

THE MEANING OF MACROECONOMICSJörg Guido Hülsmann¹**Abstract**

The present paper is based on the Ludwig von Mises Lecture given at Grove City College on February 25, 2012. It discusses the meaning of macroeconomics from the point of view of the Austrian School. We give a brief outline of the history of macroeconomics (I) and then ponder the substantive arguments for and against macroeconomics as a scientific discipline (II). We are especially interested by the question whether and to which extent Austrian economics and macroeconomics can be reconciled. Is there something like Austrian macroeconomics?

Key words: History of macroeconomics, Austrian school, Austrian macroeconomics

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In the present paper, we shall give a brief outline of the history of macroeconomics (I) and then turn to ponder the arguments for and against macroeconomics as a scientific discipline. We are especially interested in the question whether and to which extent Austrian economics and macroeconomics can be reconciled. Is there something like Austrian macroeconomics? (II)

I. The History of Macroeconomics in a Nutshell

Ever since the word “macroeconomics” had been first used in print, it meant a type of economics that had no roots in the analysis of human action.² The divide between micro and macro did not coincide with the divide between partial equilibrium and general equilibrium.³ To do macroeconomics meant to study the

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² The terminology goes back to Ragnar Frisch (1933) who distinguished between “micro-dynamic” and “macro-dynamic” analyses.

³ Frisch (1933, pp. 172f) had explicitly rejected Walrasian-style general equilibrium theory: “Indeed, it is always possible by a suitable system of subscripts and superscripts, etc., to introduce practically all factors which we may imagine: all individual commodities, all individual entrepreneurs, all individual consumers, etc., and to write out various kinds of relationships between these magnitudes, taking care that the number of equations is equal to the number of variables. Such a theory, however, would only have a rather limited interest. In such a theory it would hardly be possible to study such fundamental problems as the *exact time shape* of the solutions, the question of whether one group of phenomena is lagging behind or leading before another group, the question of whether one part of the system will oscillate with higher amplitudes than another part, and so on. But these latter problems are just the essential problems in business cycle analysis. In order to attack these problems on a macro-dynamic basis so as to explain the movement of the system taken in its entirety, we must deliberately disregard a considerable amount of the details of the picture. We may perhaps start by throwing all kinds of

relationships between aggregate variables such as aggregate spending, aggregate production, the price level, the interest rate, and aggregate employment, usually with the help of mathematical and econometric models. It meant to not even make an attempt at tracing those variables and their relationships back to human action, and thus to individual perceptions, plans, expectations, and choices. The very raw material of macroeconomics was to be found exclusively in aggregate data. Macroeconomics was a discipline apart from the study of human action.

Analysing human action was held to be pointless as far as the economy as a whole was concerned. Human action mattered only in the microcosm of households and firms. It mattered only for the study of parts within a larger whole, but not for the larger whole itself. The behaviour of households and firms could be studied in terms of choices and expectations. But the results of such microeconomic enquiries could not be generalised to apply to the economy as a whole. The latter was subject to laws *sui generis*, and these laws could very well contradict the laws that held true for the parts.

Macroeconomics in this sense was in the making long before 1933. It can be traced back at least to the French economist, François Quesnay, who in the 1750s developed his famous model of spending streams within the economy, the *Tableau économique* (1759) which depicted the economy as a whole.⁴ A century later, Karl Marx (1894, chaps 9 and 10) claimed that the equalisation of profit rates was a law of the economy as a whole. It did *not* apply to individual firms, because each firm was likely to have a permanently higher or lower profit rate, depending on the amount of labour it used relative to the other factors of production. At about the same time, Leon Walras (1874) pioneered mathematical macroeconomics by developing a system of equations to model the relationships between the prices and quantities of all economic goods. It is true that his model was based on the principle of diminishing marginal utility. However, this principle was not, as in the theory of Carl Menger, a true *law* of the economy. It was merely a convenient (dispensable) hypothesis to render some of the equations plausible.

Not surprisingly, Quesnay, Marx, and Walras have been heroes in Josef Schumpeter's famous *History of Economic Analysis* (1954). Schumpeter's successors among the historians of economic thought have adopted the same point of view, except that in their account Quesnay, Marx, and Walras were mere forerunner to John Maynard Keynes. And it is true that, with Keynes' *General Theory of Employment, Interest, and Money* (1936), macroeconomics as it is being taught today has come into its own.

It was not all of Keynes' own making. However, in the 1920s and 1930s, Keynes was the focal point at the intersection of two longstanding intellectual movements. One was the positivistic movement decisively inspired by Auguste Comte (1798-

production into one variable, all consumption into another, and so on, imagining that the notions 'production,' 'consumption,' and so on, can be measured by some sort of total indices."

⁴ Again, the pioneering paper by Frisch (1933, section 2) expressly referred to the *Tableau économique* as a predecessor.

1857) which started invading economics in the latter half of the 19th century. The other movement was the even older, namely, mercantilism. Despite the success of Adam Smith and the classical economists, mercantilism had never completely died out. At the heyday of classical liberalism, between 1840 and 1870, it lingered on in the writings of fringe figures such as Silvio Gesell. But then it started creeping into the mainstream, when governments began to create economics chairs at public universities and filled them with intellectuals favourably disposed toward interventionism.⁵

Both movements, positivism and mercantilism, had gained a critical mass after WWI. Then came Keynes, created that particular blend that we call Keynesian macroeconomics, and led it to smashing victory. The blending of positivism and mercantilism had been long in the making. Even before Keynes, the two movements were often intertwined, most notably in the writings of Claude Henri de Saint-Simon (1760-1825) and of his personal secretary, Auguste Comte. Keynes' contribution was marginal, but it was decisive. He brought into play most notably his personal virtues – a brilliant debater, he was famously smart, witty, and charming – and he invented a whole new vocabulary.

The new terminology – aggregate demand, the multiplier, propensity to consume, etc. – was a strategic stroke of genius. It was crucial to dispel the fatal impression that the new doctrine was a warm-up of dishes that had been on the menu for decades and even centuries. Those who knew this was the case also knew why the Keynesian dish had not been served much: lacking customer demand. But for the blissfully ignorant – and this group included not only beginners, but also the professors who had never made the effort to familiarise themselves with classical economics – the dish seemed to be brand new. Thus they could have the exciting impression that, following Keynes, they were about to explore uncharted territory that in the past had been neglected out of dogmatism and bad faith. They could see in themselves the avant-garde of a new dawn for Enlightenment.⁶

These circumstances of what Keynes devotees have called the Keynesian revolution (which should in fact be called the Keynesian counter-revolution) are crucial to understand the evolution of economic thought after Keynes. In economics,

⁵ See Hülsmann (2007, pp. 121f) Writing immediately after WWII, Ludwig von Mises observed: “For a correct appraisal of the success which Keynes' General Theory found in academic circles, one must consider the conditions prevailing in university economics during the period between the two world wars. Among the men who occupied chairs of economics in the last few decades, there have been only a few genuine economists, i.e., men fully conversant with the theories developed by modern subjective economics. The ideas of the old classical economists, as well as those of the modern economists, were caricatured in the textbooks and in the classrooms; they were called such names as old-fashioned, orthodox, reactionary, bourgeois or Wall Street economics. The teachers prided themselves on having refuted for all time the abstract doctrines of Manchesterism and *laissez-faire*.” (Mises, “Stones Into Bread, The Keynesian Miracle [1948]” H. Hazlitt (ed.), *The Critics of Keynesian Economics* [(2nd ed., Irvington-on-Hudson, NY: Foundation for Economic Education, 1995], p. 313.)

⁶ This erroneous self-perception was reinforced by the lavish public spending on academic salaries after WWII. On the GI Bill see Hülsmann (2007, p. 791) and the references given there.

the history of the past eighty years has been the history of the slow liberation of the mainstream from the postulates of positivism and mercantilism. The liberation from positivism has still barely begun. The liberation from mercantilism started early on and has made great strides, though it is still far from being completed. Let us briefly consider these two movements in turn.

Within the positivist movement, the revolt against mercantilism under the Keynesian flag started in the 1950s and was spearheaded by the American economist Milton Friedman.⁷ Witty and resourceful as Keynes, Friedman was very much the post-war *alter ego* of the British economist. Friedman demonstrated that positivism does not logically imply mercantilism, as it had been usually contended since the days of Saint-Simon. This was his central achievement and title to a place in the history of economic thought. Most notably, he destroyed three core contentions of Keynesianism.

One, Friedman (1962, chap. V; 1969, chap. 9) argued that the “multiplier” of public spending works both ways; that is, that there is not only a positive multiplier, but also a negative one, because the resources mobilised through public spending lack at other places of the economy. Two, Friedman (1969, chap. 5) showed that the Phillips Curve crucially relied on the hypothesis that the suppliers of labour suffer from money illusion – that is, that they mistake increases of monetary income for increases of real income – and that, in the absence money illusion, expansionary monetary policy was not likely to increase employment and production (respectively reduce unemployment). Three, extending the critique of the Phillips Curve, Friedman (1956, chap. 1; 1970) argued that the Hicksian IS-LM analysis had to be amended by taking into account the purchasing power of the money unit, respectively the price level. An expansionary monetary policy was not likely to entail a mere right-ward shift of the LM curve, thus entailing a tendency for aggregate revenue to increase at a lower interest rate. Rather, the IS curve was likely to make right-ward shift, too, because savers and investors would take account of the increased price level resulting from the increase of the money supply. Therefore, the overall impact of expansionary monetary policy on employment was likely to be nil. In the long run, unemployment would oscillate around a natural level (resulting in particular from search costs on the labour market), independent of monetary policy.

Friedman’s arguments were not genuinely new in their substance. The negative multiplier was a direct implication of the broken-window fallacy highlighted by Frédéric Bastiat (1801-1850). Similarly, the case against generalising the Phillips Curve had already been made by Ludwig von Mises (1931, p. 31), almost thirty years before Friedman. However, the expression “negative multiplier” and his ability to show that graphical models such as IS-LM could be used to make a case against neo-mercantilism, demonstrated Friedman’s rhetorical prowess and his ability to communicate classical ideas to a profession steeped into self-conceit and Keynesian

⁷ Austrian economists were of course fundamentally opposed to Keynesianism from the outset. We shall deal with their opposition below.

vocabulary. We notice in passing that Friedman did not obtain his Nobel Prize for combating neo-mercantilist errors. Rather, he was recognised for the toothless achievement of having modelled and tested a permanent-income hypothesis.

After Friedman, the academic mainstream liberation from mercantilist dogma switched to a slower pace and did not feature any genuinely new arguments. Much fuss has been made of the new classical economists around Lucas, Sargent, Wallace, Prescott, Kydland, and others. But their central tenet – the validity of the rational expectation hypothesis – was but an application of the previous insight about the role of money illusion on the labour market, already articulated by Mises and Friedman. The new element in this strand of literature is exclusively formal in nature. There was a new class of models that was centred around the concept of a representative agent, and which was tested with new econometric techniques. But the harvest was zero as far as genuinely new and lasting insights were concerned, and it was similarly dim in its policy implications.⁸

Outside of the Austrian School, only one group of economists found its way out of the neo-mercantilist impasse. At the end of the 1970s, Arthur Laffer, Paul Craig Roberts, and others coined the term “supply-side economics” to brand their return to classical conceptions about growth and government interventionism. They highlighted the beneficial role of savings, demolished the claim that consumption was the source of wealth, and refuted the idea that increased taxation might stimulate the market participants to work and produce more eagerly (“income effect”). Most importantly, in distinct contrast to Milton Friedman and the monetarists, they clearly understood and stressed the central methodological flaw of the prevailing neo-mercantilist conceptions. That flaw consisted in trying to substantiate statements about the economy as a whole on the basis of partial-equilibrium analyses. Keynesian macroeconomics *claimed* to be truly macroeconomic in scope. In fact, however, it generalised microeconomic relations.⁹

The supply-side movement was influential among business economists and was quite present in the rhetoric of the Reagan administration. However, it had much less impact on the profession of academic economics and thus the liberation of mainstream academia from mercantilist fallacies remained very incomplete. The differences that have existed between the Austrians and the mainstream in the immediate post-war period have been narrowed down – a long-run consequence of Friedman’s strong impact and of the much weaker impact of supply-side economics. However, the gap remains. Mainstream academic economists – including those of

⁸ The same thing holds true for the more recent transition to dynamic stochastic general equilibrium models. It is true that the transition from IS-LM to DSGE has been significant (see Vroey 2004), but substantive contributions have been virtually absent.

⁹ Discussing the alleged income effect of increased taxation, P.C. Roberts (1978, p. 31) argued: “It derives from trying to aggregate a series of partial equilibrium analyses (individual responses to a change in relative prices) and, in the aggregate, ignoring the *general* equilibrium effects.” For a critique of the income effect see Salin (1996). William Laffer (1990, p. 29) perceptively calls Keynesian economics “the logical extreme – and nadir – of Marshallian analysis.”

the monetarist branch – still believe that aggregate spending drives the economy, that increased consumer spending is a motor of economic growth, that an increase in the volume of credit is virtually always beneficial, and that deflationary tendencies – be it a reduction of aggregate spending or of the price level – have negative consequences for the economy. Most importantly, mainstream economists – especially of the monetarist branch – still believe that it is possible and expedient to stabilise the economy through monetary interventionism.

II. Austrian Macroeconomics

Turning now to the Austrian economists, let us first briefly review the historical stance adopted by Austrian economists toward Keynesian macroeconomics and then turn to the more substantive question of whether and to what extent there can be such thing as Austrian macroeconomics.

1. Macroeconomics and the Austrian School

First of all, we have to underline the crucial fact that the Austrians had never been infected by the Keynesian dogma in the first place.¹⁰ Mises, Hayek, Hazlitt, Sennholz, Rothbard, Kirzner, and all other Austrians opposed Keynesianism from the very beginning, and this opposition almost became a defining feature of their public image. Keynesians therefore perceived the Austrians as old-school thinkers who simply didn't get it.¹¹ As a consequence, the Austrians were marginalised from 1936 to the early 1970s – the years of triumphant Keynesianism – and almost fell into oblivion. In the very years when academic positions in economics were multiplied, the Austrians were not invited to the party. The path-dependency of institutional evolution did the rest. It kept the Austrians in a minority position even when it became blatantly obvious that it was the Keynesians who didn't get it and the mainstream slowly turned away from it. This is the reason for the feeble academic presence of Austrian economics today. This is the reason why all conventional tools and mechanisms for evaluating the achievements of academic economists are still biased against the Austrians, even though the Austrians have been vindicated on virtually all accounts.¹²

¹⁰ This concerns in particular the Böhm-Bawerkian respectively Misesian branch of Austrian economics. The Wieserian branch did make various concessions, most notably in stressing the desirability of stable respectively expanding aggregate demand.

¹¹ Astonishingly, there was at the time no serious debate, with the sole exception of the debate on socialist economic calculation. The general perception then was that the Austrians had lost this debate. The validity of the Austrian position was recognised only in the wake of the collapse of soviet socialism in the early 1990s. Heilbroner (1990) then famously acknowledged: "It turns out, of course, that Mises was right." Needless to say, this did not significantly reinforce the Austrian standing within public universities.

¹² See Block and McGee (1991), Thornton (2004), Block, Westley, and Padilla (2008), Block (2010).

The inertia resulting from the path-dependency of institutions is particularly striking today. The current economic crisis, which for more than four years has been unravelling under our eyes, has prompted as massive disillusionment with mainstream economic thinking among business economists – especially on the financial markets – and also, to some extent, among the so-called policy makers. The failure of mainstream economics has been patent. There has been much breast-beating and many public statements of good intentions to mend the bad old ways. But virtually nothing changed in practice, except for a greater attention to “behavioural finance” and other approaches that remain squarely within the mercantilist and positivistic conventions. Indeed, a fast and fundamental reorientation of research and teaching is virtually ruled out thanks to the government-financed institutional inertia in higher education. While investment funds and other companies have fired entire battalions of economists who did not deliver the goods, the academia slugs behind the real world in drawing practical consequences.

Within the Austrian camp, an interesting evolution started in the mid-1970s with the appearance of something called “Austrian macroeconomics.” The first author who used this expression was Roger Garrison in his 1976 paper “Austrian Macroeconomics: A Diagrammatical Exposition.” More recently he elaborated on this theme in *Time and Money: the Macroeconomics of Capital Structure* (2001). Given the historical context – the association of the word macroeconomics with positivistic and mercantilist ideas on the one hand, the fundamental opposition of the Austrians to these ideas on the other hand – the very expression Austrian macroeconomics was an oxymoron. There could be no such thing as Austrian macroeconomics, such as there was no vegetarian cannibal, no promiscuous virgin, and no communist who was both honest and smart.

Nevertheless, in the past ten years, a good number of Austrian economists other than Roger Garrison have adopted the term Austrian macroeconomics, too. Among them are Steve Horwitz, Renaud Fillieule, and the present writer. Still the general attitude has remained reserved and cautious. Writing twelve years ago, Steve Horwitz (2000, p. 1) characterises this attitude in these words:

*In the eyes of many economists, Austrians are seen as rejecting the whole concept of macroeconomics in favor of a focus on microeconomic phenomena such as price coordination and entrepreneurship. There is some truth to this perception. In a great deal of the post-revival (i.e., since 1974) literature in Austrian economics, Austrians have tried to define themselves in terms of their methodology (subjectivism) and their understanding of the market as a competitive discovery process rather than as tending toward, or mimicking, general equilibrium. Austrians’ self-described ‘uniqueness’ has almost exclusively been focused on microeconomics.*¹³

¹³ In a footnote, Horwitz then refers to a “representative sampling of these works and their strong, although not exclusive, emphasis on microeconomics and methodology” mentioning Israel Kirzner, Gerald O’Driscoll, Mario Rizzo, Esteban Thomsen, Roy Cordato, Bruce Caldwell, Stephan Boehm, Karen Vaughn, and Samford Ikeda. The common ground of all these authors is that they take their inspiration predominantly from Hayek, less so from Mises and Rothbard. Horwitz (2000, p. 1) is

Thus the question is if and how these seemingly different positions can be reconciled in light of the facts. In what follows we will first discuss Roger Garrison's conception of the subject matter of macroeconomics and then highlight two arguments in favour of an Austrian macroeconomics.

2. Critique of Garrisonian macroeconomics

According to Roger Garrison (1984, p. 200), the discipline of Austrian macroeconomics revolves around the analysis of time and money:

Time is the medium of action; money is the medium of exchange [...] And it is precisely the "intersection" of the "market for time" and the "market for money" that constitutes macroeconomics' unique subject matter.

Anyone familiar with Austrian capital theory (most notably presented in Rothbard's *Man, Economy, and State*) and with the Austrian theory of money (most notably in Mises' *Human Action*, as well as in his *Theory of Money and Credit*) will find Roger Garrison's statement plausible. Indeed, the market for money, by definition, covers the economy as a whole. If any good has the nature of being macroeconomic, then it is money. Moreover, as has been explained by Mises and subsequent Austrian economists, money is not neutral. It is not just a Walrasian *numéraire*. Changes in the supply of and demand for money affect the distribution of real incomes and therefore modify the structure of production. Unanticipated changes of the money supply entail inter-temporal disequilibria.

It is a completely different question, however, whether this broad characterisation is sufficient as a definition of macroeconomics, and of Austrian macroeconomics in particular. Why do we need something called macroeconomics to deal with the market for money? Why can we not apply the usual procedure: derive demand and supply schedules from subjective value scales, and then explain the pricing process in the light of the demand for and supply of money?

The same reservation needs to be made regarding other works inspired by Roger Garrison. For example, Steve Horwitz' "macroeconomics of monetary disequilibrium" stresses the economy-wide repercussions of monetary disequilibria, and rightly so. But is this fact all by itself sufficient to vindicate a special field or discipline called macroeconomics?

It is no accident that Garrison made the case for Austrian macroeconomics in 1976. At that point Milton Friedman had cleared the way to show that macroeconomics did not have to be based on mercantilist postulates. Friedman and the other monetarists not only remained within the dominant epistemological framework of positivism, they also did not question the Keynesians' rudimentary conception of capital. In other words, they lacked a capital theory, and therefore also

therefore right on target when he adds: "Even Hayek, in his last book, referred to macroeconomics in sneer quotes [...], suggesting that a rejection of the subdiscipline was still alive and well in some Austrian quarters. It comes then as little surprise that much of the microeconomic and methodological work in the post-revival literature in Austrian economics finds its roots in Hayek."

lacked understanding for the problems associated with the inter-temporal allocation of resources. Roger Garrison filled this gap by bringing Austrian themes into purview.

The question is, however, whether the mere treatment of Austrian themes – whatever this is supposed to be – is all by itself a token for Austrianness. More than ten years ago, the present writer (Hülsmann 2001) raised the question is whether Roger Garrison was about to austrianise the mainstream, or whether he was rather going to mainstream the Austrians. By virtue of hindsight, it is patent that the mainstream has not been charmed overly much by *Time and Money*. Ron Paul has probably done more to attract the attention of the likes of Paul Krugman to Austrian tenets than any academic text – Roger Garrison’s book included. By contrast, Garrison undoubtedly did have some impact on research by younger economists interested in the Austrian School, by focussing their attention on the *modelling* of relations between the time market and the structure of production.

One cannot deny the pedagogical utility of graphical models such as demand and supply schedules. Roger Garrison’s three-quadrant model, which he himself considered to be one of his chief contributions, is a case in point, despite its imperfections.¹⁴ But, again, the model all by itself does not make the case for macroeconomics, or even Austrian macroeconomics.

3. The case for Austrian macroeconomics

Still the case for Austrian macroeconomics is not all lost. In what follows we shall consider two arguments that could be adduced to vindicate that case.

Studying the relationships between markets

According to the first argument, economic analysis is chiefly concerned by studying the inter-relationships between markets. A Henry Hazlitt stressed more than sixty-five ago, the characteristic feature of the good economist is that he does not focus his attention on any single event or change, but on the corresponding changes induced elsewhere in the economic system. Or, as Bastiat has told us, we should not only consider the consequences that are seen, but also those that are not seen.

This concern is indeed a characteristic feature of Austrian economics, which stands in stark contrast to neoclassical microeconomics, which is exclusively focused on single markets, and not on the relationships between markets. Therefore, in this sense Austrian economics is by its very nature macroeconomic, rather than microeconomic in the neoclassical sense.

At the risk of appearing to be hair-splitting, however, let us emphasise that this argument is different from Garrison’s contention that time and money are the phenomena that define Austrian macroeconomics. Indeed, markets are inter-related even in a barter economy, and even in the absence of saving and capital accumulation. Even a simple change of the demand schedules for a good X goes in hand with corresponding changes in the demand for other goods.

¹⁴ For a critique of Garrison’s model see Hülsmann (2001). An alternative model is presented in Hülsmann (2011).

Microeconomic relationships cannot always be generalised

The second argument in favour of Austrian macroeconomics is even more poignant. It stresses that it is not always possible to generalise a causal relationship identified on a microeconomic level.

For example, it is possible for an individual firm to increase the quality of its products in order to increase its monetary revenue. Thus here there is a causal relationship that holds true for one market participant, *ceteris paribus*, that is, under the assumption the he alone improves the quality of his products. But this causal relationship does not hold if the *ceteris-paribus* assumption does not strictly hold.¹⁵ That is, it cannot be generalised. Under constant monetary conditions, if all firms increase the quality of their products at the same time, then it is impossible for all of them to have higher monetary earnings at the same time. The reason is, of course, that each dollar spent on one product is not available for expenditure on other products. Any additional revenue earned by one firm must therefore go in hand with lower revenue elsewhere in the economy.

This insight is as old as economics itself. Classical economists such as Ricardo (1821, chap. XX) carefully distinguished between (monetary) values and (real) riches. The reason was precisely that the embodiment of wealth from an individual point of view (money, monetary revenue, the monetary equivalent of nonfinancial assets) was irrelevant from an overall point of view.

In Austrian economics, too, this insight has always been present, and it has always played an important role. One of the Böhm-Bawerk's (1959, pp. 248-256) seminal contributions was to demonstrate that costs of production result from the value of (alternative) consumers' goods. The "law of costs" was not a cause apart from subjective value, but a mechanism through which the subjective value of products determined the prices of factors of production. From the microeconomic perspective of firms, costs appeared to be a separate cause of the price of their products, different from the subjective value that these products had for their clients. But factor prices result from the competitive bidding of firms, and because this bidding is based on expected customer demand for products, it follows that costs of production ultimately derive from the subjective value of consumers. Thus, again, one cannot generalise a causal analysis that seems to be plausible from an individual perspective. Only an overall perspective leads to the correct result.

Murray Rothbard, too, in his treatise *Man, Economy, and State*, highlighted several such phenomena. For example, Rothbard (1993, p. 600) stressed that the concept of price-elasticity cannot be generalised to the economy as a whole. It is impossible that he demand for all goods is elastic at the same time; and it is equally impossible that that he demand for all goods is *inelastic* at the same time. Rothbard (1993, pp. 515f)

¹⁵ From a counterfactual point of view (see Hülsmann 2003), one would have to stress that these laws are only "case probable" (Mises 1949, chap. 6). A firm improving the quality of its products makes the increase of its revenue *more* probable than otherwise. But if other factors come into play – for example, a simultaneous quality increase of all competing products – then its revenue will not necessarily tend to increase.

also points out that, on each *partial* labour market, the labour supply schedule is a monotonic positive function of the real wage rate. But on the *overall* labour market, the supply schedule is not monotonically positive. Rather, once real wages reach a certain level, the market participants tend to have a higher reservation demand for their time. In other words, the overall labour supply curve then starts to bend backward.¹⁶

Notice that this second strand of argument goes beyond the first one that we considered before. The contention is not just that markets are inter-related, but that there are *phenomena that appear only on an aggregate level*. They are the proverbial result of human action, but not of human design. Generalising the causal relationships that we find on partial markets can therefore be fallacious – the fallacy of composition.

A digression on the fallacy of composition

The fallacy of composition is one of the first elements taught in typical freshman classes in macroeconomics. It is also a central element in the Keynesian vulgate.¹⁷ Keynesians relish in stressing the fallacy of composition, because it highlights the limitations of a purely microeconomic approach (in the neoclassical sense) and seems to vindicate their opinion that macroeconomics is a discipline apart, with no connection to human action.

The favourite Keynesian illustration of the fallacy of composition is the so-called paradox of thrift, also called paradox of savings. They claim that an individual who increases his savings can indeed increase his wealth, but only at the expense of other people. Indeed, greater savings *by definition* go in hand with reduced consumer expenditure. Thus the revenue of firms is reduced.

Moreover, and most importantly, if *everybody* set out to save more at the same time, then firm revenues would plummet and a vicious circle would set in: investments would plummet, therefore factor revenues would plummet, therefore consumer expenditure would plummet even more, etc. etc. The economy sinks into a bottomless deflationary spiral – a paradoxical result from the point of view of purely microeconomic wisdom. It follows that higher savings are the egoistic luxury of a select few. Altruistic motives would lead to the exact opposite behaviour, namely, a reduction of savings and increased consumer expenditure. In Keynes' words: "The more virtuous we are, the more determinedly thrifty, the more obstinately orthodox

¹⁶ The same type of argument has later also been prominent in the contributions of supply-side economists, for example, in their refutation of the income-effect argument in favour of the increased taxation of incomes. As William Laffer (1990, p. 46) points out: "While increases in after-tax income due to improvements in technology and productivity over time *can* and *do* have the net effect across society as a whole [...], increases in after-tax income due to tax rate reductions are fundamentally different: While it certainly is possible for *particular individuals* to respond to a tax rate cut by working less rather than more, it is impossible for *labor supply as a whole* to respond in this way *unless total real wealth is increased* – a condition which holds in the case of a technology or productivity change but not in the case of a tax cut." See also Roberts (1978, p. 31).

¹⁷ Hunter Lewis (2009, pp. 4-6) highlights that US presidents Bush and Obama, as well as their advisors, have publicly referred to the paradox of thrift to justify their policies.

in our national and personal finance, the more our incomes will have to fall when interest rises relatively to the marginal efficiency of capital.”¹⁸

To sum up, mercantilism and the rejection of methodological individualism are but two faces of the same medal. Case closed for the happy Keynesian professors. They are right in stressing the fallacy of composition. The only problem is that they are mistaken on the other accounts. They are mistaken on methodological individualism, and they are even more mistaken on the fallacy of savings.

From the fact that some phenomena only appear on a macroeconomic level, it does not at all follow that the analysis of individual behaviour is pointless. From the fact of the existence of macro-phenomena the Keynesians jump to the assertion that there is no connection to individual behaviour.¹⁹ But one does not follow from the other. No economist before them made such an extravagant claim. The classical economists realised full well that one could not always generalise the causal relationships found in the analysis of partial markets. In particular, they understood that an increase of aggregate production – resulting from technological progress, increased savings, reduced trade barriers, or a combination thereof – was likely to reduce the general level of money prices. Greater real income would be earned at lower monetary income. For this precise reason, Ricardo stressed the distinction between (monetary) values and (real) riches. And the Austrian economists, too, perfectly understood this point. The fallacy of composition does not warrant throwing methodological individualism over board. It cautions against hasty generalisations; that is all.

Turning now to the paradox of savings, the striking fact is that the entire Keynesian argument is based on purely microeconomic reasoning. The Keynesians themselves commit the fallacy that they see so prominent in the thinking of others. It is true that reduced consumer spending will tend to entail reduced investment spending by the consumers' goods producing firms. But one cannot generalise this fact.

A firm that is confronted to reduced revenue can only stay in business if it manages to reduce costs, that is, if it reduces its own spending on factors of production by renegotiating the contracts with the factor owners. Now, if only *one* firm sees its revenue plummet – for example, because of shifting consumer demand – then it will not as a rule be able to renegotiate, because the factor owners have other alternatives. Rather than accepting a significant price reduction and continue to serve their erstwhile customer, they will look to serve other customers. Their new customers will also pay them less than what they earned before, but the reduction is

¹⁸ Keynes (1936, p. 111). Another passage of similar flavour: “It follows that of two equal communities, having the same technique but different stocks of capital, the community with the smaller stocks of capital may be able for the time being to enjoy a higher standard of life than the community with the larger stock; though when the poorer community has caught up the rich – as, presumably, it eventually will – then both alike will suffer the fate of Midas.” (p. 219)

¹⁹ In William Butos' terms (2006, p. 4): “Keynesian Macroeconomics is based on a kind of aggregation that requires students to see its various aggregates as *nonreducible* interacting entities.”

likely to be lower than the one they would have had to accept in their old contract. Thus the firm will become unprofitable and go out of business. Yet the economy as a whole thrives as before – in fact, it thrives even more than before, because the partial reduction of factor prices makes investments profitable that were not profitable before.

Things are different when *all* firms experience plummeting monetary revenues, for example, as a consequence of a return from fiat money to a gold standard. Then people will have greater incentives to hoard the good commodity money, and therefore the monetary revenue of businesses will fall. However, this does *not* imply that all businesses will become unprofitable. It is precisely because *all* firms are concerned that all firms will have to reduce their spending on factors of production. The factor owners will therefore by and large have no alternative to turn to when their old firm sets out to renegotiate their contract, and thus they will tend to accept.

Hence, the Keynesian case for the paradox of savings only results from generalising a problem to which an individual firm can be confronted. It does not result if the economy as a whole is confronted to that problem. The Keynesian contention is therefore a clear case of the fallacy of composition. From a truly macroeconomic perspective, savings do not entail paradoxical results. They lead to greater wealth, both on the individual and on the aggregate level, just as Adam Smith had argued in 1776.²⁰

III. Conclusion

Let us now conclude our discussion of the meaning of macroeconomics by highlighting two striking facts.

The first one is that the term “macroeconomics” was used first and predominantly by Keynesian economists. In their eyes it connoted a package of positivism, mercantilism, and the rejection of methodological individualism. This was the historical meaning of the term in the 1930s. Then followed a few decades of monetarist subversion that have partially altered the meaning of macroeconomics. The positivistic framework has been maintained, but the mercantilist content has been toned down, even though it is still strong. In the 1970s, Roger Garrison started joining the monetarist subversion project by adding an Austrian dimension.

In a way, this is a charming enterprise that might spell some confusion among Keynesians and monetarists. But it is also a dangerous undertaking because the confusion could spill over into the Austrian camp. Austrians should remain focused on learning and developing solid theory, and on writing sound history. Austrian macroeconomics might divert too much energy onto the sterile lands of mere modelling.

²⁰ Apparently, Milton Friedman had completely missed this crucial point. He thought the reason why he could not convince his Keynesian critics was that they reasoned from a Walrasian general-equilibrium point of view, while he perceived himself as a Marshallian. See Bordo and Schwartz (2003, p. 18).

The second striking fact that we have tried to underscore is that all sound economists could do without the term macroeconomics. The classical economists could do without it, and they were not ignorant of the specifically macroeconomic phenomena we have highlighted above. The same thing holds true for the Austrian economists. Menger, Böhm-Bawerk did not feel they needed a special label to brand their path-breaking studies of the economy as a whole. Mises and Rothbard actually rejected the label macroeconomics, and George Reisman too is adamantly opposed to using this word, tainted as it is by its historical association with Keynesian thought.

It has always been the watermark of Austrian economics to highlight the inter-relations within the economy, without being oblivious to the fact that some phenomena only appear in the economy as a whole. Using the word “macroeconomics” or even “Austrian macroeconomics” can therefore only have a pedagogic justification. It might be useful when dealing with a public, or with readers, who are steeped in the neoclassical distinction between microeconomics and macroeconomics. In contrast to neoclassical micro-economists, all Austrians are so-to-say macro-economists.

But nevertheless, all in all it is wrong-headed to adopt a fallacious terminology. Austrian economists are the present-day heirs of the classical economists. It is bad enough that the adjective “Austrian” is needed to describe what, after all, should be “economics” purely and simply. There is no need and no utility in using additional qualifiers that can only obscure this fact.

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