

2. Prices: an aspect of human action

Probably the most important Austrian School of Economics book is *Human Action*, written by Ludwig von Mises (*Human Action*, New Haven, Conn, 1949). The starting point of the Austrian School theory and how prices come about in the marketplace are the actions of humans. These actions can be anything, from buying a car, going to work, taking on studies or even taking some time off. Human beings are acting with a view to improve their situation. No one person acts with a view to work towards a less fortunate situation.

When people act they have to make choices. They choose based on their scales of relative values. On top of their value scale are those products, services or situations which are most important and most highly preferred. Once such needs have been met, people aim to satisfy the next most important need, and so on. In trying to accomplish something, something else has to be given up. This is the opportunity cost of achieving the most important need, a cost that disappears as soon as a human action has accomplished the first need, as the ranking starts all over again.

Prices are determined by people's subjective preferences

This way of reasoning laid the foundation for the marginal thinking, which in 1871 enabled Carl Menger (*Principles of Economics*, 1871) to finally give an explanation why the price of water is so much lower than that of diamonds, while water is actually much more important for our existence. The total supply of water is more than sufficient to meet our most important needs and also sufficient to meet our less important needs. The price the consumer is willing to pay for the last added unit is much lower than it would be if the supply of water was only high enough to meet the most important use alone. Prices of goods and everything that has value to us are determined in this way.

As a result of the supply and demand of products and services prices will be determined. Money is an economic good that allows for transactions to take place. Prices are a means to clear the market, to make demand meet supply. People are never acting with a view to achieve certain prices or a certain 'average price level'. Prices come about in a marketplace based on voluntarily actions and voluntary transactions. The signalling function of prices are an essential element of a free society, where people are working and living together based on their own preferences and according to their own views of how their lives and situations can be improved.

Praxeology and the impossibility to measuring Value

Prices are not the same as value. Suppose 2 people are transacting at a certain price, person A is buying from person B. Person A values the product higher than the price paid, for person B the money received is valued higher than the product he sells. Both value the product and the price paid very differently. What reflects the value of a good is how much this person appreciates using this product.

It was Mises who for the first time used the term Praxeology for the distinctive methodology of the Austrian School. In *Human Action* Mises he writes extensively about this approach, as does Rothbard in *Economic Controversies* (2011) where he writes: 'In brief, praxeology consists of the logical implications of the universal formal fact that people act, that they employ means to try to attain

chosen ends.' 'This structure is built on the fundamental axiom of action, and has a few subsidiary axioms, such as that individuals vary and that human beings regard leisure as a valuable good.'

Mises was radically opposed to a mathematical or econometrics approach. In his view econometrics tried to mimic the natural sciences by using 'complex heterogeneous historical facts as if they were repeatable homogeneous laboratory facts'. However, complex qualitative events cannot be squeezed into a quantitative number. And, it does not make any sense to assume that these quantitative relations remain constant in human history. Our circumstances, knowledge and our values are always changing and every person is different. It is an impossible task to discover a single constant in human history. Statistical figures referring to economic events are historical data and the statistics of prices is part of economic history.

Society now needs to adjust to the statistical model

However, in the course of the 20th century economists and governments more and more held the opposite view. Their view is that an economy is make-able. Central banks as the ECB believe that a 'stable value of money' is good for the economy. They define stability by rising prices, as this would be a reflection of a healthy economy as measured by a rising Gross Domestic product (GDP). The consumer prices that are the result of people living and acting in a society are only good if they rise 'on average' by almost 2% a year.

If the economy does not behave as the model prescribes, central banks will intervene by creating new money. Without an increase in the money supply, chances are that prices will go down, as people tend to become more efficient over time or because they are using new technologies, to produce goods and services more cheaply. However, with a money supply that keeps on growing, there will be more money competition for the same stock of goods and this means rising prices.

The ECB is however in no position to judge what is good or bad for 'the economy' and for all the people in society. Our human activities cannot be measured or summarised with a few statistical numbers such as GDP or average prices. A GDP number only summarises how much money has been spent on certain goods and services in the past. It does not reflect whether welfare has increased or decreased.

Without (good) prices, we cannot calculate (well)

Prices are essential for entrepreneurs, for producers, shops and companies. Their job is to meet the requirements of consumers, the people living in their society. These entrepreneurs are making analytical calculations, using prices in the marketplace and their insights into possible future developments in prices and the demand. Entrepreneurs need to analyse if a certain investment in a new technology or a new building can be made in a profitable manner.

Prices are essential as explained by Mises in *Economic Calculation in the Socialist Commonwealth* (1920). In this book he predicted why Socialist or Communist societies cannot last, as in such economies the government decides on the allocation of resources and the market process has been shut down. Even if entrepreneurs know all the value-scales of consumers and know all technological methods, they still will not be able to calculate if there are no prices of land, capital goods and costs. Hence, they will not be able to allocate resources rationally. Prices have a signalling function to

buyers and to sellers, conveying knowledge from and to the various participants in the market economy.

In a market economy where there is no intervention by central banks as the ECB, these prices reflect the preference of people in society. By manipulating prices, the ECB causes the quality of the signalling function of prices to go down. As a result of increasing the money supply, prices have the tendency to go up. But not all prices are rising in the same manner. Beforehand, the ECB does not know which prices will rise faster than other prices. To the ECB, this is not a concern, as long as 'the average prices' are going up.

However, for entrepreneurs this does matter. They do not know if prices of some good have gone up due to an increased demand or due to an increase in the money supply. In addition to the usual supply and demand forces, the ECB monetary policies are creating an additional force. With monetary policies there is now more uncertainty than without such policies. A side effect of monetary interventions is that the allocation of scarce resources does not take place as effectively as before. The market process does not function properly anymore and people's preferences are not properly reflected in the society they are living and working in.

In the next article, I will discuss in more detail why the quality of our money has deteriorated since the beginning of the 20th century, before describing a second important market mechanism, the Interest Rate.