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## Gottfried Haberler: A Century Appreciation\*

Richard M. Ebeling\*

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During the first week of July in 1936, an international conference on the "Problems of Economic Change" was held in Annecy, France. It brought together such notable economists as Ludwig von Mises, Wilhelm Ropke, Oskar Morgenstern, Bertil Ohlin, Lionel Robbins, Dennis Robertson, Charles Rist, William Rappard, John B. Condliffe, John Van Sickle, Alvin Hansen, John Maurice Clark, and Jan Tinbergen.

They had come to this attractive French city south of Lake Geneva to discuss the problem of business cycles and their effect on the world economy. Little agreement was reached over the three days during which these leading economists met. But there was a single consensus among the attendees. One of the other participants at the conference, Gottfried Haberler, had set an example and standard for how research on the subject of business cycles should be undertaken. According to the official summary of the conference:

There was throughout the whole conference one matter which secured the wholehearted support of all those present, namely the new technique in research which has been followed during the last two years in the study of the theory of the business cycle by Dr. Haberler. It will be recalled that he was appointed to a special post on the staff of the Economic and Financial Section of the League [of Nations]. ... He was charged with the duty of examining the present state of knowledge in the theory of the business cycle and was to draw up a report on this subject. . . . [T]here can be no doubt that everyone present was greatly impressed by the very valuable results that had been achieved by the procedure followed in the case of Dr. Haberler's

work. Indeed, "Haberler-like methods" became a catch phrase of the entire conference.<sup>1</sup>

Haberler had spent two years carefully researching and consulting on the various competing theories of the causes and consequences of business cycles and formulated a "synthetic" alternative, the result of which was published in early 1937 under the title *Prosperity and Depression: A Theoretical Analysis of Cyclical Movements*<sup>2</sup>. For over 60 years, it has been considered the classic summary and critical evaluation of the literature on this subject. Indeed, Joseph A. Schumpeter referred to it as a "masterly presentation of the modern material" for which he had the greatest "admiration"<sup>3</sup>. And one of America's leading Keynesian economists, Paul A. Samuelson, hailed it as "the definitive study of business cycles, both pre- and post-Keynesian"<sup>4</sup>. Austrian economist F.A. Hayek drew attention to Haberler's "excellent exposition" criticizing some of the fundamental assumptions and concepts of Keynesian economics<sup>5</sup>.

But this work was only one of Gottfried Haberler's many important contributions to economic theory and policy. In an economic career that spanned seven decades in the twentieth century, he made original contributions to monetary theory and policy, the theory of wages and union

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1. "The Proceedings of the Conference called by the Rockefeller Foundation to consider the Desirability and Feasibility of Encouraging Coordination of Fundamental Economic Research upon Problems of Economic Change", Annecy, France, July-3-5, 1936 (anonymous, mimeographed), p. 14.

2. Gottfried von Haberler, *Prosperity and Depression: A Theoretical Analysis of Cyclical Movements* (Geneva: League of Nations, 1937, revised and enlarged editions, 1939, 1941, 1958).

3. Joseph A. Schumpeter, *History of Economic Analysis* (Oxford: Oxford University Press, 1954), p. 1123.

4. Paul A. Samuelson, "Gottfried Haberler as Economic Sage and Trade Theory Innovator", *Wirtschaftspolitische Blätter*, No. 4 (1990), p. 310.

5. F. A. Hayek, *The Pure Theory of Capital* (London: Macmillan, 1941), p. 395.

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\*\* Richard Ebeling is Ludwig von Mises Professor of Economics and chairman of the economics department at Hillsdale College.

power, international trade theory, and the theory of economic development and growth.

Haberler was born on July 20, 1900, in Purkersdorf, near Vienna, Austria; the centenary of this birth offers the opportunity for an appreciation of his writings and his defense of the free market.

### Early Studies

Haberler studied at the University of Vienna with three of the leading figures of the Austrian school of economics in the years immediately after the First World War: Friedrich von Wieser, Ludwig von Mises, and Hans Mayer. At the university, his closest friends were three other students who, like himself, were to become internationally renowned economists in the decades to come: Hayek, Morgenstern, and Fritz Machlup. After Haberler earned his degrees in political science (1923) and law (1925), Mises helped arrange for him to receive a Spelman Fund (later Rockefeller Foundation) grant that enabled him to have two years of further study in the United States and Great Britain.

After returning to Austria, Haberler became a *Privatdozent* (an unsalaried lecturer) at the University of Vienna, teaching a joint seminar with Hayek and Morgenstern. Mises arranged a paid position for him in the library at the Austrian Chamber of Commerce, where Mises was employed as a senior economic analyst. Haberler was a visiting professor of economics and statistics at Harvard University in 1931-1932. In 1934, he accepted the two-year appointment with the League of Nations in Geneva, Switzerland that led to the publication of *Prosperity and Depression*. In the autumn of 1936, Haberler began a professorship in economics at Harvard University that lasted until his retirement in 1971. He also served as an economic consultant with the Board of Governors of the Federal Reserve System from 1943 to 1947. From 1971 until shortly before his death on May 6, 1995, at the age of 94, he was a senior scholar at the American Enterprise Institute in Washington, D.C.<sup>6</sup>

Many of Gottfried Haberler's writings in the 1920s and 1930s were devoted to problems in monetary and business cycle theory. Like other

Austrian economists during this time, especially Mises and Hayek, Haberler focused his attention on price-level stabilization and monetary stability. In the 1920s, the argument was made that a monetary policy that stabilized the general price level through changes in the money supply would assure economy-wide economic stability. In a series of articles and in his book *The Mean of Index Numbers: An Inquiry in the Concept of the Price Level and the Methods of Its Measurement* (1927), Haberler challenged the fundamental assumptions of a price-level stabilization policy<sup>7</sup>

He argued that in fact there is no way to strictly measure and determine the general value of money through the use of index numbers of various types. The only precise definition of the value of money is that it is represented by the network of individual exchange ratios between money and all of the individual goods against which it trades. Every general index of prices is necessarily constructed by selecting some prices (various consumer or producer prices) as representative of the subgroup of goods under study. They are weighted according to their proportion of purchases, summed together, and mathematically averaged to create a statistical composite that is then tracked through time.

Thus every price index is "arbitrary", in that it depends on the types of goods or industries the economic analyst is interested in studying, the choice made concerning the weights to assign and the averaging method chosen to calculate their mean value, and the assumption that what is taken to be «constant» does not significantly change over

6. See, "Between Mises and Keynes: An Interview with Gottfried von Haberler (1900-1995)" Austrian Economics Newsletter, spring 2000; this previously unpublished interview was conducted in 1979 by Richard M. Ebeling and Joseph T. Salerno.

7. Gottfried Haberler. *Der Sinn der Indezzahlen. Eine Untersuchung über den Begriff des Preissniveaus und die Methoden seiner Müssung* (Munich: J. C. B. Mohr. 1927); "Critical Notes on Schumpeter's Theory of Money" [1925], in Anthony Y. C. Koo, ed., *Selected Essays by Gottfried Haberler* (Cambridge, Mass: MIT Press, 1985), pp. 531-52; "A New Index Number and Its Meaning" [1928], In Anthony Y. C. Koo, ed., *The Liberal Economic Order, Vol. II: Money Cycles and Related Themes by Gottfried Haberler* (Brookfield, Vt.: Edward Elgar, 1993), pp. 107-17; and *The Different Meaning Attached to the Term "Fluctuations in the Purchasing Power of Gold and the Best Instrument or Instruments of Measuring Such Fluctuations* (Geneva: League of Nations, F/Gold/74, Marc 1931).

the period during which the selected «price level» is being tracked.

Furthermore, Haberler argued, precisely because a price-level index is an average of the set of individual market prices from which it is constructed, it may hide all the significant individual relative price changes beneath its statistical surface. "The relative position and change of different groups of prices are not revealed, but are hidden and submerged in a general index," said Haberler.

Not the movement of the general price level, but the chronological succession of special price and price combinations ... are regarded as significant for the waves of business life. . . . Such a general index rather conceals and submerges than reveals and explains those price movements that characterize and signify the movement of the [business] cycle.<sup>8</sup>

Also, Haberler maintained, a focus on an average price level tends to distract attention from the underlying microeconomic causes that result in a tendency for prices in general to move in one direction or another. And like his fellow Austrians, Haberler reasoned that a price-level "deflation" due to technological improvements and increased output resulting from lower costs of production is not a symptom suggesting a tendency toward a depression in the market economy. Instead, falling prices from those causes represent the market's method of bringing about an increase in people's real standard of living.

### **Austrian Business Cycle**

Building on this reasoning, Haberler delivered one of the clearest exposition of the Austrian theory of the business cycle at a conference at the University of Chicago in 1932.<sup>9</sup> He explained that in the process of increasing the money supply sufficiently to prevent prices in general from declining owing to lower costs and greater output, a

8. Haberler: "A New Index Number and Its Meaning". pp. 113-15.

9. Gottfried Haberler: "Money and the Business Cycle". In Quincy Wright, ed. *Gold and Monetary Stabilization* (Chicago: University of Chicago Press. 1932), pp. 43-74; reprinted in Koo, ed., *The Liberal International Economic Order*, Vol. II, 160-74, and Richard M. Ebeling, ed., *The Austrian Theory of the Trade Cycle and Other Essays* (Auburn, Ala.: Ludwig von Mises Institute, 1996), pp. 37-64.

monetary expansion through the baking system pushes interest rates below the market level that would have been established by actual savings and investment demand in the economy. In the 1920s, this policy induced long-term investment projects in excess of real savings in the market, resulting in an imbalance that finally manifested itself in the economic downturn and depression that began in 1929 and intensified in the early 1930s.

During the 1930s, Haberler took a view different from either Mises or Hayek about the solution to the Great Depression. His Austrian colleagues argued that the market had to be freed of government intervention, for supply and demand, and savings and investment to re-establish their own new equilibrium. Haberler reached a conclusion closer to that of Wilhelm Röpke, that once begun, the economic downturn of the early 1930s had increased to such an intensity that a "secondary depression" had set in, having little to do with any healthy correction from the malinvestment created by the Federal Reserve's monetary policy of the 1920s.<sup>10</sup> Rigid costs resistant to downward adjustment, bank panics and failures that caused an actual contraction in the supply of money and credit, and pessimistic expectations on the part of the investment community generated a situation in which only a government-initiated stimulus of spending and "effective demand" could bring about a reversal of the depressionary forces.<sup>11</sup>

While Haberler's anti-depression policy perspective might seem to have shifted him into a position similar to that advocated by John Maynard Keynes and the emerging Keynesian economics that came to dominate the economics profession beginning in the 1940s, that conclusion would only be partially correct. He did think that Keynes had made a number of valuable and influential contributions to economic understanding<sup>12</sup>. But in general, Haberler considered Keynes's "new

10. See, Richard M. Ebeling, "Wilhelm Röpke: A Centenary Appreciation", *The Freeman: Ideas on Liberty*, October 1999, pp. 19-24.

11. Haberler, *Prosperity and Depression* (1941 edition), pp. 323-44 For his mature evaluation of the Great Depression and policy choices during the 1930s, see "The World Economy, Money, and the Great Depression, 1919-1939" {1976} and "The Great Depression of the 1930s-Can It Happen again?" {1980} in Koo, ed., *Selected Essays*, pp. 363-427.

economics" to be inferior to the traditional body of economic and monetary theory.

A cornerstone of Keynes's argument had been that even if market prices and money wages were flexible and adjusted downward during a depression, there was no guarantee that this would result in a return to economic balance and full employment. Haberler argued in the 1939 revised edition of *Prosperity and Depression*, as part of his critical evaluation of Keynes's, *The General Theory of Employment, Interest and Money*, that Keynes had failed to appreciate what has become known as the "real cash balance effect."

Even if people were reluctant to spend in the depression because of pessimism and a desire to hold their wealth in a more liquid form, as prices and wages decreased, the real value and purchasing power of their money assets would be increasing, since each unit of money at lower prices could now buy more. A point would be reached at which people would find it advantageous to start spending again, at which time prices and wages would no longer have to fall and all those desiring employment would find employers willing to hire them to satisfy this renewed demand for goods and services. Haberler did not argue that an economic policy that fostered or permitted prices and money wages to fall during a severe depression until they found their own market level was necessarily the most desirous one. But he did insist that Keynes was wrong in stating that falling prices and wages could not restore equilibrium to the market.<sup>13</sup>

12. Gottfried Haberler, "The General Theory: Five Views", in Seymour E. Harris, ed. *The New Economics: Keynes "Influence on Theory and Policy"* (New York: Alfred A. Knopf, 1947), pp. 161-80; and "The General Theory after Ten Years" (1946) and, "Sixteen Years Later" (1962) in Robert Lekachman, ed., *Keynes General Theory: Reports of Three Decades* (New York: St. Martin's Press, 19164), pp. 269-296.

13. Haberler, *Prosperity and Depression* (1941 edition), pp. 242-44; 403-04; 498-503; and "The Pigou Effect Once More" {1952}, in Koo ed. *Selected Essays*, pp. 573-80. The positive effect from falling prices and money wages on the real value of cash balances as a method for restoring full employment became known in the economics profession as the "Pigou Effect", after the Cambridge University economist Arthur C. Pigou, who developed the argument, but only several years after Haberler's formulation in 1939. See Arthur C. Pigou, "The Classical Stationary State," *Economic Journal*, December 1943, pp. 343-51, and «Economic Progress in a Stable Environment, *Económica* {1947}, reprinted in Friedrich A. Lutz and Lloyd W. Mints, eds., *Reading in Monetary Theory* (New York: Blakiston, 1951), pp. 241-51.

## Inflation Opponent

Throughout the post-World War II era, Haberler was a vocal and forceful opponent of Keynesian-inspired inflationary policies to maintain full employment. He insisted that this was an economically dangerous path to follow, that it merely reinforced the very market rigidities that were causing any persistent and significant levels of unemployment in the economy. Neither private business practices nor powerful unions could bring about a permanent and continuing rise in prices in the market. If the money supply was not increased, prices or wages pushed above their market-clearing levels could only result in unsold inventories and unemployment. In the 1950s, 1960s, and 1970s, Haberler argued that any problem of prolonged and high unemployment was caused by anticompetitive trade union practices that priced a portion of the work force out of the market through money wage demands set above what market employers considered labor to be worth's<sup>14</sup>.

Any prolonged price inflation had its origin in expansionary monetary policy. Government inflationary policies could temporarily reduce the unemployment generated by union wage demands only by creating enough money in the economy so that employers could afford to pay higher money wages. But this was only a short-run solution, since unions would then demand even higher money wages for their members to compensate for the lost purchasing power resulting from the higher prices caused by the monetary expansion. Equally counterproductive and harmful was the imposition of wage and price controls in 1971 by the Nixon administration, Haberler insisted. This not only failed to deal with the real source of the inflationary problem-the monetary policy of the Federal Reserve System-but it inevitably created more distortions and

14. Gottfried Haberler, "Wage Policy, Employment and Economic Stability", in David McCord Wright, ed. *The Impact of the Union* (New York: Harcourt, Brace, 1951), pp. 34-62. "Wage Policy and Inflation" in Philip D. Bradley, ed., *The Public Stake in Union Power* (Charlottesville, Va.: University of Virginia Press, 1959), pp. 63-85; and, "Wage-Push Inflation Once More," in Erich Streissler, Gottfried Haberler, Friedrich A. Lutz, and Fritz Machlup, eds., *Roads to Freedom: Essays in Honour of Friedrich A. Von Hayek* (New York: Augustus M. Kelley, 1969), pp. 65-73.

imbalances by preventing prices and wages from adjusting to changing conditions of supply and demand.<sup>15</sup>

In the late 1970s there developed the strange phenomenon of both rising prices and rising unemployment, a mix of inflation and unemployment that seemed to defy the standard Keynesian ideas of the time. Haberler explained that "stagflation", or an "inflationary recession", was a frustratingly easily understood combination of events. Unions and other special-interest groups had become so used to inflation that they now demanded money wage and price increases in expectation of future price inflation. When the actual increasing rate of price inflation turned out to be less than expected, greater unemployment resulted because money wages had been pushed above even what the expanding money supply was able to validate. And Haberler was doubtful that even the most "rational" of expectations could ever assure that such mismatches did not occur.<sup>16</sup>

In an analysis of what the best of economic policy worlds should be, Haberler said that the federal government should run a budget surplus and pay off the national debt so the funds could be rechanneled into productive, private-sector investment and capital formation; taxes should be significantly lowered to enhance work and investment incentives; monetary policy should be limited to a low, steady increase in the money supply

15. Gottfried Haberler, *Inflation: Its Causes and Cures* (Washington, D.C.: American Enterprise Institute, 1961; revised and enlarged ed. 1966; *Incomes Policies and Inflation: An Analysis of Basic Principles* (Washington, D.C.: American Enterprise Institute, 1971); *Incomes Policy and Inflation: Some Further Reflections* (Washington, D.C.: American Enterprise Institute, 1972); "The Phenomenon of Worldwide Inflation" in David I. Meiselman and Arthur B. Laffer, eds., *The Phenomenon of Worldwide Inflation* (Washington, D.C.: American Enterprise Institute, 1975), pp. 13-25; *Some Currently Suggested Explanations and Cures for Inflation* (Washington, DC: American Enterprise Institute, 1976).

16. Gottfried Haberler, "The Problem of Stagflation," in William Fellner, ed., *Contemporary Economic Problems* (Washington, D.C.: American Enterprise Institute, 1976), reprinted in Koo, ed., *Selected Essays by Gottfried Haberler*, pp. 349-62; *Stagflation: An Analysis of its Causes and Cures* (Washington, D.C.: American Enterprise Institute, 1977); *The Problem of Stagflation: Reflections on the Microfoundations of Macroeconomic Theory and Policy* (Washington, D.C.: American Enterprise Institute, 1985); *Notes on Rational and Irrational and Irrational Expectations* (Washington, D.C.: American Enterprise Institute 1980); Koo ed., *Selected Essays*, pp. 603-17.

equal to the annual average rise in real gross domestic product; and deregulation should be the order of the day, eliminating the various privileges, restrictions, protections, and subsidies that restrain or prevent an open, competitive market from more fully functioning. The same rules applied to the international economic order as well.<sup>17</sup>

### **Opportunity Cost and International Trade**

Gottfried Haberler's other main contribution to economic theory and policy in the twentieth century was in the field of international trade and economic development. Beginning in the late nineteenth century, the Austrian economists, along with William Stanley Jevons and Leon Walras, had radically changed the foundations of economic theory by developing the theory of marginal utility in place of the labor theory of value championed by the classical economists from Adam Smith and David Ricardo to John Stuart Mill. But in the theory of international trade it was still common to demonstrate the benefits from the division of labor among nations on the basis of the labor theory of value. Comparing the relative costs in labor time for different countries to manufacture various goods showed the comparative advantage that different nations might have for specialization of production.

Haberler helped revolutionize the foundations of international trade theory by restating the theory of the international division of labor based on the Austrian theory of opportunity cost. The relevant cost was not the labor time to produce something, but the alternative end that has to be forgone. Haberler demonstrated the logic of this principle by being the first to construct that simple diagram that is now found in every principles of economics textbook: the production possibilities frontier, which depicts the trade-offs that an economy faces between producing, say, one of two products.

17. Gottfried Haberler, *Economic Growth and Stability: An analysis of Economic Change and Policies* (Los Angeles: Nash Publishing, 1974); *The challenge to the Free Market Economy* (Washington, D.C.: American Enterprise Institute, 1976); and, "An Overview of Economic Policy: A Positive Program for a Benevolent and Enlightened Dictator." (1985) in Richard J. Sweeney, Edward Tower, and Thomas D. Willen, eds., *Judging Economic Policy: selected Writing of Gottfried Haberler* (Boulder, Colo.: Westview Press, 1977), pp. 21-43.

The members of that economy can produce either one of the goods or some combination of the two. The curve shows the additional amount of one good that can be obtained by forgoing a particular quantity of the other.

Haberler explained that even when one of two countries is absolutely more efficient in producing both goods, each country should still specialize in manufacturing and trading those commodities in which it has relatively greater efficiency. In developing and consistently applying this reformulated theory of the benefits of international specialization, he was able to prove the continuing superiority for a policy of free trade over protectionism or autarkic self-sufficiency.<sup>18</sup>

In the years following World War II, Haberler argued forcefully against various forms of international trade restriction and protectionism, including artificial foreign exchange-rate regulations and manipulation, import and export quotas, and tariffs. While admitting that a number of hypothetical exceptions to the free trade doctrine can be formulated, in the real world both the theoretical and practical case for the greatest degree of international freedom of trade remains the benchmark for any serious economic policy discussion.<sup>19</sup>

Finally, Haberler insisted that the underdeveloped countries of the "Third World" were moving in the wrong direction by turning to planning, controls, and protectionism in the name of economic development and growth. He reasoned forcefully that international trade would not create either permanent under industrialized dependency on Western industrial nations or worsening terms of trade. Nor would government-induced domestic production either create real industrial efficiency or raise the standard of living of the people in those countries, in comparison to participation in the international division of labor. The best policy for all nations remains the freest exchange of goods and capital for economic improvement and rising living standards for the greatest number of participants in the global marketplace.<sup>20</sup>

As Gottfried Haberler once ended one of his essays,

The conclusion is obvious. The task of freeing the market economy from as many of its fetters as possible, and of promoting free competition, is of paramount importance.<sup>21</sup>

His long, productive professional life was a testament to this goal.

18. Gottfried Haberler, "The Theory of Comparative Costs and Its Use in the Defense of Free Trade" (1930), in Koo, ed. *Selected Essays*, pp. 3-19, *The Theory of International Trade, with Its Applications to Commercial Policy* (London: William Hodge, 1936 [1933]); *A Survey of International Trade Theory* (Princeton: Princeton University Press, 1961).

19. Gottfried Haberler, "The International Economic Order in Historical Perspective" (1979), in Anthony Y. C. Koo, ed., *The Liberal Economic Order, Vol. 1 Essays on International Economics by Gottfried Haberler* (Brookfield, Vt.: Edward Elgar, 1993), pp. 349-70, and several other essays in this volume.

20. Gottfried Haberler, "International Trade and Economic Development" (1959), "Terms of Trade and Economic Development" (1961), and "Integration and Growth of the World Economy in Historical Perspective" (1964), in Koo, ed., *Selected Essays*, pp. 453-527; "Liberal and Illiberal Development Policy" (1987) and "Liberal and Illiberal Trade Policy: The Messy World of the Second Best" (1988), in Koo, ed. *The Liberal Economic Order, Vol. 1*, pp. 371-413; and "Trade and Development Policy." In Sweeney, et al., *Judging Economic Policy*; pp. 173-227.

21. Haberler, *The Challenge to the Free Market Economy*; p. 18.