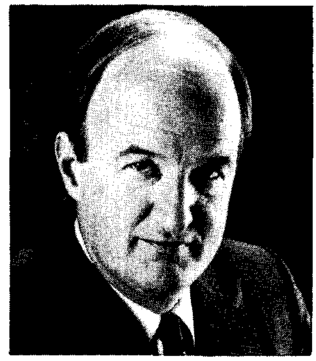

Has Capitalism Failed or Succeeded? The Tale of Two Graphs

"Yet, in the aftermath of the Keynesian revolution, too many economists forgot that classical economics provides the right answers to many fundamental questions."
—N. Gregory Mankiw[1]

The Great Depression of the 1930s brought us Keynesian economics and a broad shift in emphasis from the classical study of economic growth to concern about economic fluctuations and how to subdue the boom-bust business cycle. Postwar textbooks, led by Paul Samuelson's *Economics*, focused primarily on the ups and downs of the capitalist system and how government policy could ameliorate the business cycle. Keynesian economists stressed "countercyclical demand management" and "compensatory fiscal policy" to "iron out the business cycle, with boom surpluses canceling out depression deficits."[2] Economists taught the "New Economics" of "automatic built-in stabilizers," "discretionary fiscal policy," and "fiscal drag." Even free-market economist Milton Friedman focused his research on ways to stabilize the economy through monetary policy.

Indeed, according to the new conventional wisdom, the primary purpose of studying economics was to achieve "short-run stabilization" of the capitalism system. Postwar textbooks abound in the study of cyclical fluctuations, while burying the study of economic growth and development in the back pages.

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The Volatility of Capitalism?

If you look at Graph #1 at the top of the next page, you might agree with this focal point: The business cycle appears to be volatile and the primary problem facing the United States. This graph, published in Michael Parkin's popular textbook, shows real GDP fluctuations from 1869 to 1992.

Graph #1 suggests that the U.S. economy has run amok, suffering untold boom and bust over the past century and a half. According to the critics, capitalism has failed and needs to be tamed.

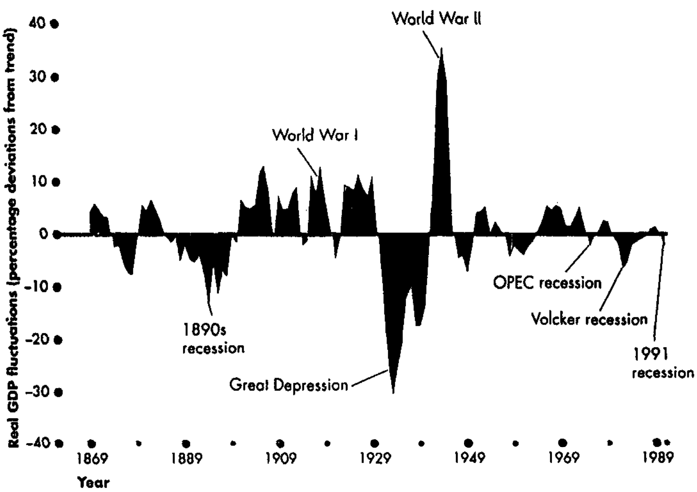
Is this an accurate picture of the U.S. economy? We all know that games can be played with charts and graphs. Darrell Huff, in his classic book, *How to Lie With Statistics* (W. W. Norton, 1993 [1954]), described the distortions that can occur with a "one-dimensional" picture.

The Long-Term View Favors Economic Growth

Now let's look at Graph #2, which tells quite a different story. This graph highlights real GDP, 1869-1992, rather than changes in real GDP.

Amazingly, Graph #2 also comes from Parkin's textbook. It uses the same statistics, but paints an entirely different picture. Here the overwhelming conclusion is not that the

Graph #1: Real GDP Fluctuations, 1869–1992

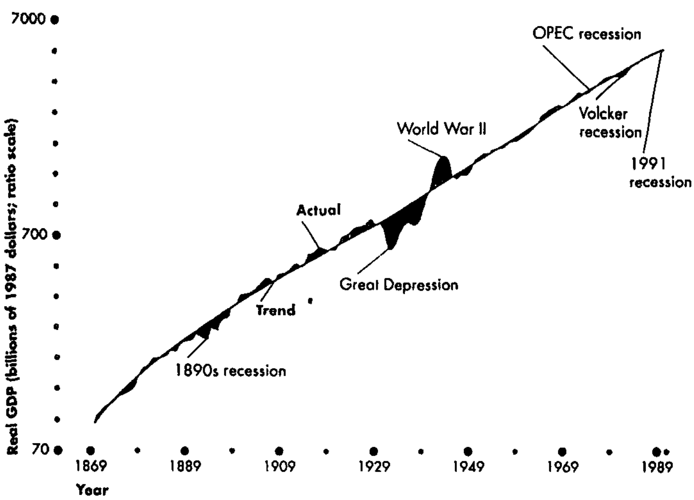


The uneven pace of increase of real GDP is illustrated by tracking its fluctuation measured as the percentage deviation of real GDP from trend. Rapid expansion of real GDP, which occurred during both world wars, puts real GDP above trend. Decreases in real GDP, which occurred during the 1890s recession, the Great Depression, and the three most recent recessions, puts real GDP below trend. The real GDP fluctuations describe the course of the business cycle.

Source: Michael Parkin, *Economics*, 2nd ed. (Addison-Wesley, 1994), p. 596.

U.S. economy is subject to violent fluctuations, but that it has grown dramatically over the past century or more. In this graph, the periods of inflationary booms and recessions are relatively minor. Even the Great Depression is dwarfed by unrelenting economic progress over the long term. The key point is that Americans have enjoyed a dramatic increase in their standard of living over the past century. Capitalism works!

Graph #2: Real GDP, 1869–1992



Between 1869 and 1992 real GDP grew at an annual average rate of 3.3 percent. But the growth rate was not the same in each year. In some periods, such as the years during World War II, real GDP expanded quickly. In other periods, such as the Great Depression and, more recently, following the OPEC oil price hikes, the Volcker interest rate increases, and in 1991, real GDP declined. There were several periods of decline in the nineteenth century as well, one of which is marked in the figure.

Source: 1869–1929: Christina D. Romer, "The Prewar Business Cycle Reconsidered: New Estimates of Gross National Product, 1869–1908," *Journal of Political Economy* 97, (1989) 1–37; and Nathan S. Balke and Robert J. Gordon, "The Estimation of Prewar Gross National Product: Methodology and New Evidence," *Journal of Political Economy* 97, (1989) 38–92. The data used are an average of the estimates given in those two sources. 1929–1958: *Economic Report of the President*, 1991. 1959–1992: *Economic Report of the President*, 1993. The data for 1869 to 1958 are GNP and those for 1959 to 1992 are GDP. The difference between these two measures is small and is explained in Chapter 23, pp. 619–620.

Source: Michael Parkin, *Economics*, 2nd ed., p. 595.

The Economics Profession Alters Its Viewpoint

For decades, the American economics profession worried about recession, unemployment, and income inequality. Economists endorsed "compensatory" fiscal policy (deficit spending and government expansion) as a way to tame the business cycle. Meanwhile, economic growth slowed relative to other nations.

Now the pendulum has swung back. More and more economists are recognizing the paramount importance of economic growth and rising standards of living rather than business fluctuations and inequality of income distribution. Greg Mankiw, a new Keynesian at Harvard, is a case in point. He places the classical model of economic growth upfront in his *Macroeconomics* textbook, ahead of Keynesian business-cycle theory. He highlights the success stories of countries that have grown dramatically since the end of World War II. It's another sign that free-market economics has triumphed in the academic world. □

1. Gregory Mankiw, *Macroeconomics*, 2nd ed. (Worth Publishers, 1994), preface.
2. Paul A. Samuelson, *Economics*, 8th ed. (McGraw-Hill, 1970), p. 337.

THE FREEMAN
IDEAS ON LIBERTY

The Undiscountable Professor Kirzner

by Roger W. Garrison

Eugen von Böhm-Bawerk, whose name has come to be virtually synonymous with "roundaboutness" (of capital-using production processes), penned the original Austrian perspective on capital and interest. He wrote three volumes (*History and Critique*, *Positive Theory*, and *Further Essays*) over a span of a quarter of a century (1884-1909). In 1959 the 1,200-plus pages of *Capital and Interest* were translated into English by Hans Sennholz and George Huncke. Ludwig von Mises reviewed the new translation in *The Freeman*, where he described this "monumental work" as "the most eminent contribution to modern economic theory."[1] Mises went so far as to suggest—as only Mises could—that no citizen who takes his civic duties seriously should exercise his right to vote until he has read Böhm-Bawerk!

And now we have Israel Kirzner's *Essays on Capital and Interest* (Edward Elgar, 1996, 166 pages, $59.95). There is no intent on the part of the author or the reviewer to station this volume between the voter and the voting booth. However, the position that this book occupies on the Austro-neoclassical landscape is an eminently strategic one—so strategic as to warrant our issuing a Mises-style taboo, not to voters, but to all economists who adopt the Austrian perspective. But first we must put into perspective this new offering by Professor Kirzner.

The significance of this volume is not diminished by the fact that all its separate parts, except for the 12-page introductory essay, have been published before. With greater accessibility and appearing now together, these *Essays* provide a virtual history—and pre-history—of the modern Austrian resurgence. Three decades ago, well before the resurgence began, Professor Kirzner wrote *An Essay on Capital*. The four parts of this book (on "Unfinished Plans," "Stocks and Flows," "Capital and Waiting," and "Measuring Capital") read like the work of a lone scholar trying—and succeeding in most instances—to satisfy himself. The 1966 *Essay*, possibly the most underrated of all his contributions, appears anew as the longest of the 1996 *Essays*.

In late 1974, Professor Kirzner presented a paper titled "Ludwig von Mises and the Theory of Capital and Interest" in a special symposium at the Southern Economic Association meetings in Atlanta. At that time, a year after Mises's death, and the year that the resurgence began (with a conference in Vermont at which Professor Kirzner was a key participant), there was a small but eager audience for his Austrian perspective. Professor Kirzner shows how Mises's theory differs from Böhm-Bawerk's and how it compares favorably to the theories of J. B. Clark and F. H. Knight. In part a stocktaking, in part

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