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**LIBERTY**  
IN OUR TIME

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**THE ESSENCE OF  
THE AUSTRIAN SCHOOL**

ACCEPTANCE SPEECH FOR THE HONORARY DOCTORATE IN  
SOCIAL SCIENCES, FRANCISCO MARROQUÍN UNIVERSITY

**JESÚS HUERTA DE SOTO**

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Jesús Huerta de Soto is Professor of Political Economy at Rey Juan Carlos University in Madrid. He holds a PhD in Law and a PhD in Economics from Complutense University of Madrid and a Master of Business Administration from Stanford University. Author of twelve books published in more than sixty editions worldwide and translated into nearly twenty languages, Professor Huerta de Soto

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# THE ESSENCE OF THE AUSTRIAN SCHOOL

ACCEPTANCE SPEECH FOR THE HONORARY DOCTORATE IN  
SOCIAL SCIENCES, FRANCISCO MARROQUÍN UNIVERSITY\*

## JESÚS HUERTA DE SOTO

It is for me a great pleasure and honour to be here at the IEA in London today, where one of the great masters of the Austrian School Friedrich A. Hayek used to come to lecture, invited by the late Ralph Harris and my good old friend, the late Arthur Seldon. I am also very happy to have the opportunity to introduce you to my second book published in the English language. It is entitled *The Austrian School: Market Order and Entrepreneurial Creativity*.

Most probably, one of the main contributions of the Austrian School consists of the development of a very original, modern, extremely fruitful and alternative approach to economic science that is already taught not only at some universities in the Spanish-speaking world, the United States and the rest of Europe, where for instance my own works are already required textbooks, but also in many other countries in the rest of the world, where a constantly increasing number of young scholars are spreading the Austrian

point of view against the fading tide of twentieth-century mainstream economics.

According to Ludwig von Mises, 'what distinguishes the Austrian School and will lend it immortal fame is precisely the fact that it created a theory of economic action and not of economic equilibrium or non-action'.

The neoclassical paradigm has prevailed thus far in economic science, but it is now stagnating, due to its highly unrealistic assumptions, its static nature and its formal reductionism. The focus of the Austrian research programme is strikingly different: economists of the Austrian School concentrate their analysis on the dynamic processes of social co-operation which characterise the market. They devote close attention to the central role played in these processes by entrepreneurship and by the different institutions that make life in society possible.

The Austrian perspective contrasts starkly with the economic analysis shared, in different

\* In a lecture in November 2008, Professor Huerta de Soto set out the key contributions of the Austrian School to economic thought.

versions, by neo- and post-Keynesians, on the one hand, and the Chicago School, on the other. Keynesians hold that the economy is in a state of equilibrium plagued by market failures, while the Chicago theorists believe it is in a Pareto-efficient state of equilibrium, and thus free of market failures. Despite the ideological contradiction between these two versions of equilibrium analysis, Austrians see in them the same lack of understanding about the real workings of the market.

The market is an entrepreneurial process of creativity and co-ordination, a process which, by definition, can never reach any Pareto optimum.

**Mises' dynamic approach explains the remarkable resurgence of this school, which is now one of the main alternatives for the future to replace the neoclassical-Walrasian paradigm.**

However, because the market fosters creativity and co-ordination, it is dynamically efficient, as long as the following condition is met: institutional state coercion, in the form of interventionism or socialism, must not hinder the free exercise of entrepreneurship nor make it difficult for any human being to freely reap the fruits of his creative action. This condition requires full respect for private property, within the framework of the rule of law, and a government of strictly limited powers.

One of the main contributions of the Austrian School has been the demonstration that it is impossible to organise society based on coercive commands and regulations, as socialists and interventionists constantly attempt to do. The reason this cannot be done is because a planning

agency cannot possibly obtain the first-hand market information necessary to achieve co-ordination with its commands.

As a result of this insight, only Austrian economists were able to predict the collapse of the economies of the former Eastern bloc, as well as the dead-end crisis of the welfare state. These predictions contrast sharply with the inability of general-equilibrium theorists (such as Lange, Taylor, Samuelson, Dickinson and others) to even perceive the insoluble economic-calculation problem that socialism poses.

It is unsurprising that they failed to recognise the problem.

In their models, they start from the assumption that all the information necessary to solve the corresponding system of simultaneous equations is 'already given' and available to the planner at all times. In short, the real problem which the spontaneous order of the market resolves each day, in a context of continual change, creativity and co-ordination, is considered already solved from the very beginning in the mathematical models of general-equilibrium theorists.

However, they were not the only ones unable to fully grasp the Austrian challenge to the mainstream. Even the equilibrium theorists of the Chicago School (such as Knight, Friedman, Stigler, Rosen and Coase) also failed to grasp it. In fact, a few years ago, at a Mont Pelerin Society general meeting held in Vienna, Sherwin Rosen stated

the following: 'the collapse of central planning in the past decade has come as a surprise to most of us' (Rosen, 1997, pp. 139–152). And Ronald Coase himself said the following words: 'nothing I'd read or known suggested that the collapse was going to occur' (Coase, 1997, p. 45).

The Austrian Theory of capital, money and economic cycles is another of the School's key contributions. It could be summarised in this way: in the banking system currently in force worldwide under the supervision of central banks, and in a context of nationalised money and legal-tender laws, bankers enjoy the privilege of operating with a fractional reserve. This privilege regularly leads to the expansionary granting of loans unbacked by an actual increase in voluntary saving. The inexorable result of this credit expansion is the unsustainable 'lengthening' of the processes of productive investment, which tend to become disproportionately capital-intensive.

A speculative bubble forms and gives rise to grave, real errors in capital-goods investments.

The intensification of the inflationary process through credit expansion will inexorably and spontaneously reverse. This reversal will trigger an economic crisis or recession in which investment mistakes will be exposed, unemployment will climb, and the need to liquidate and reallocate the resources invested in error will arise.

Economic crises are not exogenous, as the Chicago School and real-shocks theorists such as Kydland and Prescott think. Nor are they inherent in the market economy, as Keynesians and the other market-failure theorists assert. Instead, economic cycles stem from a problem of erroneous institutional design: the existence of a privileged fractional-reserve banking system. The solution lies in the following: the privatisation of money and the introduction of a rigid monetary system such as the pure gold standard; the establishment of a 100% reserve requirement on demand deposits, as with any other deposit of a fungible good, such as wheat or oil; and the elimination of central banks, which in modern market economies are the



Carl Menger (1840–1921) and Eugen Böhm-Bawerk (1851–1914), founders of the Austrian School.

only socialist planning agencies in the monetary sphere that remain operative.

It is not surprising that the only theorists to predict the Great Depression of 1929 were Austrians, namely Ludwig von Mises and Friedrich Hayek. They foresaw it as a consequence of the monetary and financial excesses committed after the establishment of the United States Federal Reserve in 1913, and especially during the roaring twenties. (Incidentally, during those years, not only Keynes, but also the monetarists led by Fisher, believed the economy had entered a new bonanza period that would never end.)

Austrian economists also predicted the

When people act in this way, they set in motion a creative process by which pre-existing maladjustments are co-ordinated. This process lies at the heart of the spontaneous order of the market, as Hayek and Kirzner have shown.

Intimately related to the above is the dynamic concept of competition, understood as a process of rivalry, creativity and discovery in which entrepreneurs compete with each other to be the first to find and seize profit opportunities. This concept is diametrically opposed to the neoclassical model of 'perfect' competition, in which, paradoxically, everyone does the same thing and sells at the same price; in other words,

### Another crucial contribution of the Austrian School is the theory of entrepreneurship: the ability of human beings to detect opportunities for profit that arise in their environment.

stagflation which emerged after the incorrectly named oil crisis of 1973 that almost entirely destroyed the Keynesian theoretical analysis. Moreover, Austrians have repeatedly warned about the credit bubble and 'irrational exuberance' characteristic of the again so-called 'new economy' period, which began 15 years ago. And they see the current worldwide financial crisis and economic recession as a perfect illustration of the Austrian theory of economic cycles.

The development of the Theory of Entrepreneurship has been another of the Austrian School's main contributions. 'Entrepreneurship' refers to the human capacity to recognise the opportunities for subjective profit that arise in one's environment and to act accordingly to take advantage of them.

in the neoclassical model of perfect competition, nobody competes.

We should also note that Austrians criticise the unjustified application of the methodology used in natural sciences and physics to the field of economics, an error Hayek refers to as 'scientism'. The Austrian School has developed an aprioristic-deductive methodology which appropriately links the formal realm of theory with the empirical realm of history.

Austrians reject the use of mathematics in economics, since mathematics is a formal language which has emerged in response to the demands of physics and formal logic. In these areas, constancy is assumed and entrepreneurial creativity and the passage of subjective, non-spatialised time are entirely absent. For the Aus-

trians, only the verbal languages that human beings creatively evolve in the course of their daily entrepreneurial tasks provide a suitable vehicle for scientifically analysing the real-world facts that pertain to spontaneous market orders, which are never in equilibrium.

In addition, Austrian economists regard the prediction of specific economic events as the task of the entrepreneur and not of the economic scientist. At most, economists can make qualitative or theoretical 'predictions', 'pattern predictions', to use Hayek's terminology, concerning the disordinating effects of economic interventionism in any of its forms.

However, they cannot, as economic scientists, make predictions which apply to precise circumstances of time and place.

In short, for Austrians, the fundamental economic problem is not a technical one of how to maximise an objective, constant and 'known' function subject to constraints which are also considered 'known' and constant. On the con-

trary, the fundamental economic problem is strictly 'economic' in the Austrian sense: it arises when many ends and means compete with each other, and when knowledge about them is not given nor constant, but dispersed throughout the minds of countless real human beings who are constantly creating it anew.

In this situation, one cannot know all of the existing possibilities and alternatives, much less those that will be created in the future, nor the relative intensity with which each is desired. Therefore, it is not surprising that a growing number of prominent mainstream neoclassical economists, such as Mark Blaug, have shown great courage and have ultimately declared their apostasy from the general-equilibrium model and the neoclassical-Keynesian synthesis. Blaug concludes: 'I have come slowly and extremely reluctantly to the view that they [the Austrian School] are right and that we have all been wrong' (Blaug and De Marchi, 1991, p. 508).

Austrian theorists view the Chicago School's



Ludwig von Mises (1881-1973), leading exponent of the Austrian School.

defence of the free market as particularly erroneous: a 'perfect' market in the neoclassical sense is a contradiction in terms. The market must be defended not because it is 'perfect' or Pareto efficient, but because it is a process of discovery, creativity and co-ordination which is never in equilibrium. Furthermore, it is the only possible alternative, and it cannot be improved (but only worsened) through government regulations.

It is generally agreed that the 1871 publication of *Principles of Economics*, by Carl Menger (1840–1921), gave birth to the Austrian School of economics. Nevertheless, Menger actually adopted

Juan de Salas); *fourth*, the dynamic concept of competition, understood as a process of rivalry among sellers (which is a contribution of Castillo de Bovadilla and Luis de Molina); *fifth*, the principle of time preference (rediscovered by Martín de Azpilcueta); *sixth*, the distorting effect of inflation on the real economy (explained by Juan de Mariana, Diego de Covarrubias, and again Martín de Azpilcueta); *seventh*, the critical analysis of fractional-reserve banking (included in the writings of Luis Saravia de la Calle and Martín de Azpilcueta); *eighth*, the fact that bank deposits form part of the money supply (discovered by Luis de Molina and Juan de Lugo); *ninth*, the insi-

**The market is a process of discovery, creativity, and coordination that is never in equilibrium and cannot be improved (quite the contrary) through government regulation.**

a tradition of thought which originated in continental Europe and can be traced back to the Spanish theorists from the School of Salamanca, of the sixteenth and seventeenth centuries. Thus, we could say that in a strict sense, the Austrian School should also be called the 'Spanish School'.

The scholastics of the Spanish Golden Age had already formulated the following ten basic principles of the Austrian School: *first*, the subjective theory of value (articulated by Diego de Covarrubias y Leyva, Bishop of the City of Segovia); *second*, the idea that prices determine costs and not vice versa (as discovered by Luis Saravia de la Calle); *third*, the dynamic nature of the market and the impossibility of obtaining the information which relates to equilibrium (as explained by the Jesuit cardinals Juan de Lugo and

ght of Juan de Mariana that a lack of information makes it impossible to organise society through coercive commands; and *tenth*, the liberal in the classical sense or libertarian tradition that all unjustified intervention in the market violates natural law.

Menger's primary contributions include the subjective theory of value, the discovery of the law of marginal utility, the theory of the spontaneous emergence of institutions, the conception of the production process as a series of successive temporal stages, and the criticism of historicism in the *methodenstreit* against Schmoller and the rest of the German 'socialists of the chair'.

Menger's brilliant pupil, Eugen von Böhm-Bawerk (1851–1914), developed these contributions and applied them to both the theory of

interest (which holds that interest is determined by the subjective valuation of time preference, and never by the marginal productivity of capital) and the theory of capital, understood as the estimated value, in terms of free-market prices, of the capital goods which embody the intermediate stages in any production process. Moreover, Böhm-Bawerk demolished the Marxist theory of exploitation, as well as Marshall's theory of price determination, which wrongly held that utility and costs jointly determine prices. (Marshall was right about utility, but mistaken about costs.)

Ludwig von Mises (1881–1973) was the leading member of the third generation of Austrian economists and without a doubt the most important member of all of them. Mises was responsible for the School's most vital practical contributions: the theory of the impossibility of socialism, the theory of economic cycles, the theory of entrepreneurship, the criticism of interventionism, and the systematisation of the Austrian methodology. He also gave us the best-known

treatise on Austrian economics entitled *Human Action*, which has appeared in numerous editions in many languages.

Mises' foremost disciple was Friedrich A. Hayek (1899–1992), winner of the 1974 Nobel Prize in Economics.

Hayek further developed all Mises' contributions, demolished Keynesian economic theory, and was the key theorist of the spontaneous market order in the twentieth century. And as you know, he was instrumental in the foundation of the Institute of Economic Affairs when he advised its founder Antony Fisher not to dedicate his efforts to the political arena but rather to try to influence the intellectuals through a think tank.

Closer to our time, the chief Austrian economists have been Murray N. Rothbard (1926–95), the author of over 20 books and hundreds of articles on theory and history who provided the driving force behind the theory of anarcho-capitalism; and Israel M. Kirzner (b. 1930), a professor of economics at New York University who



Friedrich August von Hayek (1899–1992), winner of the Nobel Prize in Economics in 1974.

has perfected the Austrian Theory of Entrepreneurship.

But our greatest cause for optimism about the future of the Austrian School as the main intellectual background for this new globalised world of the twenty-first century, based on entrepreneurship and creativity, is the growing number of young scholars, who in their uncompromising search for scientific truth, are abandoning the Keynesian and monetarist theories of the old mainstream, and embracing the Austrian School of economics all over the world.

For this reason, I consider it is very important to foster knowledge and research in the field of Austrian economics, so that at a growing number of universities, this approach steadily replaces

the old Keynesian, neoclassical and monetarist teachings, which are included like a pot-pourri in the confused university textbooks currently used, most of them of American origin. In this way, I am very happy to announce to you that the Spanish government approved the first official master's degree in Austrian economics, with validity in all the European Union, and that I am directing it at King Juan Carlos University in Madrid.

Let us hope that this new tide soon also reaches England, where the Austrian School was first known thanks to Hayek in the 1930s. And if my book helps even just a bit to accomplish this important task, I will consider that all my effort has been worthwhile.

**Most importantly, a host of young theorists and professors from universities in Europe and America are now delving deeper into the contributions of the Austrian School.**

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