the investment projects, which were considered ineffective by reference to the natural rate of interest, are now viable. Tempted by easy credit, many manufacturers will lend and invest in the sectors of high productivity, and in the means of production. The consequence will be to reduce investments in sectors producing consumer goods and the emergence of an excess of production means, in relation to the purposes for which they were designed.

The effects of these distortions in the investment process upon the structure and duration of the production process can be schematically presented in the following figure (von Hayek, 1984, p. 76).





When the natural rate (rn) and the market rate (rp) are identical there is no disproportionality between the production of consumer goods and capital goods. The economy is in equilibrium (point E) and total investment will be financed from the voluntary savings (commodity credit).

If the market rate will be lowered under the market rate, mr1, we will witness an increase in the investment volume I1, and will be funded in part from voluntary savings and partly from the forced credit (circulation credit). This will cause an involuntary reduction in consumption from the Y0-Y0-I0 to I1, along with an extension of the production structure from T0 to T1. This extension of the production structure will not be able to continue as long as consumption is not allowed to return to its original level.

If the growing demand for capital goods would have been caused by a growing inclination towards saving (moving the chart to the right is saving → E'), then the extension could be continued and supported. Returning to initial levels will be made through a policy of decapitalization or divestments. It will give up its investment in the production of capital goods sector process, together with rising unemployment and higher interest rates. We're talking about at this time of a deflation.

CONCLUSIONS

Thus, the recommendations of Hayek's economic policy, aimed at the complete elimination of the fluctuations in the monetary mass, is approaching in this way to Friedman theory and Monetary Economics, with their belief in sustaining a constant an increase in money supply.

A neutral monetary policy is seen by Hayek as an theoretical ideal, which is difficult to follow in practice, taking into account the lack of knowledge regarding the way in which you have make the adjustment. Recognizing this Hayek said: " It is very important that we become fully aware of the enormous difficulties presented by the problem of eliminating disturbing monetary influences, difficulties that monetary reformers are always inclined to undervalue. We are still far from the point where either our theoretical knowledge or education of the general public gives us justification for revolutionary reform or hope that such reforms lead to a successful end (von Hayek, 1931, p. 176).

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