The Free Market

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The Interest Rate Question

by Murray N. Rothbard

The Marxists call it "impressionism": taking social or economic trends of the last few weeks or months and assuming that they will last forever. The problem is not realizing that there are underlying economic laws at work. Impressionism has always been rampant; and never more so than in public discussion of interest rates. For most of 1987, interest rates were inexorably rising; for a short while after Black Monday, interest rates fell, and financial opinion turned around 180 degrees, and started talking as if interest rates were on a permanent downward trend.

No group is more prone to this day-to-day blowin' with the wind than the financial press. This syndrome comes from lack of understanding of economics and hence being reduced to reacting blindly to rapidly changing events. Sometimes this basic confusion is reflected within the same article. Thus, in the not-so-long ago days of double-digit inflation, the same article would predict that interest rates would fall because the Fed was buying securities in the open market, and *also* say that rates would be going *up* because the market would be expecting increased inflation.

Nowadays, too, we read that fixed exchange rates are bad because interest rates will have to rise to keep foreign capital in the U.S., but also that *falling* exchange rates are bad because interest rates will have to rise for the same reason. If financial writers are mired in hopeless confusion, how can we expect the public to make any sense of what is going on?

In truth, interest rates, like any important price, are complex phenomena that are determined by several factors, each of which can change in varying, or even contradictory, ways. As in the case of other prices, interest rates move inversely with the supply, but directly with the demand, for credit. If the Fed enters the open market to buy securities, it thereby increases the supply of credit, which will tend to

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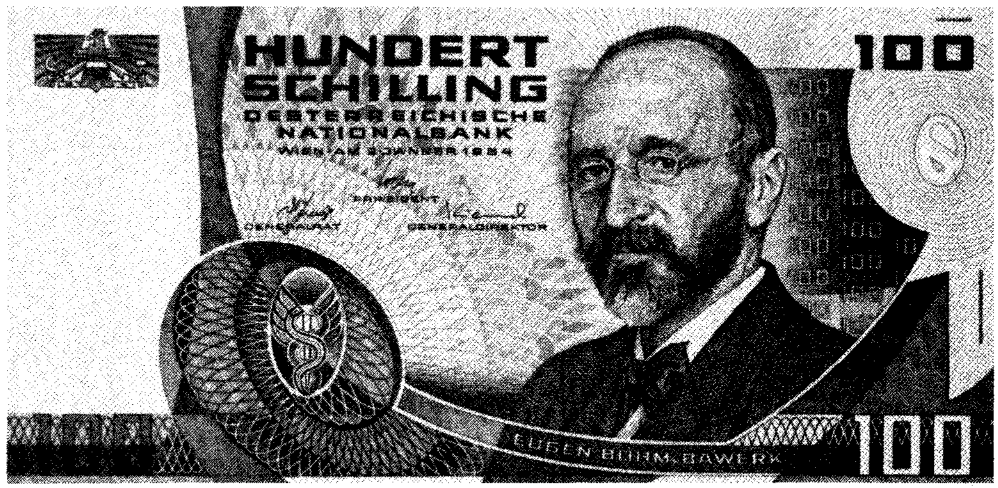


Austrian paper money honors Eugen von Boehm-Bawerk, Mises's teacher, although a "gold coin would have been more appropriate," says Dr. William A. Dunn, who sent us the note.

The Intellectual Cover for Socialism

by Hans-Hermann Hoppe

Compared with life in Western countries, where the socialist sector is sizable, life under total socialism is miserable.

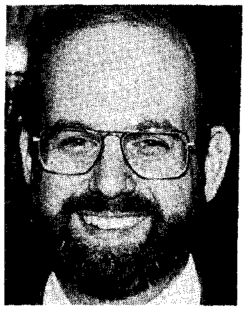
The standard of living is so deplorable that, in 1961, the socialist East German government built a system of walls, barbed wire, electrified fences, minefields, automatic shooting devices, watchtowers, watchdogs, and watchmen, almost 900 miles long, to keep people from running away from socialism.

The empirical evidence shows that socialism is an obvious failure. And the cause of socialism's failure is crystal clear: there is almost no private ownership of the means of production, and almost all factors of production are owned in common in precisely the same way that Americans own the Postal Service.

Why, then, do seemingly serious people still advocate socialism? And why are there still thousands of social scientists who want to put more and more factors of production

Continued on page 4

INSIDE



From the President

by Llewellyn H. Rockwell, Jr.

Monetary Crises

Since the 1690s, America has undergone more than 20 monetary crises. Some have led to genuine reform, others to increased government power.

The fitful fiat-money inflation of the colonial governments had its culmination in the much worse inflation engineered by the Continental Congress. "Why should we consent to load our constituents with taxes," said one Member, "when we can send to the printer for a whole wagon-load of money, and pay for it with but one quire's worth?"

The Americans managed to win the Revolution, despite the Congress, but the inflationary burden fell heaviest on the patriots. The Tories, Pelatiah Webster reports, refused to have anything to do with the new money, and would accept only gold and silver. But many of those fighting for American freedom and independence accepted the Continental paper currency. As a result, they were wiped out when the Continental fell, because of the printing press, to one tenth of one percent of its original value. Webster, probably America's first economist, said the whole experience was summed up for him by the sight of a drunken sailor dressed in a suit made entirely of Continental money.

But the debacle of government fiat money led, not to authoritarianism as is usually the case, but to restrictions on state power and the establishment of the classical gold standard. The American gold standard was never perfect. The government and its attendant banking interests were still able to manipulate it, which led to recurrent crises, but the damage was always limited. Until the establishment of the Federal Reserve System in 1913.

The Fed's bank credit inflation of the 1920s led directly, in the Austrian business cycle, to the Great Depression, which gave Franklin D. Roosevelt the excuse to violate the Constitution and end the domestic gold standard. The international gold standard was killed by Richard Nixon on August 15, 1971, when he also imposed price and wage controls.

We've seen prices go up more than 350% since that day, with the inevitable busts. Since the depression of 1981-82, the Fed has increased the money supply by more than 100%. We saw the effects, as in the 1920s, in stock market and other booms. Since the crash of October, the media keep nervously asking if we're facing a recession. The answer is, of course, yes. That was made inevitable by the inflation of 82-87. The question is what we do with it.

The government, as in previous crises, will try to use the coming troubles as an excuse for more of the poison that caused the troubles to begin with. But the climate of ideas really has changed.

Americans are much more suspicious of politicians and their nostrums than they were in the 1930s. There are signs that today, as in the 19th century, money can again become a political issue.

Thanks to Ron Paul and others, tens of millions of Americans own gold today, and know that its value is independent of government. Many know about, and approve of, the idea of a gold standard. In the academic world, thanks to Murray N. Rothbard and others, the intellectual case for the gold standard is being made with a logical brilliance unseen since the glory days of hard money, and it is buttressed as well with Ludwig von Mises's Austrian business cycle theory, which shows the hidden damage wrought by inflation.

For those of us who believe in individual liberty and sound money, these are days of opportunity. There is chance for real reform. If we grasp it. ■

Bequests are an important source of Institute funding. This booklet on Wills is available at no charge by checking the appropriate box on the enclosed form. Including the Institute in his will, one Member wrote us, "enables me to continue working for my beliefs and my country permanently."

Boehm-Bawerk's *Shorter Classics*

Reviewed by Jeffrey A. Tucker

In order to fully appreciate Austrian economics—now over a century old—the serious reader must study and understand its rich tradition.

The tradition began with the revolutionary work of Carl Menger, who established the guiding principles of Austrian analysis: subjectivism, individualism, and the logic of human action.

Eugen von Boehm-Bawerk continued the tradition by applying Mengerian analysis to a wide variety of economic problems. Although they never formally studied together, Menger had such a high regard for Boehm-Bawerk's work that Menger's last article was a tribute to him. Boehm-Bawerk is also remembered for having had enormous influence on his greatest student: Ludwig von Mises.

Boehm-Bawerk was a pioneer. He was not unfailing, but he brilliantly solved problems that perplexed even the greatest minds of his time. In fact the economics profession today has yet to catch up to Boehm-Bawerkian standards, especially his theories of interest, production, prices, and capital.

Born in 1851, he began teaching at the University of Innsbruck when he was 30 years old. And it was there that he started his great work *Capital and Interest*, which he later completed as professor at the University of Vienna.

He was Austria's Finance Minister from 1899 to 1904. During those years he was a champion of privatization, balanced budgets, and the gold standard. He resigned from the post to protest budget fudging by the military, and died in 1914. Today Boehm-Bawerk's picture is on Austria's 100 schilling note, fiat paper money that will buy a taxi ride around Vienna.

Shorter Classics is a collection of five essays written over the course of his entire career, which follow the tradition of clarity and exactness traditionally identified with Austrian economics.

The first essay, "The Austrian Economists" is an excellent summary of the status of the Austrian school in 1891 and its movement toward a consistent application of the subjective theory of value. While still in the minority, the school was quickly developing an interdisciplinary following.

Like all Austrians in the Mengerian tradition, as this essay reveals, Boehm-Bawerk was an outspoken opponent of historicism, the dominant school of thought at the time. The historicists denied the validity of economic theory, scientific law, and deductive logic. They instead viewed economics as an endless process of gathering empirical data about the past (usually government-produced empirical data), a process which contributes nothing to our understanding of economics or the future. And because historicists denied the possibility of a universally valid theory of economics, they could say nothing about government intervention. In fact, they were willing collaborators of statism.

Contrary to the historical school, says Boehm-Bawerk, Austrians rely upon "deduction as the sole source of our knowledge" in most economic questions, creating a firm foundation for a principled case against the State intervention.

In the second essay, "Whether Legal Rights and Relationships Are Economic Goods," Boehm-Bawerk defines the term "economic goods" in a theoretical sense, that is, making it "truly comprehensive and universally valid." In the process he debunks the myths of those who had not grasped the subjective nature of valuation. Many economists defined the term "economic good" in contradictory and erroneous ways, and some said that credit itself is a good or is capable of creating goods.

The great Eugen von Boehm-Bawerk was the strongest influence on Ludwig von Mises; this important book helps show why.

Boehm-Bawerk develops a broader definition of "goods" which takes into account the subjective use-value of goods to individuals, and makes a distinction between rights and relationships themselves, and the services and materials for which they are valued. He thus classifies love, friendship, payment claims, and rights as economic goods only to the extent that they render either a valued service or material goods.

The third essay, "Control or Economic Law?" is a study of the influence that coercion and monopoly control can have on the economic laws governing wages and prices. Or put another way, Boehm-Bawerk attempts to discern whether government is subject to economic law. His answer is yes; economic law prevails over coercion. And to the extent that there is "social control" or government activity in the economy, it must "operate through the formula and laws of pure economic theory."

The highpoint of *Shorter Classics* is Boehm-Bawerk's magnificent demolition of the Marxian system, first published in 1896. For all the critiques and revisions of Marx—and revisions of the revisions of Marx, and the critiques that follow each revision—Boehm-Bawerk towers above them all. His exhaustive analysis penetrates the heart of Marx's system—the labor theory of value, the idea that economic value depends solely upon incorporated quantities of labor—and drives a stake through it.

Much of Marxism is based on the idea that exchange

Continued on page 7

Morning at the Trough

by Bradley Miller

For politicians, it's hard to find a sweeter deal than today's welfare system, which allows them to buy elections with the money of people who don't even know they're being fleeced. Indeed, some of us fleeced ingnoramuses actually vote for them.

All politicians talk about "getting people off welfare rolls and onto payrolls." Midst that kind of rhetoric, before Christmas the House passed a $5 billion welfare-reform plan. Now the Senate gets its turn to come up with an even better public-relations veneer for throwing more billions down the drain. Politics will triumph over economics again, and nothing essential will change.

Self-interest can be the mother of delusion, especially when access to the federal gravy train is at stake. The typical welfarist, even if he can't deny *all* the mountainous evidence of the system's loathsomeness, still likely believes that, on balance, he's a true servant of the poor. No doubt some anti-poverty warriors do actually alleviate poverty. If only because of the sheer size of the monster, some parts of the welfare industry doubtless do help some people, never mind the alternatives would help far more.

But if it's unjust to brand every welfarist a fool or careerist, at this stage it's hard to resist. Reams of evidence show that the welfare system has bankrupted the treasury while *perpetuating* poverty and other social ills. The reason the system keeps bloating is that politicians and bureaucrats and consultants profit from the bloat. Most of the bloat consists of programs for the middle class, not for the poor.

The root of the mess is that most Americans know and care nothing about public policy. Most, indeed, don't even know their senators' names, let alone anything about their records. If they pay attention to anything, it's only to programs that benefit them. If they're in the minority who vote, they vote for those who'll expand these programs and against those who oppose expansion or, in a suicidal outbreak of courage, support actual cuts.

If people don't benefit directly from a program, they're probably not even aware of it, and have no material reason to care anyway. Since the cost of federal programs is spread over the whole nation, the cost to an individual of even the larger programs is relatively insignificant.

From that, politicians can figure out that the way to get re-elected is to keep peddling, with the appropriate rhetoric, the tax-and-tax, spend-and-spend moonshine. Hence the trillion- dollar federal budget and the scant impact of exposes of limitless federal theft and waste.

Any way out of the mess, if there is one, must take account of these political realities, as Stuart Butler and Anna Kondratas point out in their recently published book, *Out of the Poverty Trap*.

The problem is not lack of jobs. If it were, the United States wouldn't have so many millions of immigrants who find lucrative work as soon as they get here. The problem is lack of motivation to take jobs.

Even before Franklin Roosevelt's New Deal set us on a one-way course to this mess, it was foreseen by thinkers such as Ludwig von Mises, Henry Hazlitt, and H.L. Mencken. But the *degree* of decay, as documented in recent years by observers of all political stripes—George Gilder, Daniel Patrick Moynihan, even Jesse Jackson and Edward Kennedy—is still astounding.

The work ethic is done for. As Charles Murray notes in his *Losing Ground*, which punctured the few remaining intellectual pretensions of today's welfarists, many recipients view as "chumps" those who hold low-level jobs. No wonder. Counting in-kind, or non-cash, benefits, untaxed welfare benefits often add up to far more than after-tax incomes from the jobs most recipients qualify for.

Everyone who cares to look knows by now that the system encourages unwed teenagers to have babies and live alone. Liberated from work, young males chase the far greater thrills of drugs, crime, and womanizing. Impregnating women is proof of studliness, not a call to become a responsible breadwinner. In the extreme unlikelihood that you land in jail, it's no sweat gulling the rehabilitationists into letting you go—read all about this in Stanton Samenow's *Inside the Criminal Mind*, for example. In sum: hard work, clean living, frugality, etc., are for wimps, bores, and dolts.

But before I soar to even higher dudgeon, I should note that workaholism has never afflicted me either. I well recall my outrage during my freelance days at having to go down to the government office to pick up my food stamps—aren't they supposed to mail the damn things? My typical day would begin around noon, and by the time I'd finished my meal at an area restaurant, browsed through a couple of newspapers, and pecked around a couple of bookstores, the day would be shot.

It wasn't the fast lane, but is was addictively pleasant. I hated myself, but not because I was unemployed; I hated knowing I was slothing away the potential that, in those days, I could still presume to have. But I also knew that unemployment is just one of the two chief tragedies of life; the other is employment.

Studies show, though, that most Americans, even now, would keep working even if they fell into independent wealth. Like most able-bodied welfare recipients, I marvel at their deficient imaginations. But evolution marches on, and by 2020 most Americans, not just welfare recipients, will value leisure as much as today's Swedes and Italians.

Like their panderers in Congress and the bureaucracy, most welfare recipients care next to nothing about the long-term health of our society or even about their own long-term well-being, but only about immediate gratification. The

Letters to the Editor

Thank you so much for the chance to go to the conference in New York. Each conference that I go to gives me so many new insights and encourages me to go learn more on my own. I feel privileged to hear such scholars speak.

I also wanted to let you know how much your work for the Institute is appreciated. So much has been accomplished that it seems incredible the Institute is only five years old. I hope the next five years are even more productive!

Jennifer Kreischer
Syracuse University

I just wanted to tell you that I was very impressed by your 1987 news round-up. You and the Institute have made extraordinary progress in a very short time. Congratulations.

Bruce Bartlett
Senior Policy Analyst
The White House

The recent Institute Fifth Anniversary conference was, as usual, first-rate. I always come away from an Institute conference both enlightened and energized. As for the dinner, I applaud the Institute for honoring Henry Hazlitt. It was a fitting tribute in which I felt honored to participate (and it was a thrill to meet him again). Finally, it was good to see all of my Institute friends and fellow students of Austrian economics again, and to meet new ones.

It is hard to believe that the Institute is already five years old. At the same time, in looking at all it has accomplished, it is equally hard to believe that it is *only* five years old. I am gratified at the tremendous strides the Institute is making, from the Advanced Instructional Seminar at Stanford over the summer, to the new student centers being opened up in Fairfax, Virginia and the University of Nevada, Las Vegas. And congratulations on the new West Coast office!

I know that wonderful things will continue to happen for the principles Ludwig von Mises espoused.

Marguerite A. Guinta
Columbia University

Congratulations on your 1987 Report for the Mises Institute, which I have just reviewed. It was concise, informative, and very well done.

You are doing a superb job.

James U. Blanchard III
New Orleans, Louisiana

You are doing a great and explosive job with the Institute. The five-year report is very, very attractive.

Steve Hanke
The Johns Hopkins University

Study Misesian Economics This Summer

Ludwig von Mises
1881-1973

The O.P. Alford III Center of the Ludwig von Mises Institute presents two week-long conferences in Austrian economics:

Introduction to Austrian Economics
Dartmouth College
Hanover, NH
August 13-19, 1988

Advanced Austrian Economics
Stanford University
Palo Alto, CA
June 25-July 1, 1988

Dartmouth is designed for undergraduates and others interested in studying the Austrian school. Stanford is intended for advanced graduate students.

Both programs are directed by the outstanding Austrian economist, Professor Murray N. Rothbard; other faculty will include: Professors Roger W. Garrison, David Gordon, and Hans-Hermann Hoppe.

"The most exciting intellectual experience of my life," said one student about last year's program. *"I have made many friends and look forward to years of keeping in touch."*

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The fee of $595 ($95 for full-time students) includes: dormitory housing; three meals a day; study materials; library privileges; and extensive recreational and athletic facilities. The teaching is world-class, the campuses are breathtaking, and the weather is magnificent. Join us for the intellectual experience of *your* lifetime.

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Cover for Socialism...from page 1

under social instead of private control?

For one thing, of course, some socialists might simply be evil. They might have nothing against misery, especially if it is only misery for others, and they are in charge of administering it while living very well indeed.

But I am interested in those who advocate socialism because it is allegedly more "value-productive" than capitalism. They claim that the evidence showing otherwise, as in East Germany, is beside the point, or perhaps merely accidental.

But how can anyone deny that the East German or Russian experience is decisive evidence against socialism? How can people get away with promoting the absurd view that the evidence against socialism is merely fortuitous?

The answer lies in the respectable-sounding philosophy of empiricism. It is empiricism that shields socialism from refutation by its own failure, and gives socialism whatever credibility it still has.

That's why the Misesian critique of socialism attacks both socialism and empiricism. It explains that there is a necessary connection between socialism and lower living standards; the Russian experience is no accident; and the empiricists' attempt to make it appear an accident is founded on intellectual error.

Empiricism is based on two fundamental assumptions: first, one cannot know anything about reality with certainty, apriori; and, second, an experience can never prove definitively that a relationship between two or more events does or does not exist.

Using those two assumptions as the starting point, it is easy to dismiss empirical refutations of socialism.

The empiricist-socialist does not deny the facts. In fact, he will (reluctantly) admit that living standards are deplorable in Russia and Eastern Europe. But he claims that this experience does not constitute a case against socialism.

Instead, he says, the miserable conditions are a result of some neglected and uncontrolled circumstances that will be taken care of in the future, after which, everyone will see that socialism means *higher* living standards.

With empiricism, even the striking differences between East and West Germany can thus be explained away. The empiricist says, for example, that it's because West Germany got Marshall Plan aid while East Germany had to pay reparations to the Soviet Union; or because East Germany encompassed Germany's less developed, rural provinces; or that the mentality of serfdom wasn't discarded in the East until much later; and so on.

Not even the most perfectly controlled experiment can change this predicament, because it is impossible to control every variable that may conceivably influence the variable we want to explain. We don't even know all the variables making up the universe, which renders all questions permanently open to newly discovered experiences.

According to empiricism, there is no way that we can rule out *any* event as being a possible cause of something else. Even the most absurd things—provided they have taken place earlier in time—can be possible causes. Thus there is no end to the number of excuses.

The empiricist-socialist can dismiss any charge brought against socialism so long as it is based only on empirical evidence. He can claim that since we cannot know what the results of socialist policies will be in the future, we have to try them out and let experience speak for itself. And no matter how bad the results may be, the empiricist-socialist can always rescue himself by blaming some heretofore neglected, more or less plausible, variable. He makes a newly revised hypothesis, and it is supposed to be tested indefinitely.

Professor Hans-Hermann Hoppe

The empiricist says that experience can tell him that a particular socialist policy scheme did not reach the goal of producing more wealth. But it can never tell him if a slightly different one will produce better results. Nor will experience tell him that it is impossible to improve the production of goods and services, or raise living standards, through any socialist policy at all.

Now we see just how dogmatic the empiricist philosophy actually is. In spite of its alleged openness and its appeal to experience, empiricism is an intellectual tool that completely immunizes one from criticism and experience. It is the perfect intellectually dishonest means for shielding socialism from the glaring truth of its own failure.

Misesian economics shows that socialism fails because it violates the irrefutable laws of economics—among them the law of exchange, the law of diminishing marginal utility, the Ricardian law of association, the law of price controls, and the quantity theory of money—which can be deduced from the axiom of action by means of applied logic. And thus we can know— beforehand and absolutely—what the consequences of socialism will be wherever it is tried.

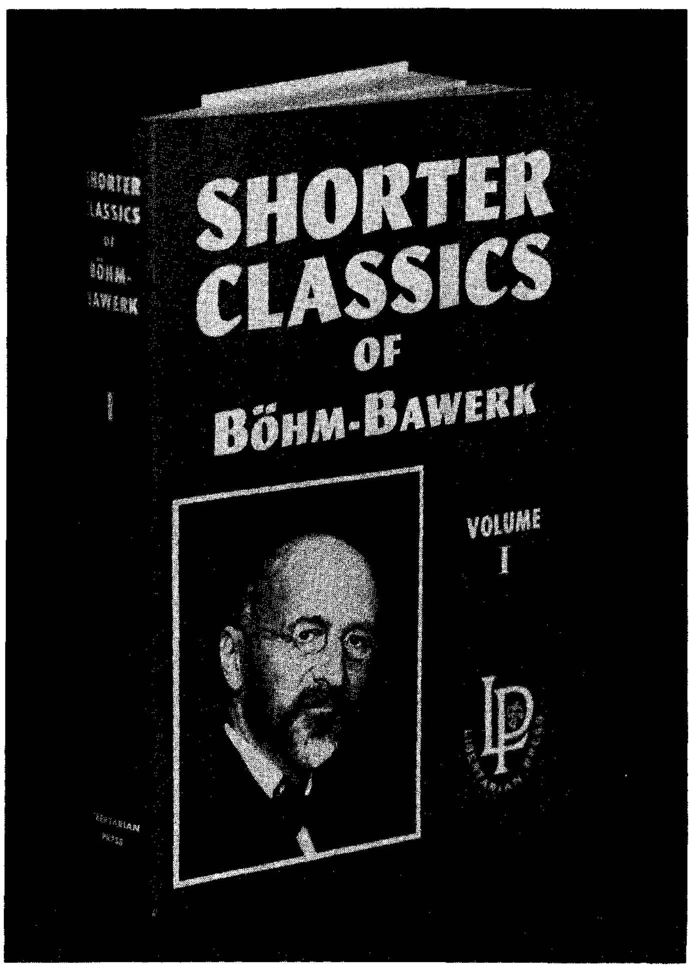
If we want to attack socialism, we must also attack the absurd intellectual error of empiricism. And if we want to defeat socialism, we must make a principled Misesian case based on the logic of human action and the irrefutable laws of economics. ■

Professor Hans-Hermann Hoppe teaches economics at the University of Nevada, Las Vegas, and is senior fellow at the Ludwig von Mises Institute.

Census Bureau reports that about 30 percent of U.S. households get direct benefits in public funds, which makes the combination of recipients and administrators of federal largesse the most formidable political bloc in America. So the rest of us chumps should realize that another 30 years of those trends coupled with the "graying" of America will make the number of Americans now feeding at the public trough seem minuscule.

But, while cynics sneer, it's comforting to contemplate the selfless sages slaving to avert this on the House Subcommittee on Human Resources of the Committee on Education and Labor, to say nothing of the Subcommittee on Labor, Education, and Health and Human Services of the Committee on Appropriations. I'm sure they'd turn the tide on poverty with a few hundred billion more of your bucks to spend. ■

Mr. Miller today works hard as director of editorial services at the Heritage Foundation and media fellow of the Ludwig von Mises Institute.



Eugen von Boehm-Bawerk's *Shorter Classics* is available in a 376-page hardbound from the Institute for $16.00, which includes U.S. postage and handling. Just check the appropriate box on the enclosed form.

Shorter Classics...from page 5

cannot occur without equality in valuation. But, as Boehm-Bawerk proves, inequality is necessary for exchange, that is, an individual must value the good he is getting more than the good he is giving up; otherwise no exchange can take place.

Marx's fundamental mistakes led to a system:

> which runs in one direction, facts go in another; and they cross the course of the system sometimes here, sometimes there, and on each occasion the original fault begets a new fault. The conflict of system and facts must be kept from view, so that the matter is shrouded either in darkness or vagueness, or it is turned and twisted with the same tricks of dialectic as at the outset; or where none of this avails we have a contradiction.

Boehm-Bawerk understood the destructive power of the Marxian system long before it was tried and devoted enormous effort towards its refutation. If intellectual integrity were the fuel of Marxism, Boehm-Bawerk would have finished it off. It is unfortunate that the success of Marxism lies beyond its veracity as an economic doctrine.

The final essay, "The Ultimate Standard of Value," is the perfect introduction to the Austrian view of prices and the meaning of market exchange. Boehm-Bawerk leaves no doubt as to the ultimate source of value: demand, as defined by individual subjective utility, a theme first elaborated by Menger. But Boehm-Bawerk illustrates the idea's implications with numerous examples and then provides a fastidious defense against its detractors.

Boehm-Bawerk holds a place alongside Menger and Mises as a great scholar in Austrian economics. No one can claim to have a comprehensive understanding of Misesian, or Austrian, economics without a working knowledge of Boehm-Bawerk's magnificent contributions. *Shorter Classics* is a great beginning toward that goal. ■

Mr. Tucker is managing editor of The Free Market, *administrator of the Institute's Lawrence Fertig Student Center in Fairfax, Virginia, and a graduate student in economics at George Mason University.*

Quote of the Month

"Sound money still means today what it meant in the nineteenth century: the gold standard."

—Ludwig von Mises

[*Theory of Money and Credit*, p. 480]

Interest Rate Question...from page 1

lower interest rates; and since this same act will increase bank reserves by the same extent, the banks will now inflate money and credit out of thin air by a multiple of the initial jolt, nowadays about ten to one. So if the Fed buys one billion dollars of securities, bank reserves will rise by the same amount, and bank loans and the money supply will then increase by $10 billion. The supply of credit has thereby increased further, and interest rates will fall some more.

But it would be folly to conclude, impressionistically, that interest rates are destined to fall indefinitely. In the first place, the supply and demand for credit are themselves determined by deeper economic forces, in particular the amount of their income that people in the economy wish to save and invest, as opposed to the amount they decide to consume. The more they save, the lower the interest—the more they consume, the higher. Increased bank loans may mimic an increase in genuine savings, yet they are very far from the same thing.

Inflationary bank credit is artificial, created out of thin air; it does not reflect the underlying saving or consumption preferences of the public. Some earlier economists referred to this phenomenon as "forced" savings; more importantly, they are only temporary. As the increased money supply works its way through the system, prices and all values in money terms rise, and interest rates will then bounce back to something like their original level. Only a *repeated* injection of inflationary bank credit by the Fed will keep interest rates artificially low, and thereby keep the artificial and unsound economic boom going; and this is precisely the hallmark of the boom phase of the boom-bust business cycle.

But something else happens, too. As prices rise, and as people begin to anticipate further price increases, an inflation premium is placed on interest rates. Creditors tack an inflation premium onto rates because they don't propose to continue being wiped out by a fall in the value of the dollar; and debtors will be willing to pay the premium because they too realize they have been enjoying a windfall. And this is why, when the public comes to expect further inflation, Fed increases in reserves will *raise*, rather than lower, the rate of interest. And when the acceleration of inflationary credit finally stops, the higher interest rate puts a sharp end to the boom in the capital markets (stocks and bonds), and an inevitable recession liquidates the unsound investments of the inflationary boom.

An extra twist to the interest rate problem is the international aspect. As a long-run tendency, capital moves from low-return investment (whether profit rates or interest rates) toward high-return investments until rates of return are equal. This is true within every country and also throughout the world. Internationally, capital will tend to flow from low-interest to high-interest rate countries, raising interest rates in the former and lowering them in the latter.

In the days of the international gold standard, the process was simple. Nowadays, under fiat money, the process continues, but results in a series of alleged crises. When governments try to fix exchange rates (as they did from the Louvre agreement of February 1987 until Black Monday), then interest rates cannot fall in the United States without losing capital or savings to foreign countries.

In the current era of a huge balance of trade deficit in the U.S., the U.S. cannot maintain a fixed dollar if foreign capital flows outward; the pressure for the dollar to fall would then be enormous. Hence, after Black Monday, the Fed decided to allow the dollar to resume its market tendency to fall, so that the Fed could then inflate credit and lower interest rates.

But it should be clear that that interest rate fall could only be ephemeral and strictly temporary, and indeed interest rates have already resumed their inexorable upward march. Price inflation is the consequence of the enormous monetary inflation pumped in by the Federal Reserve for several years before the spring of 1987, and interest rates are therefore bound to rise as well. Moreover, the Fed, as in many other matters, is caught in a trap of its own making; for the long-run trend to equalize interest rates throughout the world is a drive to equalize not simply money, or nominal, returns, but *real* returns corrected for inflation. But if foreign creditors and investors begin to receive dollars worth less and less in value, they will require higher money interest rates to compensate—and we will be back again, very shortly, with a redoubled reason for interest rates to rise.

In trying to explain the complexities of interest rates, inflation, money and banking, exchange rates and business cycles to my students, I leave them with this comforting thought: Don't blame *me* for all this, blame the government. Without the interference of government, the entire topic would be duck soup. ■

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