Economic Order and Business Cycles:

Four Essays on the Ordoliberal Economists

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I. General Introduction

1. On the Current Interest in Ordoliberalism

The last financial and subsequent sovereign debt crises sparked a moderate interest in history of economics on the side of modern economists, students of economics and broader audience. But the reasons for this interest differed radically during both crises. After the outbreak of the financial crisis, economists as Paul Krugman (2018) or Paul Samuelson (2009) or series of articles "Weltverbesserer" in *Frankfurter Allgemeine Sonntagszeitung* (July 2013–March 2015), and the series of books "Ökonomen für jedermann" published by *Frankfurter Allgemeine Buch* since 2009 as well as "Die größten Ökonomen" published by *UTB* since 2012 focused on how the titans of the discipline as Karl Marx, John Maynard Keynes, Joseph Alois Schumpeter or Friedrich A. Hayek perceived the occurrence of economic crises, and what role governments played – or ought to play – in alleviating the severity of economic downturns (Samuelson 2009; Kolev 2017, 6; Krugman 2018, xxv; Alcouffe, Baslé and Poettinger 2019, xi; Poettinger 2019, 190–191).[1]

The sovereign debt crisis shifted and even narrowed the focus of interest on the side of modern economists because the purpose of this interest changed radically. One of the reasons for narrowing the focus could be the different speeds of government reactions combating the severity of both crises. Unanimity among policy makers during the financial crisis whose prompt and decisive responses stopped the crisis from spreading from the financial to the real sector, thus preventing events tantamount in scope to the Great Depression, once more lent credence to the stabilizing abilities of governments and provided the impression that we had

[1] Kolev (2017) provided a detailed overview of this interest (Kolev 2017, 6). Poettinger (2019) provided an interesting account of how the intellectual legacies of Marx, Smith, Keynes and Schumpeter occupied the pages of leading European newspapers after the outbreak of the financial crisis.

learned the lessons from the Great Depression (Eichengreen 2015; Krugman 2018, 164). The sovereign debt crisis, which was caused by high indebtedness of southern Eurozone countries, however, was not met by similarly swift and decisive reactions. Eurozone policy makers were far from unanimous in their interpretation of the crisis, and how to respond to it so as not to jeopardize the unity of European union (e. g. The Guardian 2011; Drezner, 2012; 15–16; Eichengreen 2015, 368–375).

On the one hand, northern Eurozone governments led by Germany argued in favor of maintaining a commitment to fiscal rules, emphasizing the fiscal unsustainability of highly indebted Eurozone countries. Northern Eurozone governments called for structural reforms, which were viewed as necessary to facilitate the prompt recovery of debt-ridden economies (Brunnermeier, James, and Landau 2016, 30–40; Feld 2016, 43). On the other hand, governments from Southern Europe, such as Greece, Spain and Italy, argued for more flexible fiscal rules and at the same time accused Germany of following a peculiar logic based on their "own intellectual tradition" (Krugman 2014). As a consequence, the German position, which was opposed to bailouts and found expression in moral hazard concerns, was subject to harsh criticism. Critics alleged that the German position entailed unnecessary austerity which exacerbated the sovereign debt crisis (e. g., Münchau 2014; Biebricher and Vogelmann 2017).

A book by Brunnermeier, James and Landau (2016) claimed to have discovered the inherent reason for this "odd" German position, noting that it was the influence of ordoliberalism which impacted German policy makers. The argument ignited a vast discussion about whether ordoliberal thinkers really did influence German economic policymaking during the sovereign debt crisis to the extent that was claimed (Brunnermeier, James and Landau 2016, Beck and Kotz 2017; Kolev 2018b). This shifted and narrowed the focus of interest in history of economics. Economists as Peter Bofinger as well as Rüdiger Bachmann, political scientists as Thomas Biebricher and historians as Volker Berghahn and Frieder Vogelmann who had not been known for their expertise in history of economics, suddenly concentrated their efforts and energies to revitalize the economic writings of Walter Eucken (1891–1950) and his colleagues the jurists Franz Böhm (1895–1977) and Hans Großmann-Doerth (1894–1944) who were the founder of Freiburg School and considered as the main representatives of the ordoliberalism (Biebricher 2014; Bofinger 2016; Biebricher and Vogelmann 2017; Kolev 2019; Bachmann 2020; Berghahn 2020; Biebricher 2020). Research into the work of Eucken's students Friedrich A. Lutz (1901–1975) and Leonhard Miksch (1901–1950) also underwent a revival (Feld and Köhler 2015; Köhler 2019). Further discussants as Brigitte Young or Nicholas Barbaroux did not stop with the Freiburg School. The intellectual legacies of Wilhelm Röpke, Alexander Rüstow and even Friedrich A. Hayek received renewed interest, stressing the many facets of ordoliberalism (e. g. Brunnermeier, James, and Landau 2016; Biebricher and Vogelmann 2017; Young 2017; Slobodian 2018; Barbaroux 2019; Young 2020).[2]

The main purpose of the exegetical works was to judge whether the government interventions during the sovereign debt crisis would have been endorsed by the main representatives of ordoliberalism. If these exegetical works concluded that the representatives of ordoliberalism would have rejected government interventions because they violate the rules of the game which should be obeyed whatever it takes then the intellectual legacy of the ordoliberal thinkers would become subject to harsh criticism (Bofinger 2016; Biebricher and Vogelmann 2017). On the other hand, authors as Lars P. Feld, Ekkehard A. Köhler, and Daniel Nientiedt promoted the narrative that Eucken and Röpke actually accepted a pragmatic position during the Great Depression, arguing for government interventions during the discussions of the Lautenbach plan in 1931 in order to rescue the foundations of free Western societies, then it is far more difficult to accuse ordoliberals of merely being proponents of austerity for the sake of austerity.[3]

[2] Kolev 2019 provided a great introduction into the idea of Ordoliberalism and its historical development.

[3] The discussions about Lautenbach plan were documented by Borchardt and Schötz 1991.

The same authors continued that such a pragmatic position was actually adopted by German policy makers during the sovereign debt crisis. According to them, Germany endorsed government interventions violating the Maastricht rules and rules determining ECB monetary policy, and thus German economic policy adopted the same pragmatic stance promoted by Eucken and Röpke during the Great Depression (Feld, Köhler, and Nientiedt 2015; 2017; 2021).

My doctoral thesis argues that this is an inadmissible way to treat the intellectual legacy of thinkers who produced their major works in the context of intellectual influences which dominated the German-language academic landscape several decades ago. This partially ahistorical treatment conducted by the aforementioned economists and historians becomes more peculiar when the reader realizes that the scholars searching for ordoliberal traces in the German economic policy have actually been taking the normative part out of research programs of these thinkers whereas the descriptive (analytical) parts remained rather neglected. Such an approach deprives the reader from understanding the relevance of normative message in the ordoliberal writings.

The most striking example of such an approach is Bofinger's contribution (2016) in which he reduces Eucken's "philosophy of economics" to "constitutive" and "regulatory" principles "which do not look very original, they are almost trivial" (Bofinger 2016, 12). Bofinger overlooked the fact that Eucken's principles actually originate from his *Grundsätze der Wirtschaftspolitik* ([1952] 2004) in which he formulated his normative approach regarding how the state ought to conduct its economic policy so that a competitive order could be realized. The relevance of competitive order can be understood in his *Grundlagen der Nationalökonomie* ([1940] 1950a). Even Eucken himself placed significant emphasis on the relevance of this methodological book which is fundamental for understanding his "philosophy of economics" and has certainly been neglected in recent years. Eucken himself, in several letters to his student Lutz, expressed his request to find a translator and publisher of his book. The purpose was not only to make his research agenda accessible to the English-speaking audience, but also to contribute to the Anglo-Saxon economic debates (Grudev 2020; Grudev 2021).

This partially ahistorical treatment forgot that actually Eucken, Hayek, Lutz, Röpke and Miksch started their academic careers as economists who did not shun the conversations with a broader circle of economists as Joseph A. Schumpeter, Ludwig von Mises or Heinrich von Stackelberg. These conversations were conducted in search of methods and concepts with whose help they aimed to explain the occurrence and essence of economic phenomena. Their efforts to understand these phenomena, which comprised the analytical part of their research programs, has remained understudied in the debate concerning the degree to which German economic policy can be conceived as ordoliberal.

Consequently, students of economics could easily get the impression that ordoliberal thinkers' intellectual legacies are tied up with normative issues, such as the role of government in the context of the proper functioning of markets, the relevance of rules for economic stability, and the rejection of government intervention. If the ordoliberal thinkers insisted on these normative issues, then the logical question arises how they explained economic phenomena so that rules would play such a key role in their research programs. I argue that these normative issues should actually only occupy the advanced, or even the final, chapters of any history of the Freiburg School and the economists oscillating around Eucken. Only then can these normative issues be grasped as logically consistent parts of their research programs and cannot be faced by lack of understanding on the side of modern economists.

2. My Contribution

2.1 Scope of the Study

My thesis consists of four articles which concentrate on the research program of three ordoliberal thinkers: Wilhelm Röpke (1899–1966), Friedrich A. Lutz (1901–1975) and Walter Eucken (1891–1950). My articles focus on their understanding of economic crisis which they developed during the interwar period. In this sense, the contributions of this thesis revitalize the analytical parts of their research programs and show, in particular, how these thinkers were provoked by historical events like the instability of the Weimar republic and the severity of the Great Depression. My main intention consists of illustrating that the analytical part of their research programs did not remain stuck in specific historical events but were oriented at the construction of concepts and methods whose universal character was supposed to provide future generations with techniques to explain dynamic economic phenomena such as change, development and progress (e.g., McAdam, Kolev and Dekker 2018, 189).

The end of the First World War abolished the last remnants of the Wilhelmine era. This era was remembered by the ordoliberal thinkers as a period of relatively stable political and economic orders. The consequence of the war gave rise to unseen economic problems that destabilized the political landscape in the German-speaking area. This nourished the emergence of extreme political movements and revealed the helplessness of German economists to explain and thus propose measures counteracting the devastating hyperinflation and continuing increase in unemployment during the Weimar Republic. Historians of economics have interpreted this helplessness as a result of the descriptive methods employed by the Historical School which deprived their representatives from formulating a theoretical explanation of the observed (macro-)economic phenomena. Their aversion against abstract-deductive theories isolated German economic science from the progress achieved by Anglo-Saxon and Austrian economics (Balabkins 1988; Barkai 1991; Janssen [1998] 2012; Kolev 2017).

After the First World War, younger German economists aimed to emancipate themselves from the Historical School and join the international academic community (Hagemann 1997, 300–302). My four articles recognize that two Austrian economists, Schumpeter and Mises, served as gravitational poles around which the theoretically minded young scholars oscillated (Hayek 1959, 26; Dal Pont Legrand and Hagemann 2013, 244; Kolev 2018a, 70–71; Dal Pont Legrand and Hagemann 2019, 6). These two economists pursued research programs that prima facie seem to have been diametrically opposed to each other. Schumpeter wrote his habilitation thesis in the positivist tradition and praised the works of Léon Walras, who promoted the mathematization of economics. It was the positivist lens which was the reason why Schumpeter later advocated the idea that socialism could be theoretically possible (Vanberg 2008; Dal Pont Legrand and Hagemann 2013, 243–244).[4] The theoretical impossibility of socialism was the cornerstone of Mises's intellectual legacy, which was based on a criticism of positivism and the mathematization of economics. Mises convinced the younger generation that, for pure theoretical reasons, socialism was impossible. His powerful arguments would play a key role in the young scholars' theoretical works. This would distinguish them from their Anglo-Saxon colleagues (Boettke and Vaughn 2002, 161–162; Vanberg 2008).

Despite some obviously irreconcilable differences, there were nevertheless areas of agreement by both economists on fundamental concepts and terms. This exerted a huge influence on the thinking of young scholars, which enabled them to find a common language in their quest against the Historical School. This common language can be ascertained in the debate between Adolf Löwe and Friedrich A. Hayek, which marked the culmination of the young scholars' quest against the Historical School (Hagemann 1994, 105–106; Klausinger 2013, 13–14). In order to translate their language into plain English, it is important to discuss briefly the concepts

[4] In this context, Vanberg's paper on Schumpeter and Mises as "Austrian Economists" sheds more light on the tension between Mises and Schumpeter (Vanberg 2008).

and terms used by these German-speaking scholars. Schumpeter's habilitation thesis, *Das Wesen und der theoretische Hauptinhalt der Nationalökonomie* (1908), and his later book, *Theorie der wirtschaftlichen Entwicklung* (1911), considered as two complementary works, were instrumental in creating a shared technical language (Hagemann 2003, 48–49).

The former praised the system of general equilibrium formulated by Léon Walras, whose mathematical expositions of exchange relationships contributed to immense progress in economics. Schumpeter described the realm of general equilibrium theory and its reaction to changes in exogenous factors as problems of static theory. Equilibrium was understood as a gravitational point determined by data (underlying exogenous factors), and any changes in exogenous factors gave rise to an adjustment toward the given (predetermined) state of equilibrium. The study of this adjustment was conducted with the help of the variation method. The second book, *Theorie der wirtschaftlichen Entwicklung* (1911), based the business cycle analysis on Karl Marx's ideas about the inherent dynamics of capitalism which reflected Schumpeter's life-long challenge. This described the shift of the gravitational point, the equilibrium, which arose endogenously and discontinuously by changes in technological progress. This concept of dynamics described the wave-like movement of capitalism stating that business cycle was inherent features of capitalism and necessary prerequisite for its growth (Rühl 1994, 179–183; Hagemann 2003, 53).

The concepts "adjustment of the system to changes in data" and "inherent tendency towards equilibrium" represented the cornerstone of Mises's arguments regarding superiority of market order over planned economy and impossibility of socialism in his work *Gemeinwirtschaft* (1922, 150–169). He understood equilibrium as a gravitational point with fully utilized resources and employment of production factors towards which the economic systems was converging once the clearing function of markets had started to ensue (Mises 1922, 150; Arena 1994, 211). He claimed that without markets and property rights, the exchange process would disappear and price formation would become impossible. But without prices, entrepreneurs would be unable to conduct rational calculation and the production process would succumb to chaos. In Mises's eyes, the existence of markets that facilitated the exchange process was fundamental to the formation of prices, interest rates and wages. This made prices social phenomena which fulfilled the function of communicating information concerning the scarcity of resources. Any changes in data would be communicated via prices to entrepreneurs who would adjust their plans so that equilibrium was reestablished – a feature which would be impossible in planned economies, since, in Mises's view, these would permanently be in disequilibrium. He rejected the idea that technological progress was able to disturb exchange relationships and thus give rise to cycle whereas money, which facilitated the exchange process, was treated as the ultimate cause of the cycle (Mises 1922, 199; Mises [1912] 1924, 170–180; Hayek [1935] 1967, xiii).

The vocabulary employed by Mises and Schumpeter exerted a significant influence on the debate between Hayek and Löwe about how to construct a deductive business cycle theory. Particularly Schumpeter's understanding of dynamic theory played a key role in Löwe's argument about how a business cycle theory had to be constructed as a deductive theory; it had to deduce "the polarity of upswing and crisis … analytically from the conditions of the system just as the undisturbed adjustment derives from the conditions of the static system" (Löwe 1997, 267). Löwe concluded that equilibrium as a gravitational point gave rise to static laws on which existing economic theory was based. Its variation method made economic theory ineligible for the explanation of dynamic phenomena, such as business cycles. He described this as an antimonic problem which could only be solved if economists abandoned the concept of equilibrium responsible for the static laws and instead concentrated on the formulation of new dynamic system which could enable the formulation of theory that could explain the dynamics of business cycles (Löwe 1926, 171; Hagemann 1994; Gehrke 1997; Klausinger 2013).

Hayek agreed with Löwe's statement that a deductive business cycle theory was the only satisfactory solution to explain business cycle phenomena. However, he rejected Löwe's proposals to abandon the concept of equilibrium and construct a new dynamic concept from which a deductive business cycle theory could be created. Hayek treated the concept of equilibrium as a benchmark to study business cycle phenomena, which he described as disequilibrium process wherein the economic system moved away from a predetermined equilibrium path. In order to construct such a "dynamic" theory, the economist should prove how the interdependences within the static system could be hypothetically disturbed so that the system left the equilibrium path (Hayek [1933] 1966, 44–45 and 93–94; Hagemann 1994, 101–105; Klausinger 2013, 13–14).

Hayek, who was influenced by Mises's works, argued that only money was able to disturb the interdependences within the static system because it exerted an adverse effect on relative prices (Hagemann 1994, 103). Economic agents based their intertemporal plans on the "wrong prices," and the production structure of the economy would reflect a disequilibrium state of the system whose reversal would only be brought about through a crisis. At the same time Hayek rejected the notion that real factors could be the reason for the cycle as he believed in the self-equilibrating forces of markets so that the economic system would always adjust to the change in real factors (Hayek [1933] 1966, 44 and 77). On the other hand, Löwe claimed that money played a rather secondary role in the business cycle, whereas in the era of industrialization, technological progress reflected this disturbing factor that had been making the capitalistic system to "swing" (Löwe 1926, 187; Hagemann 1994, 102).

2.2 Content of the Study

The Secondary Depression: An Integral Part of Wilhelm Röpke's Business Cycle Theory

One of the first German economists who was influenced by Mises's ideas was Wilhelm Röpke. This was acknowledged by Mises's most famous student Hayek, who reminisced in *Gegen die Brandung*, a Festschrift in honor of Röpke's sixtieth birthday, how Mises's book *Die Gemeinwirtschaft* (1922) had exerted a strong influence on the thinking of younger scholars and particularly on Röpke as a representative of the theoretically oriented scholars from Germany (Hayek 1959, 26). Mises himself expressed his esteem for Röpke's writings in his second edition of *Die Gemeinwirtschaft* ([1922] 1932), which together with the works of Adolf Weber, Lionel Robbins and Georg Halm represented those "admirable works" whose "unprejudiced scientific study of the problems of Socialism" produced "good results" showing "'the sterility' of socialist thought" (Mises [1932] 1962, 19). I ascertain that the influence of Mises's ideas can be traced back to Röpke's 1926 article "Kredit and Konjunktur" (Grudev 2018, 137). At the same time, Röpke's article criticized Löwe's challenge. Röpke underlined the concept of equilibrium as an indispensable benchmark to study business cycle phenomena, while its disturbance arose as a consequence of the divergence between natural and monetary interest rates (Röpke 1926, 243–250). The same message was adopted later by Hayek in his habilitation thesis (Hayek [1933] 1966, 45–46).

Röpke scholarship, however, paid more attention to his focus on secondary depressions, which has been described as an innovative contribution to understanding deep economic downturns (Landmann 1981; Allgoewer [2009] 2010). In contrast, his understanding of upswing periods fell into oblivion. My first article raises the question about the relationship between Röpke's early considerations concerning the boom period with his later concept of the secondary depression. The results of examining this connection were published in my chapter "The

Secondary Depression: An Integral Part of Wilhelm Röpke's Business Cycle Theory" (2018), which was published in a volume edited by Stefan Kolev and Patricia Commun, *Wilhelm Röpke (1899-1966): A Liberal Political Economist and Conservative Social Philosopher* (2018).

My chapter comes to the conclusion that Röpke considered the duration of the monetary induced boom period as relevant for understanding how long the misallocation of resources would take place, and thus whether the primary depression would morph into a secondary one. Röpke postulated equilibrium as a benchmark to study the business cycle where income destined to production of capital goods and consumers' goods were proportionate to the production of capital and consumers' goods, i. e. demand equaled supply. He stressed that the boom was a divergence from this equilibrium path, and that equilibrium was disturbed by any deviation of monetary interest rate from the natural one. Later, Röpke introduced the acceleration principle with whose help my chapter sheds light on when the secondary depression would occur. This principle stated that any increase in demand for consumer goods would give rise to a stronger increase in demand for capital goods. The latter was necessary to satisfy the higher demand for consumer goods. I establish the link between Röpke's understanding of the acceleration principle with his early ideas on how increase in income can affect human needs and wants. These early ideas were crucial in Röpke's habilitation thesis.

Any decrease in the monetary interest rate compared to the natural interest rate raised the credit provision to entrepreneurs. This gave rise to an increase in entrepreneurial income and demand for capital goods, with the latter causing a rise in capital goods of higher order due to the acceleration principle. This was characterized by installment of new equipment and construction of new plants which, in Röpke's eyes, reflected a disproportionate rise in production of goods of higher order, a process incompatible with equilibrium. If the monetary-induced boom continued for a long time, then this disproportionate period would continue and entrepreneurs would become more optimistic about the future development of profits.

Production and installment take time and give rise to the creation of a new secondary (replacement) demand. Consequently, new stages of production occurred which completely depended on the demand for the replacement of durable goods. Once the monetary interest rate increases, then the construction of those projects which started the boom would slow down and the slower pace of primary demand would even make secondary demand disappear.

My chapter stresses that in Röpke's view the severity of depression depended on the progress in which the projects had been installed during the boom as well as the ability to continue them during the primary depression. Even though the monetary interest rate rose which gave rise to the upper-turning point if the enterprises would try to finish their projects despite the higher interest rate, then the depression could not be so severe. The secondary depression would then only come into being if it affected those enterprises which existed before the upswing and whose production contracted under the pre-boom level. This would give rise to a severe increase in unemployment and a reduction in the production of consumer goods that had not expanded during the boom. As a result, the economy would experience an inverse cumulative process in Wicksellian sense which would cause the secondary depression. The state, with the aid of monetary and fiscal policy, should counteract such measures by expanding the demand for consumer goods until the equilibrium between natural and monetary interest are equalized and equilibrium in the economy is restored.

Friedrich A. Lutz's Epistemological and Methodological Messages

During the German-Language Business Cycle Debate

Röpke discussed primary and secondary depressions as phases that reestablished or overshot equilibrium, respectively. Röpke did not focus on the compatibility between the concept of equilibrium and theoretical explanations of business cycle phenomenon, which, as already discussed previously, occupied the minds of theoretically oriented German-speaking economists during the methodological business cycle debate. Röpke recommended Friedrich A. Lutz's habilitation thesis *Das Konjunkturproblem in der Nationalökonomie* (1932) as "a very commendable book," which gave a good review of the business cycle debate (Röpke 1936, 67, fn. 7). Lutz's treatise is considered the last highlight of the debate (Rühl 1994, 188). The second article of the current dissertation thesis "Friedrich A. Lutz' Epistemological and Methodological Messages during the German-Language Business Cycle Debate" (2019) focused on Lutz's contribution to the debate and was published in *Journal of Contextual Economics – Schmollers Jahrbuch*.

The paper claims that Lutz's thesis was written in the context of the formation of the Freiburg School. Following the doctoral thesis of his colleague Leonhard Miksch, Lutz described economic crises as a general glut which reflects a situation where individuals could not realize the expected prices and were forced to sell their goods at lower prices (Miksch 1929, 93–97; Lutz 1932, 1–4). Lutz criticized business cycle research because it unduly introduced the boom period as the reason for the general glut and most importantly assumed its periodic recurrence. This shifted the focus from the relevant question. Instead of searching for a theoretical explanation of the general glut, researchers concentrated their efforts on explaining the causes of the upswing period and, most importantly, the reasons for its periodicity. This new subject of inquiry gave rise to the understanding that capitalism was subject to wave-like developments, as had been outlined by the Historical School and Joseph A. Schumpeter (Lutz 1932, 28–32 and 93–104; Dal Pont Legrand and Hagemann 2007; Grudev 2019, 11–12).

Lutz traced the origins of this subject to inquiry back to Clément Juglar's "unconditional" observation, which stated that depression had always been preceded by prosperity. While the latter always occurred in periodic manner, it also predetermined why the former was an inevitable phenomenon (Juglar 1889, 3 and 14). Even though Lutz did not completely abandon the first part of Juglar's observation that prosperity and depression stood in a relationship which was fundamental to the study of the severity of depression, he viewed the periodic recurrence of crisis – and thus depression – as an unjustified observation (Lutz 1932, 32–35). In Lutz's view, this observation provided the basis for business cycle research that attempted to "squeeze" all crises into a general scheme trying to formulate general dynamic laws that could explain its recurrence (Lutz 1932, 37; Rühl 1994, 177–178; Dal Pont Legrand and Hagemann 2013, 253). These attempts either ended up as mere descriptions, or as pure logical explanations that failed to contribute to the understanding of the occurrence and severity of depressions. According to Lutz, the problem became obvious when economists of highest rank, such as Keynes or Gustav Cassel, were unable to explain the severity of the Great Depression. They either described what they observed, or their descriptions were mixed up with static laws of existing economic theory which did not lead to a theoretical explanation of crisis (Lutz 1932, 145–146).

Lutz concluded that economists should concentrate their efforts on explaining the occurrence and depth of economic crises. Lutz asserted that each crisis represented a unique historical phenomenon caused by historically given factors whose impact on the economy depended on its institutional framework. At an abstract level, these factors were system fundamentals (economic data). My article highlights that Lutz contributed to the business cycle debate with epistemological and methodological messages. His epistemological message was that business cycle research shifted the fundamental question by unduly claiming that upswing – and thus depressions – recurred in periodic manner and thus failed to provide answers about the occurrence and depth of economic crises. Later, Lutz would say that business cycle research shared the inadmissible understanding of a predeterminate development of capitalism which stood in the tradition of historicism (Lutz 1967, 4).

The methodological message, on the other hand, appealed to the construction of models that could show hypothetically how exogenous factors disturbed equilibrium. The main message of these models was to convey how economic systems react to changes in system fundamentals according to the institutional framework. On an abstract level, economists should examine how changes in data affect equilibrium and how institutional factors could affect those tendencies which were necessary in order to reestablish equilibrium. He described the models as ideal types which should serve as case studies whose aim was to examine how a change in the underlying factors can affect equilibrium. The theoretical propositions deduced from these case studies were fundamental for the theoretical explanation of economic crises.

Walter Eucken's Concept of Economic Order and Business Cycle Analysis

Lutz described ideal types as instruments with whose help economists could explain the persistence of crises, but he did not concentrate on how they could be constructed. Eucken scholarship has concentrated explicitly on how Lutz's teacher discussed the concept of ideal types (Lutz 1944; Meyer 2002; Albert 2009; Goldschmidt 2013); through them, Eucken thought to have provided a solution to a long-standing problem in the social sciences reflected by the conflict between theoretical approaches and observed reality which had given rise to the Methodenstreit between the Austrian School of Economics and the Historical School (Lutz 1944). Furthermore, Eucken demonstrated the value of thinking in orders, which in turn consist of various ideal types by discussing the course of different upswing and depression periods (Albert 2009, 95). My third article "Walter Eucken's Concept of Economic Order and Business Cycle Analysis" (2020), which was published in *ORDO – Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft*, focuses on how Eucken envisaged the relationship between ideal types and economic orders, and how this relationship was employed in the explanation of economic crises.

My article concludes that Eucken's research program focused on the persistence of crises, rather than on their emergence. He rejected the idea of the business cycle because it assumes a predetermined development of the economic process. Its development was based on dynamic laws to which capitalism was subject, laws, which were considered independent of human control. Eucken's intellectual legacy was based on the criticism of such an understanding of capitalism, which must be understood in the context of Eucken's attempts to emancipate himself from the Historical School's 19th century research program entailing both relativism and historicism. The latter characterized economic systems as subject to an evolutionary process, reflected by successive stages from barter to advanced capitalism (Eucken [1940] 1950a 182; Watkins 1953, 132; Goldschmidt 2016, 187–190).

In Eucken's view, economists should answer the question how institutional factors affect the reestablishment of equilibrium, since these institutional factors affect the ability of individuals to adjust their plans to changing circumstances (Eucken [1940] 1950a, 98–100). Taking into account that Eucken considered employment as derivative of entrepreneurial decision-making, it followed for him that any persistence of unemployment as an expression of the persistence of crisis depended on whether entrepreneurs were able to reestablish the profitability of their entrepreneurial activity (Eucken [1940] 1950a, 149 and 194).

At an abstract level, Eucken understood equilibrium in the same way his students Lutz and Miksch, as well as his Austrian colleague Hayek, did. The long-run trajectory of the economy was determined by economic data, whereas periods of upswing and depressions should be understood as movements away from equilibrium. The concept of equilibrium thus represents a benchmark to study the dynamic phenomenon of the cycle. The reestablishment of equilibrium should be studied hypothetically with the help of case studies, and theoretical explanations of crisis can shed light on how different institutional frameworks affect the reestablishment of equilibrium differently. These models can be understood in the context of the impulse-propagation mechanism that Ragnar Frisch developed in his "Propagation Problems and Impulse Problems in Dynamic Economics" (1933) (Stackelberg 1940, 276). The propagation mechanism translated exogenous shocks into the system according to the mathematical assumptions of the system. This propagation mechanism shows the explosiveness of the system due to parameters determining the behavior of economic variables (Frisch 1933, 181–197).

In Eucken's writings, however, this "explosiveness" should result from institutional assumptions that determine the parameter – and thus the reaction of economic variables to change in data. In other words, each economic order possesses its own propagation mechanism which translates the impulse into the economic system. Eucken suggested an economic analysis akin to that of classical economists which examines the succession of disequilibrium states until equilibrium is reestablished (Eucken [1940] 1950a, 255; Leijonhufvud 1968, 36; Grudev 2020, 36). The speed of adjustment as an expression of the severity of depression depends on whether market forms were accompanied by monopolistic or competitive structures. Monopolists could be willing to abuse their power vis-à-vis commercial partners in the context of earning income. This power, however, could exacerbate the depression because monopolies which possessed significant power to change their prices would be willing to do so whereas market participants who were subject to monopolists would face a lesser ability to maneuver and adjust their activity to the changed circumstances once the shock set in (Eucken 1953, 15–17). This can lead to strategic behavior expressed by long bargaining processes which can be explained with the help of game theory (Leonard 2010, 320), potentially prolonging the severity of depression. It reveals, however, how valuable it can be to explain the severity of depressions with the help of strategic game theory.

With the internal dynamic of his model thinking, Eucken demonstrated that he did not change his mind regarding the explanation of the Great Depression, namely that it was institutional factors which prolonged the adjustment process – an explanation which he issued at the conference discussing the Lautenbach plan (Borchardt and Schötz 1991, 146). Exactly this explanation of the Great Depression was diametrically opposed to Keynes's general model

([1936] 2018). Keynes argued that institutional factors were not the reason for the persistence of the Great Depression. With a general model, he aimed to explain the instability of capitalism (Leijonhufvud 1968, 37; Samuelson 1950, 147). This methodological approach was diametrically opposed to Eucken's, who suggested that reality could not be explained with only one model (Ostrom 2014). Even though Eucken's model thinking possesses many drawbacks, it contains an important message regarding the incorporation of institutional factors into the coordination problem, which is central to understanding the severity of crisis. In my opinion, Eucken's thinking could be better expressed by a game-theoretical approach where the disturbance of equilibrium would give rise to strategic behavior on the side of dominant economic agent (Leonard 2010, 15). Hence, it was not a coincidence that Morgenstern sent his co-authored book *Theory of Games and Economic Behavior* (1944) to Eucken. Morgenstern, who was a colleague of Lutz's at Princeton, should have recognized the game-theoretical potential in Eucken's research program after Lutz had organized several meetings about Eucken's methodological *Grundlagen* at the Princeton economic club.

Emigration with a Pulled Handbrake: Friedrich A. Lutz's Internal Methodenstreit

Eucken aimed to popularize his approach of economic orders in the Anglo-Saxon world. This was the reason why he accepted Hayek's invitation to deliver five lectures at LSE in March 1950. Eucken's sudden death does not permit a definitive conclusion whether he would have succeeded in convincing his Anglo-Saxon colleagues of the relevance of thinking in orders. My fourth paper entitled "Emigration with a Pulled Handbrake: Friedrich A. Lutz's Internal Methodenstreit" (2021) published as a working paper at the Center for the History of Political Economy at Duke University focuses on whether Anglo-Saxon economists would have taken Eucken's approach into account when they aimed at discussing macroeconomic phenomena. Lutz's intellectual development represents the most promising case to answer this question. He had a stellar career at Princeton, with his publications in monetary economics, monetary policy, and international monetary theory establishing him as an internationally renowned expert in the field of money and banking. Lutz's young years were deeply entwined with his teacher's quest against the Historical School. In this context, my article raises the question whether Lutz was able to popularize Eucken's approach within the Anglo-Saxon world, a question which is of interest in the context of research on the importation of European economic ideas from German-speaking area in the late 1930s into the American universities (Hagemann 1997; Hagemann 2005).

My article illustrates an increasing gulf between the economics promoted by Freiburg School and Anglo-Saxon economics in the 1930s. The Freiburg School approach stood in the tradition of Max Weber's socioeconomics that introduced economic sociology as an intermediary layer between economic theory and economic history, aiming at reconciling the Menger–Schmoller Methodenstreit battlefields (Kolev 2020, 47–48). Lutz's emphasis on the necessity of ideal types reflected an attempt to combine theory and history. During his first Rockefeller Fellowship at LSE, Lutz recognized that his research in socioeconomics was diametrically opposed to Anglo-Saxon economics whose mathematization was documented by G. L. S. Shackle's book *The Years of High Theory* ([1967] 1973).

Lutz saw in mathematical economics an approach that was completely detached from reality. In the United States, he experienced the consolidation of American and English economic thought during the "Keynesian Revolution". He realized that an academic career in the New World would be virtually impossible if he did not acquire the mathematical skills necessary to conduct modern economic research. This gave rise to an internal Methodenstreit, during which he was full of moments of anxiety to release the handbrake of emigration, because he was aware of the immense efforts to learn these new methods, but most importantly, he was convinced that without the methodological consideration of institutions, mathematical economics was doomed to fail to explain the occurrence and essence of macroeconomic phenomena. With a methodological paper criticizing Keynes's *General Theory* published in *QJE,* Lutz adapted to the new tendencies in American economics and at the same time made a grand entrance into American economics. Lutz's paper took an intermediate position between the technical Anglo-Saxon economics and methodologically and institutionally focused German economics tradition. He criticized Keynes's saving-investment concept on methodological grounds. Perhaps due to career-tactical reasons Lutz stopped stressing the institutional analysis from his Freiburg years.

As an assistant professor at Princeton, he organized a discussion evening at the Economic Club at Princeton with the aim to popularize Eucken's methodological message from *Grundlagen* and thus central ideas of Freiburg School. With huge regret, he described in a letter to his teacher "it was impossible for me to convince the participants of the relevance of the issue. I was thoroughly discouraged." In the same letter, he described his failure to find a publisher for a translation of Eucken's book before the end of the war (Lutz to Eucken, 23.07.1940). In spite of a stellar career as a monetary theorist at Princeton and a connectivity with top-level American economists, it was only at Zurich, where he taught history and theory of socioeconomics, that Lutz found peace from the anxieties and tensions of his Methodenstreit. With this paper, I showed that Eucken would not have achieved the expected success from his LSE lectures. The economics of 1950s were already engulfed by the Neoclassical synthesis whereas any thinking in orders as a probable explanation of severity of economic crisis was out of question.

3. Conclusion

The findings of my articles collected here agree with Schumpeter's claim that the content of the toolbox used by economists to analyze economic phenomena did not undergo a linear development (Schumpeter 1954, 5). A short glance in contemporary economics textbooks does not do justice to the more than two hundred fifty years of the history of economics (Boulding 1971, 229). It was precisely this approach, however, which has been *en vogue* recently, and which marks many recent discussions on whether ordoliberal ideas have affected German economic policy during the sovereign debt crisis. Not only its critics, but also their benevolent interpreters, such as Vanberg (1998), for example, did not put the glasses of modern economics aside when discussing the intellectual legacy of economists who produced their major works several decades ago. Critics and benevolent interpreters of ordoliberalism tacitly followed George Stigler's assessment concerning the alleged (non-existent) relevance of the history of economic thought (Stigler 1969). In fact, Stigler rejected Schumpeter's claim that the history of economics could play an inspirational role, even dissuading scholars from studying the history of economics to discover new ideas or insights that could help to improve techniques of economic analysis (Stigler 1969, 217; Backhaus 1983, 146–147).

Economic orders, as developed by Eucken, marks such a contribution to existing techniques of economic analysis, as it can help explain the emergence and essence of macroeconomic phenomena. The last sovereign debt crisis provided evidence for how valuable Eucken's thinking in orders is. The different performance of Eurozone countries during the financial crisis suggests that it actually is the institutional framework which significantly impacts economies' ability to recover. This framework exerts an undoubtedly strong influence on the interaction process because the former determines the artificial constraints that affects the result of the interaction. In this vein, I suggest that future research should not only concentrate on Eucken's concept of orders, but also on the way Hayek adopted and furthered this approach. As a consequence, this doctoral thesis should be understood as an impulse for further research on how institutions can affect the emergence and essence of macroeconomic phenomena. But the power of an impulse itself should be not underestimated.

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II. The Secondary Depression:

An Integral Part of Wilhelm Röpke's Business Cycle Theory*

1. Introduction

During the global financial crisis, the advanced economies experienced a huge contraction of investments. The bulk of this slump has been constituted by a reduction of investments in the private residential (housing) and nonresidential (business) sector. It was precisely investments in these sectors that marked the boom during the pre-financial crisis period. According to forecasts, a complete recovery is still not visible in the near future (IMF 2015, 2016). In addition, the financial crisis has had negative effects on the ability of Southern European governments to cope with increasing debts, which reached tremendous levels as a result of the European governments' responses to the crisis. This contributed to the outbreak of the sovereign debt crisis in the Eurozone, endangering the stability of Southern European economies (e.g., ECB 2009; Haugh, Ollivaud, and Turner 2009). These crises raise many questions—not only regarding their causes but also with respect to the appropriateness of governments' reactions to them (e.g., Rajan 2010).

In order to understand when government interventions are able to "cure" crises and depressions, there must be a theoretical analysis of what happens during these processes or, in other words, a theory of economic contraction (Hayek 1932, 1933). Such a theory was considered obsolete after the WWII—particularly in the 1950s and 1960s. The main explanation for this, formulated by the neoclassical synthesis which was the leading paradigm in economic science then, was

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that monetary and fiscal policy could play a stabilizing role so that economic downturns would be prevented (e.g., Landmann 2007). Despite the fact that many theoretical streams appeared afterward and were critical of the neoclassical synthesis, economic theory still credited government policy—particularly monetary policy — with the capacity to stabilize the economy (e.g., Clarida, Galí, and Gertler 1999). A confirming example was the Great Moderation (1984–2007) period, praised for its low volatility in real output and the inflation rate. One of the explanations for the low volatility was that monetary policy played a pivotal role in stabilizing the macroeconomic process (Romer and Romer 2002; Bernanke 2012).

Nonetheless, the last financial and ensuing sovereign debt crises can be regarded as a proof that economic policy failed to achieve the stabilizing role—not only in preventing but also in overcoming these challenges (e.g., Taylor 2012). In order to understand when the "medicine" works, we should understand the reasons for the "illness" as well as its course. This makes it necessary to revitalize and expand those theories that concentrate not only on the processes and course of depressions, but also on their causes. In this sense, the question of whether economic policy is able to prevent or even overcome crises and depressions at all can be answered.

The theoretical analyses of the mechanics of economic crises that were considered the results of preceding booms were a leading paradigm in the business cycle theories in the first three decades of the twentieth century. The Great Depression was considered the practical test regarding their validity. This period caused the crystallization of two prevailing views on the meaning of depression: on the one hand, the view of the Austrian School around Friedrich A. Hayek (1899–1992) and Ludwig von Mises (1881–1973) and, on the other, the opposing view of John Maynard Keynes (1883–1946) (Hansen and Tout 1933). Their different interpretations of the depression provided different theoretical foundations regarding the necessity of government intervention. In those times when the depression reached its most severe period, the Austrians did not change their opinion that the depression was a cleansing or readjustment process from the imbalances that occurred during the preceding boom. Consequently, they rejected any government intervention, arguing it would prolong the painful process. In contrast, Keynes suggested that this economic contraction had entered a severe stage where government should reestablish confidence in society by acting as investor and borrower (Haberler [1937] 1946; Hansen and Tout 1933). In those times of despair, Keynes's ideas were celebrated as the necessary medicine against depression, whereas the Austrians had to leave the battlefield in defeat (e.g., Streissler [1969] 1970).

Nonetheless, not all the members of the Austrian School rejected the view of the destructive nature of depressions and hence the need for government intervention. Among them, Wilhelm Röpke was a proponent of the idea that depressions cannot always perform a readjustment function. Röpke recognized relatively early that crisis and depression could turn out to be economically senseless, as described by Keynes (Haberler [1937] 1946; Ebeling [1979] 2000). In this vein, Röpke was one of the German proto-Keynesian economists who distinguished between two phases of depressions. He recognized the existence of primary depression—with its readjustment function—and simultaneously a secondary depression as a destructive and economically senseless period that should be forcefully counteracted with fiscal and monetary policy (Klausinger 1999).[5]

Röpke was one of the most prominent business cycle theorists in the German-speaking area during the interwar period. He started his career early after publishing his habilitation *Die Konjunktur* (1922) at the age of 23. However, Röpke's writings in this realm of economic theory—particularly his works during the interwar period – have mostly been ignored (Klausinger 1999). Precisely the importance and topicality of these writings will be revisited

[5] The German proto-Keynesian economists formulated different views on the primary depression, but all shared the same opinion that government interventions in this phase would prolong the process of contraction (Klausinger 1999, 382).

here, by discussing Röpke's theoretical considerations of the secondary depression with the purpose of answering the question of when the mechanics of the preceding primary depression can give rise to the existence of a secondary one. The reason for considering the primary depression is Röpke's statement that "under certain circumstances […] [the primary depression, LG] loses more and more its function of readjustment and degenerates into a *secondary depression*" (Röpke 1936a, 119, emphasis in the original). In addition, the primary depression is in turn an immediate result of the boom period (Röpke 1933d). This paper explores the question whether the boom is able to cause such a primary depression that is liable for the existence of such "circumstances." In this sense, the paper can be regarded as a further step toward the currently necessary theory of economic contraction.

The paper is structured as follows: Sect. 2 will review Röpke's business cycle writings; Sect. 3 will discuss the destructive nature of the secondary depression; Sect. 4 will concentrate on Röpke's concept of equilibrium, its distortion, and dynamic of disequilibrium in his business cycle theories; Sect. 5 will discuss the impact of the boom on the primary depression; and Sect. 6 will present the conclusions.

2. Röpke's Business Cycle Legacy

2.1 The Secondary Depression: Röpke's Innovative Contribution

At a conference of the Friedrich List-Gesellschaft in September 1931 (Borchardt and Schötz 1991), Röpke presented the view that the world economy was experiencing a kind of depression which had nothing to do with the economically necessary depression in Hayek's and Mises's works. Although Röpke agreed with them that a depression could generally have an important readjustment function, he claimed that the world had left this state of depression and was now entering the phase of a secondary depression. Due to its senseless and destructive nature, Röpke recommended an expansionary credit policy with the aim of overcoming it (Borchardt and

Schötz 1991). A few days later, amidst one of the most severe banking crises, Röpke published "Geldtheorie und Weltkrise" (Röpke 1931b), a paper whose explanation of the reasons for economic fluctuations was based on the theoretical approach of Keynes's *A Treatise on Money* (Keynes 1930). In this piece, perceivable also as a positive review of Keynes's book, Röpke used the opportunity to popularize the idea of the secondary depression and the necessity of active fiscal and monetary policy to counteract it (e.g., Landmann 1981). In *Krise und Konjunktur* (Röpke 1932), Röpke elaborated on the idea of secondary depression and at the same time integrated it into his theoretical considerations regarding business cycles.

In the subsequent pieces "Reflation oder Reexpansion" (Röpke 1933b), "Die sekundäre Krise und ihre Überwindung" (Röpke 1933d), and "Trends in German Business Cycle Policy" (Röpke 1933c), Röpke expanded the theoretical analysis regarding secondary depression and elaborated on the measures necessary for overcoming it. In "Die säkulare Bedeutung der Weltkrisis" (Röpke 1933a), he not only discussed the depression in technical terms but also emphasized its dangerous influence on the attitude of the masses toward the current economic system. In this vein, Röpke warned readers of the new, emerging nationalist movements in which the masses saw salvation from the depression. The book *Crises and Cycles* (Röpke 1936a) can be considered a culmination of the theory of secondary depression in which Röpke dedicated a whole chapter to its mechanics. In all the aforementioned publications, the explanation of the secondary depression remains under the influence of Keynes's *A Treatise on Money*. This was clearly stated by Röpke: "The treatment given in this paragraph owes much to this great work [*A Treatise on Money*, LG]" (Röpke 1936a, 133).

2.2 The Theory of the Boom: Röpke's Quest for Identity

Whereas Röpke demonstrated a relative consistency in his views with respect to the theory of depressions, his theories of the boom period experienced a tremendous development. This paper distinguishes between four main periods in Röpke's theories of the upswing in his interwar writings, which could be an expression of his attitude toward the Austrians and Keynes:

1. The first period was marked by the habilitation *Die Konjunktur* published in 1922. Röpke underscored that the exchange economy is vulnerable to disequilibrium. Based on the arguments of Böhm-Bawerk, Cassel, Menger, and Spiethoff, Röpke postulated that the intensity of production of the various commodities is defined by the volatility in the demand for them. Röpke stated that volatility in the demand for capital goods was stronger than that for consumer goods, which explained the higher fluctuation in the production of capital goods. Afterward, Röpke described the fluctuation in the production of capital goods as the cornerstone of business cycle theories (Röpke 1936a, 97). In "Konjunkturtheorie und Konjunkturpolitik" (Röpke 1925), Röpke confirmed the ideas developed in *Die Konjunktur*. Additionally, he recognized the relevance of money and credit in explaining economic fluctuations by defining them as a condition (but not a cause) for their occurrence.

2. The second period was covered by the papers "Kredit und Konjunktur" (Röpke 1926) and "Die Theorie der Kapitalbildung" (Röpke 1929). Here, Röpke introduced the importance of the discrepancy between the money interest rate and the natural interest rate for explaining business cycles. This belongs to the Austrian period of Röpke (Hayek [1929] 1976, 58).[6] Here Röpke emphasized that lowering the money interest rate below the natural interest rate and increasing the credit supply were the only reasons for the start of the boom and hence for the occurrence of disequilibrium. Consequently, a crisis is an inevitable consequence that should restore equilibrium.

[6] Hayek underlined that Mises developed and even improved the Wicksellian theory by analyzing how a discrepancy between the money interest rate and natural rate of interest had an impact on consumer goods prices and the prices of capital goods (Hayek [1931] 1935, 25–26). Furthermore, Hayek emphasized that in "Kredit und Konjunktur" Röpke formulated similar views to those of Mises (Hayek [1929] 1976, 58).

3. The Great Depression and the publication of Keynes' *A Treatise on Money* not only influenced Röpke's views about the depression but also his theory of the boom period. The paper "Geldtheorie und Weltkrise" (Röpke 1931b) and the subsequent book *Krise und Konjunktur* (Röpke 1932) mark the third period of Röpke's views on the boom. He remained convinced of the importance of the impact of the discrepancy between the natural and money interest rates on capital and consumer goods industries. However, he elaborated on the mechanics of the boom in Keynesian style by using the saving-investment approach.

4. The publication of the paper "Socialism, Planning, and the Business Cycle" (Röpke 1936b) followed by the book *Crises and Cycles* (Röpke 1936a) marked the fourth period of Röpke's views on the boom. In this period, Röpke distanced himself from Keynes and Hayek. Even a difference between the descriptions of the process of the upswing in *Krise und Konjunktur* and *Crises and Cycles* can be noticed. Whereas Röpke used the saving-investment approach *in Krise und Konjunktur*, he not only dismissed but also criticized it in *Crises and Cycles*. This could be considered the beginning of Röpke's critique of Keynes's theoretical views.[7]

Regarding the formation of Röpke's fourth period, which can be considered as Röpke's emancipation period, this paper offers two hypotheses. The first hypothesis is that the ideas developed by Hansen and Tout (1933) had huge impact on Röpke's explanation of the reasons for economic fluctuations. Röpke stressed only that

[7] Such criticisms were also made by other German proto-Keynesians—particularly after Keynes gained huge popularity. A possible explanation is a certain disappointment with Keynes due to his lack of attention to those economists who made his views popular in German literature. In the case of Röpke, this disappointment can be regarded as justified since he published "Trends in German Business Cycle Policy" (Röpke 1933c) in the Economic Journal, whose editor was Keynes (Landmann 1981). In "Trends in German Business Cycle Policy," Röpke stressed the importance of Keynes' theoretical considerations in formulating the measures proposed by the Brauns Commission to the German government with the purpose of overcoming the depression. Additionally, at the very beginning of his exile, Röpke visited Hayek in London in June 1933 and also met Keynes there (Hennecke 2005, 93–94).

> “Dr. von Hayek’s theory has been criticized on rather similar lines by Alvin H. Hansen and Herbert Tout […] The views of these authors seem to coincide particularly closely with the views of the present writer” (Röpke 1936a, 111).

The second hypothesis is related to Röpke’s use of the acceleration principle for explaining the mechanics of the boom. According to Boianovsky (2005), Roy F. Harrod—who also made use of the acceleration principle in his book *The Trade Cycle* (Harrod 1936)—became aware of its importance by reading the first draft of Haberler’s *Prosperity and Depression*, an unpublished manuscript with the title “Systematic Analysis of the Theories of the Business Cycle” (Haberler 1934; Boianovsky 2005, 10). The draft of Part II of Haberler’s book “Synthetic Exposition of the Nature and Causes of the Business Cycle” was very well familiar to Röpke who was invited to Geneva with other economists to discuss it (Boianovsky and Trautwein 2006, 62–73). The discussions took place few months before publishing “Socialism, Planning, and the Business Cycle” which marked the start of Röpke’s fourth period. Hence, it is highly probable that Röpke read the first draft of Haberler’s book. This could have convinced Röpke to stress the importance of the acceleration principle and to use this principle to criticize Keynes – he stressed that Keynes’s reluctance to use the acceleration principle for explaining the mechanism of the boom was the main reason for his unwillingness to recognize the existence of a primary depression (Röpke 1936a, 109).

Having discussed the main ideas and thoughts which can be distilled from Röpke’s business cycle writings, the next chapters will make the first step toward connecting them.

3. The Secondary Depression

3.1 The Process

In his early writings, Röpke referred to depressions as readjustment processes. This concept was introduced for the first time in the paper “Kredit und Konjunktur” (Röpke 1926). The main purpose of this readjustment processes was to restore the equilibrium disturbed by an incompatible-for-the-community increase in accumulation of capital (Röpke 1926, 262) or (in later works) rise of investments (Röpke 1936a, 108–109) during the boom period. In his early and later works, Röpke emphasized that this process of disturbance caused relative inflation. Depressions had to restore the once disturbed equilibrium and correct the inflation occurred. This restoration process took the form of a decline in production of those industries that had caused the overinvestment during the boom (Röpke 1931b, 1746; 1936b, 333). In analogous manner, this correction process was accompanied by falling prices which had to be considered a necessary reaction to the relative inflation that occurred during the boom. Röpke rejected any government intervention aimed at stopping this process, as it would cause the prolongation of the painful process (Röpke 1933d; 1936b).

If the depression did not succeed in restoring equilibrium, it could cause new disequilibrium and degenerate into a secondary depression. According to Röpke, “no cut-and-dried answer” could be given to the question when the secondary depression starts and the primary one ends. However, he emphasized that there were “broad principles” which would indicate the onset of the secondary depression:

> “The simplest is the mere elapse of time after which it may be reasonably expected that the primary depression has fulfilled its purging mission,” and he continued: “More conclusive is the symptom of persistent mass unemployment, which may be taken as an indication that the primary depression has quite outgrown the dimensions imposed by its function of readjustment, and most conclusive of all will be the fact that the

depression has also engulfed the industries producing consumption goods" (Röpke 1936a, 129–130).

The comparison between the merits of Keynes's theory of the depression and Hayek's theory of the boom remains the central point of *Crises and Cycles*, contained in statements such as "While in the case of Keynes the analysis of the upswing is much weaker than that of the depression, just the opposite may be said of Hayek's theory" (Röpke 1936b, 334), or that the course of the secondary depression "can indeed be no better stated than in the terms of the saving investment approach elaborated by him [Keynes, LG]" (Röpke 1936a, 109). According to the saving-investment approach, the secondary depression is characterized by a higher rate of saving than investment. Röpke tried to combine two different theoretical doctrines: he adopted Hayek's views to formulate the primary depression that took the form of the reducing of capitalistic production, and he used Keynes's considerations to explain the secondary depression by describing the process via the saving-investment method. Furthermore, Röpke accepted Keynes's idea of the importance of the kind of savings (Röpke 1936a, 123; 1931b, 1742).[8] In this manner, Röpke explained why savings do not automatically transform into investments during the secondary depression. He referred to the Keynesian terms "bearishness" and "liquidity preference" of the public—meaning the public prefers liquidity and security over profit (Röpke 1932, 90–91; 1936a, 123). This can be observed, on the one hand, by the behavior of enterprises that hold money and stay liquid, so they do not use these funds for new investments or even for a replacement demand. Röpke accentuated that this was an immediate consequence of a crisis of confidence, a result of the recurrent losses which the entrepreneurs

[8] "Keynes succeeds in making clearer than others have done the part played by hoarding in the business cycle. The decision of a saver to save is not enough. It is necessary for him also to decide the form which his savings shall take" (Hansen and Tout 1933, 127).

had been suffering, and the reason for their unwillingness to undertake new investments.[9] On the other hand, private households also suffered from a crisis of confidence, expressed in the willingness to "sterilize" their funds in banking accounts instead of investing them by buying securities (Röpke 1936a, 123).[10]

This bearishness of the public, in turn, could have negative effects on the money and credit system. These negative effects would find an expression by ruining the financial status of the banks. According to Röpke, the effects would not only be on the debit (or asset) side of banks' balance sheets but also on the credit (or liability) side. The asset side was negatively affected since the repayment of many credits was interrupted and the value of the securities held by the banks also decreased, both because of the reduced profits of the enterprises. On the other hand, the credit side of the banks' balance sheets also suffered from the crisis of confidence due to the "immobility of the banks' accounts" which was an immediate result of the aforementioned bearishness (Röpke 1936a, 122). Furthermore, the crisis of confidence caused the public to withdraw its money from the banks and hold cash which exacerbated the problem of hoarding.

As a result, this kind of saving taking place during the secondary depression had nothing to do with the saving typical in normal times. In this vein, Röpke even characterized this saving as "downright destructive" and the process of saving as "positively harmful for the economic welfare" (Röpke 1936a, 123). The destructive character worked in a twofold manner. On the one hand, saving means per definition that less than the total income is devoted to

[9] Psychological factors such as absence of confidence (pessimism) or state of confidence (optimism) played a pivotal role in the theories of A. C. Pigou. His views may have influenced Keynes who emphasized their importance for explaining investment behavior (Haberler [1937] 1946, 143).

[10] According to Richard von Strigl (1891–1942), another member of the Austrian School whose views on the depression were similar to those of Keynes (Röpke 1936a, 109), increased liquidity in enterprises and banks was expressed in the low money market interest rates. By contrast, the interest rate in the capital markets surged to unprecedentedly high levels. The outflow of funds from the capital market to the money market was explained by distrust and pessimism (Haberler [1937] 1946, 60).

consumption—any increase in savings should cause a decline in the part of income devoted to consumption, thereby shrinking the demand for consumer goods. On the other hand, the increased savings do not take the form of demand for capital goods, as it happens in normal times. On the contrary, savings take the form of hoarding, which is a result of the crisis of confidence.[11] The result is a general decline in overall demand (Röpke 1936a, 122).

Röpke stressed that the decline in total demand was the "prime mover" or the "causa movens" of the secondary depression. This decline in demand gave rise to a further decline in production and hence in income, thereby causing further shrinkage in demand. This made the investment rate converge to zero, causing the exacerbation of disharmony between saving and investment rates. Röpke stated that the disharmony between the saving and investment rates was a direct result of "the disastrous *destruction of that harmony between the process of the formation of incomes and the process of the utilization of incomes*" (Röpke 1936a, 122, emphasis in the original). This disharmony would be overcome only if the investment rate rose to match the savings rate or if the savings rate decreased until it reached the level of the investment rate. Both will be discussed in the next section.

3.2 Lower Turning Point or the Necessity for Government Intervention

3.2.1 The Increase in the Investment Rate

An increase in investment can happen only under two conditions: restoring the incentives to entrepreneurs to invest, and the willingness of banks to expand credit in the economy. Röpke pointed out that both of these conditions must be fulfilled to achieve recovery. If one of the conditions was absent, then the desired effect would fail. On the one hand, if there was only an expansion of credit in the economy, then a situation similar to the famous liquidity trap in

[11] Röpke described this in one sentence: "[…] money is withheld from expenditure on consumption goods, without any compensation for this non-consumption taking place in the form of investments in capital goods" (Röpke 1936a, 123–124).

Keynes's sense would occur (Allgoewer [2009] 2010). He used the US economy as an example in which interest rates approached zero, but entrepreneurs were not willing to undertake new investments. Röpke pointed out that the elasticity of the demand for credit tended to become virtually zero (Röpke 1936a, 125). On the other hand, if there were enterprises willing to start new investments, but they were faced with the reluctance of commercial banks to provide long-term credit, then the recovery would also fail: the reason is that the enterprises would be unwilling to invest longer-term if they feared being unable to refinance their credits at a future point in time.

Röpke emphasized that longer-term investment is exactly the prerequisite for recovery. Hence, the main condition for recovery is reviving security markets and, in particular, the stock market. This market represents an important funding source for enterprises and a necessary condition for banks to turn their securities into cash and an important funding source for commercial banks. However, reviving the security and stock markets is related to restoring confidence in the economy (Röpke 1936a, 125–126).[12]

3.2.2 The Decrease in the Rate of Savings

If the rate of investment does not increase to the rate of saving, then an "automatic safety brake" will be engaged. This implies that the rate of saving would decline to the rate of investment until the equilibrium is restored. However, Röpke warned that such a development would create huge pressure on the stability of society. This would happen either through impoverishment of the people since savings would be consumed, or due to the impossibility of the state to cover

[12] On similar lines, Strigl explained the mechanics of the depression. According to him, any breakdown of the boom would lead to a process of hoarding and become the reason for deflation. In this environment of pessimism and uncertainty, private enterprises would not be willing to carry out new investment (Haberler [1937] 1946, 60; Strigl 1934, 214–220). Like Röpke, Strigl stressed that long-term investment on the one hand and the willingness of the banks to lend for a long period on the other were necessary conditions for reviving the economy (Strigl 1934, 217).

any increase in the budget deficit by reducing expenditures or raising taxes, something which could be done at the cost of a revolution. Röpke warned that if no actions were taken, the economic crisis would turn into "a real crisis of our entire economic and social system" (Röpke 1936a, 129). He discussed the depression not only in technical terms but also warned against the developments that would unfold if no measures were taken against combating it (Röpke 1931c, 450). Röpke made this clear in the following statement:

> "Even if we do nothing, the natural course of things will bring about its own solution though in the cruel way […]—with several thousands more having recourse to the gas-hose, several hundreds more being killed in civil warfare, and (consequent on the general destitution and exasperation) with the hysteria of the masses and their leaders increasing to such a degree as to shake State and society to their foundations" (Röpke 1936a, 129).

As a result, Röpke defended the need for government intervention to stop this destructive process.

Having discussed and analyzed the process of the secondary depression and its negative social effects, the question arises under which circumstances such a disastrous process can occur. In this sense, Röpke gave a hint that

> "The primary depression […] may be followed by a secondary depression whose real causes are to be sought in the circumstance that an independent and economically purposeless secondary deflation develops out of the unavoidable deflation of the primary depression" (Röpke 1936a, 135–136).

Furthermore, the primary depression was an immediate result of the preceding boom. Therefore, the next chapter will describe Röpke's views on the boom, with the goal of answering the question when the boom can be succeeded by such a depression that has the tendency to converge into a secondary one. In other words, this paper primarily elaborates on Röpke's formulation:

> "The rising curve of investment during the boom has its counterpart in the falling curve of the depression, and the more steeply inclined upwards is the first the more sharply does the second tend to slope downwards" (Röpke 1936a, 97).

4. The Instability of Economic Systems: Fundamental for the Recurrent Booms

4.1 Equilibrium and Capital Accumulation

As discussed above, Röpke characterized the primary depression as a process that had to restore the equilibrium in the economy. If the primary depression did not succeed in readjusting the balance in economy, it would transform into secondary one which represented a process moving away from the equilibrium. Hence, the notion of equilibrium played an enormous role in Röpke's business cycle theory, which makes it necessary to explain how Röpke defined equilibrium and what factors caused its distortion.

According to Röpke, a community devotes one part of its total income to consumption and another to savings (defined also as capital accumulation). In a similar way, the community divides total production into production of consumer and capital goods. Röpke emphasized that the state of equilibrium in an economy was expressed by the correspondence between the composition of the total income and total production of the community. In other words, the proportion according to which the community devotes part of its income to direct consumption and to savings should be the same as that to which the community divides its total production into production of consumer and capital goods. This explains the harmony between the process of income formation and the process of income utilization (Röpke 1929, 7; 1936a, 122).

In cases where the community wants to increase its production of capital goods, it should restrict its current consumption. This gives rise to a change in the composition of production. This change is expressed in the expansion of the production of capital (or future) goods at the cost of the production of consumption (or present) goods. In other words, accumulation expands at the cost of the consumption of the community. Röpke underlined that any sudden and substantial increase in accumulation would cause a disturbance of the state of equilibrium (Röpke 1926; 1929; 1931a; 1936a). However, he warned the reader that not every kind of capital accumulation gave rise to the sudden increase in the accumulation of the economy that upset the balance. He distinguished between two kinds of capital accumulation: voluntary and forced. Voluntary capital accumulation could be divided into savings of private households and the increasing entrepreneurial capital expressed by reinvesting surpluses in capital goods. On the other hand, forced capital accumulation took place by taxation and forced monetary accumulation, the latter taking the form of credit expansion (Röpke 1929; 1931a).

Röpke postulated that the saving of private households took the form of laying aside part of the income in bank accounts or buying securities like bonds and stocks. In this way, households financed enterprise and indirectly created a demand for capital goods (Röpke 1936a). The amount of savings and hence the volume of demand for capital goods were determined by the subjective factor “propensity” and the objective factor “ability” to save (Röpke 1929, 23; Hayek 1929, 475).

According to Röpke, propensity was based on three motives. The first was the desire to save for rainy days, the second due to earning additional income by obtaining interest rates, and the last—on which Röpke placed particular emphasis – was automatic saving. This takes place in cases where income is so high that its entire consumption is characterized by low marginal utility.[13] The amount of saving was here determined by balancing the marginal utility of consuming the entire income and the marginal utility of saving it. With increasing income the marginal utility of consuming the entire income which defines that a larger part of income will be saved decreases. According to Röpke, any further increase in high income caused a progressive (and not proportional) increase in the amount of saving. This last motive is related to the objective factor – ability to save. The ability to save is determined by the amount of income. Röpke inferred that what was still true for any household could be true for the entire economy. He stated that with increasing income the capital formation of one economy would improve progressively and rejected the idea that interest rates were the only reason for saving. He argued that savings could take place automatically even when the interest rate reaches zero. By contrast, income should be understood as the prime mover in the process of saving (Röpke 1929, 28).

Entrepreneurial capital building, also called "self-financing," took the form of direct demand for capital goods. Röpke argued that corporate surpluses contributed to accumulation (or saving) in the community since enterprises were more inclined to reinvest their surpluses in new machines rather than to lend them on the capital market (Röpke 1936a, 106). Hence, the demand for capital goods of enterprises represented the bulk of voluntary capital accumulation in society—and any increase in the surpluses (income) of enterprises would rise their demand for capital goods and thereby the accumulation of the community (Röpke 1936a, b). In this sense, income (or corporate surpluses) played the same role as the considerations developed regarding the saving of private households: with increasing surpluses (income), the desire to expand the demand for capital goods increased. Röpke described the inherent inclination of enterprises to do this as the "seeds of wasting capital" which arose from the absence of a

[13] This is similar to the Keynesian analysis where increasing income decreases the marginal propensity to consume (Samuelson 1939).

division between savers and investors. The lack of division abolished the payments of interest rates and hence the regulating character of interest rates with respect to the optimal use of capital. This explained the wasting behavior by entrepreneurs and their tendency toward overinvestment (Röpke 1929; 1936a, 106).

As a result, the size of income was the prime mover in the process of voluntary accumulation in the economy since it defined the savings of private households and the demand for capital goods of enterprises. Röpke rejected the idea that voluntary capital building would on its own reach such a magnitude that it would destroy economic equilibrium. In addition, Röpke underscored that a "powerful mechanism" will make voluntary capital accumulation reach these dangerous dimensions (Röpke 1936a, 106; 1936b, 328). Credit expansion represented this powerful mechanism, defined as monetary forced saving. The latter worked via changes in "the social structure of incomes" (Röpke 1936a, 107). These changes were expressed by a disproportionate increase in different types of income of private households and enterprises. This disproportionate increase caused a disturbance in equilibrium (Röpke 1925, 409; 1936a, 107).[14]

In order to recognize the distortive impact of credit expansion, Röpke emphasized the importance of understanding the method of credit creation. He described that the commercial banks possessed certain autonomy, explicitly discussed in Röpke (1930), regarding credit creation. The basis for understanding this autonomy is that the bulk of payment transactions in the economy were carried out by using checks which entitled the public to use their demand deposits to carry out payments. Commercial banks were able to change the volume of deposits in the economy via credit provision. This was carried out by accommodating deposit accounts not limited by real factors (like gold, cash, etc.). If commercial banks decided to increase the

[14] Röpke appraised that insights regarding this problem were derived from the views of underconsumption theorists like Marx (Röpke 1936a, 89).

credit supply due to profit considerations, they could just decrease the interest on credits and create new deposits (Röpke 1930, 760–761; 1936a, 113–114). This explained that the monetary interest rate depended on the power of commercial banks.[15] Röpke sometimes even called it a "manipulated" (Röpke 1929, 31) or "artificial" rate of interest (Röpke 1926, 268). He recognized that the law of the formation of this interest rate, defined as a monetary interest rate, does not work as the law of the formation of prices for commodities where demand and supply are the underlying forces (Röpke 1926, 272).

Röpke emphasized that not the absolute—but rather the relative—height of monetary interest rate to the "natural interest rate" in Wicksell's sense played a role in the start of the boom (Röpke 1926, 273; 1936a, 114). In this sense, he was on the same page as the Austrian School also known as the "Neo-Wicksellian" School (Haberler [1937] 1946, 31–32). Similarly, Röpke defined the natural interest rate as the equilibrium rate that arises in a fictional economy where capital is lent "in natura" and not in monetary form and underscored that the natural interest rate was the price for waiting, emphasizing the time dimension (Röpke [1937] 1951, 237). This interest rate balanced the demand for capital with the supply of capital represented by the existing capital funds in the economy and secured the stability of price level (Röpke 1926, 269; Hayek [1931] 1935, 217; Wicksell 2001).[16] In this fictional economy, the amount of credits was

[15] This autonomy, underlined by Wicksell in order to discuss the nature of the money rate of interest, was the focal point in the work of L. Albert Hahn (1889–1968), especially in *Die volkswirtschaftliche Theorie des Bankkredits* (Hahn 1930). See also Röpke's statement on Hahn in *Eine Freundesgabe für Albert Hahn* (1959) where Röpke stressed the importance of Hahn's theoretical considerations. Röpke explained that the interest rate was not only a real problem but also a monetary problem, as discussed by Wicksell, Hayek, Keynes, and Hahn (Röpke [1937] 1951, 257).

[16] In "Kredit und Konjunktur", Röpke defined Wicksell's interest rate as the real interest rate. It should be emphasized that Irving Fisher's and Wicksell's real interest rates are two completely different definitions of interest rates (Hayek [1931] 1935, 23). For the possibility to combine the two interest rates, see the work of Friedrich A. Lutz (1901–1975), especially *Zins und Inflation* (1973), and the subsequent comments of Emil-Maria Claassen (1974).

"built up solely of real savings and not out of additional credits besides" – and he described additional credits as "created out of nothing" (Röpke 1930, 760; 1936a, 114–115). The creation of credits "out of nothing" was exactly the expression of the aforementioned commercial banks' autonomy (Hagemann 2010).

The commercial banks could cause this discrepancy in two ways—either by decreasing the money interest rate or by satisfying higher credit demand without increasing the money interest rate when the natural interest rate was starting to rise. The tendency to the latter was a signal of economic recovery because he described the natural interest rate as the "average rate of profits anticipated from capital investment" (Röpke 1936a, 113) or just the rate of return on capital (Röpke 1930, 760).[17] Any increase in the profits on capital was an indication of optimism and the desire to expand investment (Röpke [1937] 1951). By contrast, the money interest rate was the result of the liquidity considerations of commercial banks. These liquidity considerations were directly influenced by the policy of central banks. Thus, if commercial banks arbitrarily decided to decrease the interest rate on credits compared to a given natural interest rate, they would cause the volume of credit in the economy to increase (Röpke 1926, 274–275).

4.2 Distortion of Equilibrium and Dynamic of Disequilibrium

Röpke stressed that any increase in the volume of credit led to the creation of additional purchasing means ("Kaufmittel") available to enterprises (Röpke 1926, 1936a).[18] He was on the same page with the Austrians that any increase in credit provision made the income of enterprises rise faster than the fixed income of private households. As already said, the relative

[17] It is important that Hayek stated 3 years after *Crises and Cycles* that the interest rate and the profit rate were completely different concepts, while many wrongly considered them to be the same (Hayek [1939] 1975).

[18] It should be stressed that Röpke made a distinction between purchasing means ("Kaufmittel") and purchasing power ("Kaufkraft"). This distinction was also embraced by Hayek ([1929b] 1976).

changes in incomes in society distorted the equilibrium of economy. This distortion happened in a double manner (Röpke 1925, 1936a). First, as mentioned above, the rising income of enterprises made them expand their demand for capital goods which constituted the bulk of capital accumulation in the economy.[19] Second, the rising income of enterprises enabled them to expand their production, thereby increasing employment and hence income of the society (Röpke 1936a, 106; Haberler [1937] 1946, 365). The increasing income in the community would not only play a role regarding the aforementioned voluntary accumulation of capital but also regarding the quality of the current demand for goods, even generating demand for new goods. This is due to the arising of new tastes and desires with increasing income that caused new needs and hence demand for commodities in order to satisfy those desires (Röpke 1925).

Röpke stressed that in both cases, any increase in the demand for goods of lower order could – due to technical reasons – cause a stronger increase in the demand for goods of higher order.[20] He described in an Austrian manner that goods of lower order were those goods that are close to consumption, whereas goods of higher order were those goods further away from the sphere of consumption, such as capital goods (Röpke 1922, 62; 1936a, 103). This mechanism, defined as the acceleration principle, constitutes the dynamics in Röpke's boom, defined as a

[19] This gave rise to the phenomenon called "monetary forced saving." This phenomenon was fundamental for the Austrian Business Cycle Theory, and its use proves Röpke's proximity to the Austrian School. In contrast, this phenomenon was criticized by Keynes. The phenomenon will be explained as follows: The faster increase in the demand for capital goods of enterprises leads to an increase in their prices. At the same time, these goods appear in the commodity markets where they are in demand by private households. That their income does not rise at the same rate as the income of enterprises forces private households to decrease their demand for these goods. In other words, private households reduce their consumption. The reduction in consumption means an increase in the savings in the community. That this process of saving is not carried out in a voluntary manner explains why it is called "monetary forced saving" (Röpke [1937] 1951, 88).

[20] Haberler emphasized that goods of lower order did not necessarily mean consumption goods but any final goods (Haberler [1937] 1946, 88).

disequilibrium process. Röpke emphasized that the acceleration principle could work in two ways (Röpke 1936a, b):

First, the increase in demand for any goods caused an increase in the demand for productive equipment (or goods of higher order) in order to satisfy the initial increase in demand. In addition, the augmentation of the productive equipment required a further increase in productive equipment with the aim of making possible the initial increase in productive equipment. Röpke illustrated this with the example of the demand for fowls or silver foxes. Any increase in the demand for fowls or silver foxes (in other words demand for goods of lower order) would cause an expansion of the farms producing those goods. As a result, the expansion required an increase in the capital equipment in order to make that expansion possible. In addition, the increase in demand for capital goods needed for the expansion of farms capital equipment would cause an expansion of the factories that produced those capital goods. In other words, an enlargement of factories producing capital goods not only caused an increased demand for building additional plants to make the increased production possible, but also an expansion of those factories delivering the necessary resources for the building of those plants. Hence, Röpke stressed that "in order to produce more machinery the machines industry itself has to produce more machines for producing more machines" (Röpke 1936a, 103).

Second, the increase in the demand for goods would make sellers increase their stock holdings. This would be repeated in the higher stages at a progressively rising rate. Röpke assumed that a definite fixed percentage of sales was held as stocks in each production stage, and any increase in sales would cause a further increase in orders carried out by the sellers greater than the initial sales (Röpke 1936a, 104). The stock holding was recognized very early by Röpke in his habilitation, where he noted that with increasing durability of one commodity, its ability to be held in stock rose. That commodity was vulnerable to the effect described as "anticipatory cycles" ("Antizipationskonjunktur") (Röpke 1922, 24–63; 1936a, 14). In other words, with increasing optimism during the boom, the sellers and producers were inclined to increase the stocks of this commodity due to expectations of higher sales in the future. The opposite was true when pessimism became ubiquitous (Röpke 1922, 58).

In summary, any lowering of the money interest rate below the natural interest rate would cause credit to increase. This would lead to an increase in the income of enterprises and their demand for capital goods. Hence, the monetary forced capital accumulation would "force"—in a roundabout way—a different impact on different incomes and the voluntary capital accumulation to increase, not only disturbing the equilibrium but also exacerbating disequilibrium in the economy (Röpke 1936a, b).[21] This disequilibrium was characterized by "disproportionate expansion in the higher stages of production, the rate of expansion being the greater the higher is the stage of production, i.e., the further it is removed from the sphere of consumption" (Röpke 1936a, 103).

Röpke emphasized that this disproportionate increase in the higher stages would come to an end if the demand in the lower stages did not increase at the same rate. This described the upper turning point in Röpke's business cycle theory (Röpke 1936a, 103). According to later writings, Röpke stressed that a satisfaction of demand is the main reason for its contraction (Röpke 1936a, 102). However, this paper argues that this reasoning is a very contradictory one and accepts Röpke's early explanation that those enterprises which initially expanded their demand for capital goods and caused the boom were suffering from lack of profitability and reduced the expansion of their capital equipment. He emphasized that this happened when credit became more expensive compared to the profits of enterprises. Röpke referred once again to the importance of the discrepancy between the natural and money interest rate. In other words, not the absolute increase in the interest rate but the relative increase compared to the natural interest

[21] Röpke also stated that the effects of the authoritarian forced savings in planned economies were similar to those of the monetary forced savings in capitalist economies (Röpke 1936b, 331).

rate caused the aforementioned industries to suffer. Consequently, the decrease in income, expressed in lower profits, was important for the breakdown in the demand for capital goods (Röpke 1926, 273–274). In order to understand if this breakdown leads to a primary depression that will either restore the equilibrium or degenerate into a secondary one, the paper will expand the discussion on the boom with some additional characteristics.

5. The Boom and the Severity of the Primary Depression

The process of primary depression was a process of shrinkage in industries that experienced expansion during the boom—particularly the capital goods industries (Röpke 1936a). In order to understand when the primary depression transformed into disequilibrium, we should ascertain when the boom could sow the seeds for this tendency.

As discussed above, during the boom when economic activity was expanding, the production of capital goods (defined here as durable goods) experienced a more rapid growth rate than the production of consumer goods (defined here as less durable goods). At the upper turning point, when economic activity stopped expanding, the public suddenly ceased to increase its demand for more durable goods. Hence, in case of depression, the demand for capital goods was limited to required replacement or even completely avoided (Haberler [1937] 1946; Röpke 1936a). This prompt change in the demand for capital goods can be understood by considering Röpke's early theoretical formulations.[22,23]

[22] These considerations are from the chapter in Röpke's habilitation entitled "Causes of the Business Cycles". This chapter was considered early on an important contribution to understanding the process of business cycles (Fleck 1923).

[23] Haberler stated that "in the last few years [it] has been more and more recognized and emphasized, that it is the production of durable goods, consumers' goods as well as capital goods that fluctuate[s] most violently in the business cycle" (Haberler [1937] 1946, 86–87), a pattern which Röpke described 15 years earlier.

According to Röpke, the demand for different kinds of goods was characterized by different volatility. This was explained by the assumption that new demand for a specific type of goods could be shifted to the future in accordance with the amortization period of these goods. Hence, the new demand for the goods whose amortization period was very long could be easily postponed (Röpke 1922, 64). Additionally, the ability to postpone the demand depended also on the wants which had to be satisfied. The urgency of the wants and the period of time of their new occurrence after their initial satisfaction defined the ability to postpone demand for the different commodities that would satisfy the wants. In other words, the more urgent the wants were and the more frequently they occurred, the more limited the ability to postpone the demand for the commodities that satisfied these wants. Hence, the demand for these kinds of commodities would be characterized by low volatility, which Röpke associated with consumer goods (or less durable goods). On the other hand, if the wants were not so urgent and their occurrence infrequent, then the demand for the commodities to satisfy those desires could easily be postponed. This made those sorts of demand react more elastically to changes in economic and psychological factors—such as income or crisis of confidence—upon which the purchasing process depended. This explained why the demand for capital goods (or more durable goods) was characterized by larger volatility, since they reacted more promptly to the changes in the aforementioned economic and psychological factors than the demand for consumer goods (Röpke 1922, 61).[24]

The demand for capital goods would increase smoothly only if the economic and psychological factors did not change so frequently. In other words, enterprises would be willing to substitute

[24] It is interesting to note how Röpke described metaphorically cyclical movements in the economy. Röpke compared the business cycle to a sea hit by a hurricane, distinguishing between different sea layers representing the different stages of production or goods of different order in the same manner as Menger and Böhm-Bawerk. The bottom of the sea is not affected by the hurricane, whereas the closer to the top we move, the stronger is the impact of the hurricane. In a similar way, the higher the stage of the production or the further away from the consumption sphere, the stronger the volatility of that stage of production (Röpke 1922, 61–62).

existing machines with new ones or make production more capital intensive only if they were facing continuously increasing demand for their commodities, making them more optimistic regarding their future profits (or income) (Haberler [1937] 1946, 306; Strigl 1934). In this vein, we can refer once again to the statement formulated in the previous chapter that with increasing income, new tastes and wants that caused new needs and hence demand for commodities to satisfy these wants arose. The longer the process of expansion went on, the more optimistic enterprises became regarding the future developments of profits, thereby making them adopt the most modern capital goods. Furthermore this allowed the acceleration principle to develop and gave rise to the appearance of many new industries whose production of capital goods depended on the production of the industries that created the new demand (Haberler [1937] 1946, 365). The continuous increase in capital equipment would further give rise to a so-called secondary demand, defined as demand for the replacement of durable goods. The latter demand was inclined to develop when the expansion of economic activity continued for a long time. Röpke emphasized the intensifying and pro-cyclical character of the replacement demand by describing that during the boom replacement sped up, and that during the depression it was not carried out but instead “postponed as long as possible” (Röpke 1936a, 104).

Consequently, a long-lasting boom was able to change the tastes and wants of the public, which, in turn, increased their demand for durable goods. Furthermore, Röpke emphasized that the production of capital goods itself needed time as well. He described that the period from new orders for capital goods to their production was a long process and concluded: “It is evident that the length of the boom is connected to some extent with the period of time necessary for the construction of the productive plant” (Röpke 1936a, 105). In addition, the length of the boom depended on the existence of unused factors of production. This is explained by the assumption that in cases of fully employed resources, expanding industries would face increasing production prices due to increased competition for their use. In other words, the costs would surge, thereby interrupting the expansion. In contrast, if the increase in production happened during periods of unused resources, then entrepreneurs would face the elastic supply of unutilized factors of production (Haberler [1937] 1946, 366). If the monetarily compelled capital accumulation "forced" voluntary capital accumulation in periods of partial equilibrium, serious instability in production would develop.

The longer the instability developed undisturbedly, the longer it would take for the economic process to regain equilibrium during the primary depression. In other words, the duration of the boom could have an impact on the duration of the readjustment process. However, if the shrinkage of the capitalistic process lasted for a very long time, then the expectations of entrepreneurs would turn more pessimistic—and many would fear for their survival. This would cause pessimism to become widespread, provoking hoarding and bearishness. As already stated, that bearishness was a result of the crisis of confidence that occurred due to the losses enterprises suffered. Furthermore, that crisis of confidence was the main cause why the transformation of saving into investment was not happening. A situation of a secondary depression occurred when industries that also had not expanded or had expanded at a slower rate during the boom started to suffer, i.e., the consumption industries (Röpke 1936a, 130). This was the first attempt to explain when the boom could cause a primary depression that, in turn, would be inclined to evolve into a secondary one.

6. Conclusion

This paper set out to revitalize Röpke's writings in the field of monetary theory and business cycle theory, aiming at connecting Röpke's views on the secondary depression with his arguments regarding the mechanics of the boom and the primary depression. The main purpose was to address the question of when a primary depression is inclined to degenerate into a secondary one. The answer could be found in the upswing period which affects the structure of the primary depression and hence the likelihood of a secondary one to occur. At the same time, the paper underscores the proximity of Röpke’s business cycle views to those of the Austrians.

The paper argues that the impact of the discrepancy between the natural and the money market interest rate on relative prices and the importance of the monetary forced savings are the underlining views in Röpke’s business cycle theory. These two views constitute the Austrian Business Cycle Theory (Hayek [1931] 1935) and were criticized by Keynes ([1936] 1973). Hence if we use John Hicks’ quotation “Wicksell plus Keynes said one thing whereas Wicksell plus Hayek quite another” (Hicks 1967, 204) as a basis for classifying Röpke’s business cycle views, then Röpke unambiguously took Hayek’s side. In this vein, the paper’s conclusion is a further proof of Haberler’s statement that Röpke could be considered a member of the “Neo-Wicksellian” or the Austrian School.

At the same time, this insight represents a huge challenge, since the boom period and the primary depression in Röpke’s writings were thoroughly in the spirit of the Austrian School, whereas the secondary depression was under the influence of Keynes. In order to overcome this challenge, this paper made an attempt to link Röpke’s early insights (Röpke 1922) with his later views (Röpke 1936a) and expand them with Haberler’s theoretical consideration of the acceleration principle. As a result, the paper could point out that the structure of the boom is prevalent in determining the likelihood of a secondary depression to occur. This is explained as follows: By accepting the main arguments of the “Neo-Wicksellian” School, Röpke emphasized that the increased credit provision made possible by lowering the money market interest rate below the natural interest rate gave rise to changes in the distribution of income in the economy. As a result, the variable income of enterprises rose faster than the fixed income of private households. When enterprise income rose, demand for capital goods increased, as did the desire to make production more capital-intensive. This sets the acceleration principle in motion, in which any increase in demand for any goods can cause a stronger increase in the demand for capital goods. Thus the process of accumulation speeds up, breaking up the equilibrium.

However, in order to increase their demand for capital goods and switch to a more capital-intensive production, enterprises must have incentives to do so. In other words, if they face continuously increasing demand for their commodities – and hence profits – then they will increase their demand for capital goods. As a result, the counterpart to the pessimism of the secondary depression is the optimism of the boom, the latter making enterprises turn each earned cent into investment. The longer this process goes on, the more tremendous the disequilibrium will grow. The result will be a more severe reaction. Hence, the readjustment process during the primary depression will be inclined to evolve into the destructive process of the secondary depression.

This paper represents the first step toward more profound research on Röpke's business cycle views. It concludes that Röpke's arguments are an essential basis for further research on the theory of economic contraction. Such theory is not only of historic interest but also—in light of the long-lasting financial and the ensuing sovereign debt crises—a very topical one.

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III. Friedrich A. Lutz's Epistemological and Methodological Messages During the German-Language Business Cycle Debate[*]

Abstract

Friedrich A. Lutz's 1932 habilitation thesis is considered the last highlight in a German-language business cycle debate that took place during the interwar period. This debate, initiated by Adolf Löwe, concentrated on the necessary conditions in defining a dynamic theory that should explain the business cycle understood as a dynamic disequilibrium phenomenon in a deductive way. This article contributes to Lutz scholarship by focusing on Lutz's criticism of Clément Juglar's "unconditional" observations. This constituted the basis for the problematic concept of wave-like fluctuation subsequently adopted by the Historical School and Joseph A. Schumpeter. I establish a relationship between Lutz's criticism and his statement that this perspective does not find support in economic history. Lutz asserted that each crisis represents a unique historical phenomenon caused by specific factors whose impact on the economy depends on its institutional framework. From this, I derive an epistemological claim, namely that the equilibrium tendencies within the market order should be the subject of inquiry, and a methodological call, namely the development of models showing hypothetically what factors can disturb these tendencies. The paper contextualizes Lutz's criticism and messages into the formation of the Freiburg School's research program.

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1. Introduction

In his lecture "Understanding Business Cycles" (1977) at the Kiel Institute for the World Economy, Robert E. Lucas claimed that he had provided a solution to a long-standing problem fundamental for pre-Keynesian economic analysis. Lucas formulated this problem by quoting a passage from Friedrich A. Hayek's habilitation thesis *Monetary Theory and the Trade Cycle* (1933) that "[T]he incorporation of cyclical phenomena into the system of economic equilibrium theory, with which they are in apparent contradiction, remains the crucial problem of Trade Cycle Theory" (1977, 7). In a footnote, Hayek had elaborated that by equilibrium he meant the "modern theory of the general interdependence of all economic quantities" developed by the Lausanne School (1966 [1933], 42).[25] Lucas characterized this as the Walrasian influence on Hayek, thus interpreting modern equilibrium business cycle theories as a continuation of a pre-Keynesian research program (Hoover 1988, 231–232; Rühl 1994, 168).

Lucas's quotation was subject to vast criticism. He was not aware of the fact that during the interwar period, German-speaking economists understood equilibrium to mean the natural tendencies within an economic system of markets to clear. In this context, the cycle was understood as a process of movement away from equilibrium, i. e. as a disequilibrium dynamic phenomenon (Arena 1994, 211; Klausinger 2013, 12). Furthermore, it is not widely known that Hayek's thesis was a response to Adolf Löwe's paper "Wie ist Konjunkturtheorie überhaupt möglich?" (1926).[26] This paper gave rise to a methodological debate in the German-language area because it pointed out the discrepancy between the dominant equilibrium approach of economic theory and observed dynamics of the business cycle. Löwe claimed that the

[25] It is crucial to mention that Hayek's footnote cited Leonhard Miksch's dissertation *Gibt es eine allgemeine Überproduktion?* (1929). Leonhard Miksch (1901–1950) was considered one of the most gifted students of Walter Eucken (1891–1950), one of the founders of the Freiburg School (Berndt and Goldschmidt 2005). This will be discussed extensively later in the context of the formation of the Freiburg School.

[26] For the English translation, see Löwe (1997).

equilibrium approach deprives economists the opportunity to formulate dynamic theories aiming to explain the business cycle. Solving this antinomic problem, it was alleged, required the abandonment of the notion of equilibrium and the development of new dynamic theory.

Friedrich A. Lutz's habilitation *Das Konjunkturproblem in der Nationalökonomie* (1932)[27] was considered "the last word in this debate" (Rühl 1994, 188) that "should be considered indispensable for any truly comprehensive account of the origins of contemporary equilibrium business cycle theories" (Rühl 1997b, 416).[28] Lutz stressed that crisis is an individual economic phenomenon. Hence, all attempts to squeeze crises into general business cycles either resulted in mere descriptions or in models of pure logic failing to explain reality. A crisis, Lutz suggested, has to be studied with the propositions derived from the economic equilibrium theory. This thesis was published as the second volume in the series of treatises *Probleme der theoretischen Nationalökonomie* edited by Walter Eucken, the founder of the Freiburg School. At a later stage, Eucken formulated a message akin to Lutz's in the context of his solution to the Great Antinomy, namely that the business cycle should actually be abandoned as a subject of inquiry from economics.

This paper derives two messages from Lutz's habilitation thesis: one epistemological and one methodological. The aim is to establish the intellectual nexus between Lutz's ideas and Eucken's research program whereby Lutz himself underscored that the conversations and discussions with Eucken played a formative role in the process of writing his thesis (Lutz 1932, Preface; Veit-Bachmann 2003, 12). Furthermore, I propose that these messages play an important role in the context of the current quest for the general theories of deep downturns (Stiglitz 2016), particularly when contemporary economists recognize that they emphasize

[27] Only parts of the thesis were translated into English, see Lutz (2002).

[28] Hagemann (2002) and Dal Pont Legrand and Hagemann (2013) refer positively to Rühl's verdict about Lutz' contribution to German-language business cycle debate.

mimicking the cycle and thereby neglect the explanation of the propagation mechanism (Stiglitz 2018; Dal Pont Legrand and Hagemann 2019). This article is structured as follows: Section 2 discusses the historicity of the German-language business cycle debate. Section 3 considers Lutz's thesis in the context of the debate. Section 4 derives the epistemological and methodological messages from his thesis. Section 5 examines various reactions to Lutz's thesis. Section 6 offers a conclusion, summarizing the main results.

2. Aspects of the German-Language Business Cycle Debate

2.1 Joseph A. Schumpeter's Relevance for German-Speaking Economists

The First World War not only changed the political landscape in German-language countries, but it also had a decisive impact on their economies. Hyperinflation and the surge in unemployment in the early 1920s were considered immediate economic consequences of the war. Historians of economic thought (e. g. Balabkins 1988 77; Barkai 1991, 38 – 39; Caldwell 2004, 95; Lenel [1989] 2008, 295) assert that during this period, German economists were unable to explain the problems in a theoretical way and thus failed in proposing economic policy measures necessary to combat the economic slump effectively. One of the possible reasons for this was that the German Historical School still played a crucial role in the German academy. Its descriptive methods were dominant in the education of younger economists, and thus German-language economics was becoming evermore isolated from the developments of Anglo-Saxon economics. In an effort to emancipate themselves and to break with these methods, younger economists endeavored to end this isolation. One of the most pronounced groups was the "German Ricardians" whose most notable members were Walter Eucken, Alexander Rüstow, Wilhelm Röpke, Adolf Löwe, and the Austrians Friedrich A. Hayek and Ludwig v. Mises. According to historians, one of the many reasons why the group failed to become a more permanent factor was Joseph A. Schumpeter's decline to join the group and particularly his paper "Gustav v. Schmoller und die Probleme von heute" ([1926] 2018), in which he emphasized the relevance of Schmoller's research program, who was one of the leading representatives of the younger German Historical School. Schumpeter's largely positive disposition caused the indignation of younger theoretically-minded scholars (Janssen 1998, 29–30; Köster 2011, 227–229; Dathe and Hedtke 2018, 6).

For the younger scholars, Schumpeter's writings and particularly his concepts and terms played a decisive role in the context of their emancipation. His habilitation thesis *Das Wesen und der Hauptinhalt der theoretischen Nationalökonomie* (1908)[29] and *Theorie der wirtschaftlichen Entwicklung* (1911)[30] exercised a strong impact on their way of thinking. Schumpeter defined that *Theorie der wirtschaftlichen Entwicklung* was the complementary work to his habilitation thesis, which itself was concerned with the static problem in economics where Léon Walras and his equilibrium system represented the cornerstone of the book. *Theorie der wirtschaftlichen Entwicklung*, contrarily, was primarily occupied with the concept of dynamics influenced by Karl Marx's vision of the long-term development of capitalism, and which remained Schumpeter's life-long challenge (Schumpeter [1934] 1949, viii; Dal Pont Legrand and Hagemann 2013, 223).

He described that the static theory reflected by the Walrasian system of general equilibrium is concerned with conditions of equilibrium and the economy adjusting to this equilibrium after change in system fundamentals. The German-speaking economists defined the system fundamentals as "data." Derived from Latin, *datum* (pl. data) means something "given" to the observing economist, which is outside of explanation of economic theory (Schumpeter [1934]

[29] For the English translation, see Schumpeter (2010).

[30] For the English translation, see Schumpeter ([1934] 1949).

1949, 5 and 11; Hayek 1937, 38–39).[31] Data could thus be a level of technological progress, tastes, preferences etc. Economic theory based on a static system derives its insights with the help of the "variation method" which studies how the system reacts to this change, and which claims that the system only adapts to the new data constellations *without* affecting the structure of the equilibrium. This makes an equilibrium a gravitational point towards which the economy moves (Rühl 1994, 168–169 and 174–175).

In contrast, in line with Marx's understanding of capitalism, Schumpeter defined that a dynamic theory should explain the endogenous movement of the economy arising from the inherently antagonistic powers within capitalism. This causes the change in the structure of the equilibrium, i. e. movement of the gravitational point in the system. This change arises spontaneously, discontinuously, and endogenously, creating wave-like movements representing the cyclical fluctuations and characterizing the nature of the capitalist system. However, in contrast to Marx, Schumpeter's view was not that capitalism would be dissolved with an attendant turn to socialism, but that the cycle is the integral part of the growth process of capitalism (Schumpeter [1934] 1949, 5–7 and 213–214; Schneider 1951, 104–108; Rühl 1994, 179–188; Dal Pont Legrand and Hagemann 2017, 247).

2.2 Adolf Löwe – Friedrich A. Hayek: Methodological Discussions

The conflict between static theory and observed dynamic nature of capitalism in Schumpeter's works is a focal point in Emil Lederer's essay "Konjunktur und Krise" (1925)[32] and Adolf Löwe's "Wie ist Konjunkturtheorie überhaupt möglich?" (1926). Löwe's thesis is of particular interest because it gave rise to the methodological debate in the German-language area (Hagemann 1994, 102; Gehrke 1997, 235). Löwe rejected the concept of equilibrium as a tool

[31] It is important to note that Hayek distinguished between two levels of data: on the individual and at the market (macroeconomic) level (1937, 38–39; see also Caldwell 2004, 207 – 208).

[32] See Löwe (1925).

of analysis because the dynamic nature of the cycle shows that modern capitalist economies are always diverging from any equilibrium state. The reason for this is that any convergence towards equilibrium is always disturbed by a systemic (i. e. endogenous) factor. As a result, the disequilibrium phases – boom and depression – represent permanent states of the modern capitalist system expressed by "generality and solidarity of the movement of the circulation factors [i. e. economic magnitudes, LG] and their periodic turnover" (Löwe 1997, 53). This stands in complete contrast to the motion of economic magnitudes determined by the variation method based on the premises of equilibrium and of convergence towards equilibrium. In order to eliminate this discrepancy between theory and reality, and solve the antinomy, Löwe advocated for the abolition of equilibrium as an archimedic point of deduction and, consequently, the formulation of these conditions from which the motion of economic variables reflecting the dynamics of capitalism can be logically deduced, thus providing the basis for dynamic theory:

> "The business cycle problem is not a reproach for, but a reproach against the static system, because in it it is an antinomic problem. It is solvable only in a system in which the polarity of upswing and crisis arises analytically from the conditions of the system just as the undisturbed adjustment derives from the conditions of the static system" (1997, 267).

This "brilliant" (Kuznets 1930a; Kuznets 1930b) article emphasizing the incompatibility between the static theory of general equilibrium and the dynamic nature of the cycle gave rise to the methodological debate in the German-language area, involving numerous young scholars, where one of the most prominent representatives was Friedrich A. Hayek.[33] His earlier work

[33] Löwe's paper furthermore inspired Harrod to develop his business cycle theory by constructing an instable system (Besomi 2002).

resulted as a response to Löwe's thesis (Hayek [1933] 1966, 15 and 27– 28; Hagemann 1994, 102; Hagemann 1997, 406) and later provided the basis for his habilitation thesis *Monetary Theory and the Trade Cycle* (Hayek [1933] 1966). Löwe and Hayek adopted Schumpeter's distinction between static (as adaptation) and dynamic (as development), defining them as "two structurally distinct systems of motion" (Klausinger 2013, 15; Löwe 1925, 357). Hayek ([1933] 1966, 43 and 59–60) agreed with Löwe that cyclical fluctuations cannot be caused by an exogenous change in data, because the system adapts to this change. The causal factor for the cycle ought to be identified *within* the capitalist system which is able to dissolve the relationships among the economic elements constituting the system. This was the reason for their agreement that an endogenous business cycle theory would be the only appropriate representation of observed reality, where the factor causing the cycle would be set as an axiomatic assumption in the theory. The dynamics of this factor would cause cyclical fluctuations, while at the same time these dynamics should be fundamental for the existence of capitalism (Hayek [1933] 1966, 32–33; Rühl 1994, 169–175).

Despite this methodological agreement, there was a divergence in opinions regarding the factor causing the cycle, on the one hand, and the role of equilibrium in the context of business cycle research, on the other. Löwe, influenced by Schumpeter and Marx, argued that technological progress is the systemic factor, whereas Hayek claimed that the modern credit mechanism was the responsible factor for making the system oscillate. In this sense, Hayek introduced the English view formulated by Ralph Hawtrey (1913) and popularized by Ludwig von Mises ([1912] 1924) in the German-language area (Röpke 1936, 111). Regarding the equilibrium concept, Hayek, in contrast to Löwe, emphasized that this is an indispensable tool for analysis of the business cycle phenomenon. First, in methodological terms, it is a starting point where the cycle was considered a movement away from equilibrium and which makes the equilibrium a fundamental benchmark to study the business cycle (Hayek [1933] 1966, 183). Second, it is central from a theoretical point of view, because this allows for a clarification of the impact of the discrepancy between the monetary and the natural rate of interest on the production structure (Hayek [1935] 1967, 35). Third, general equilibrium in particular is necessary to grasp the interconnections among the economic variables and the different industrial groups (Hayek [1933] 1966, 42). Fourth, the tendency towards equilibrium should be an empirical characteristic of the market economy, so that "economics ceases to be an exercise in pure logic and becomes an empirical science" (Hayek 1937, 44). As a result, the problem of the business cycle is not to abandon equilibrium, but to demonstrate how credit creation, i. e. the dynamic element, disturbs the interconnections of economic variables in the static system. This can only happen when the assumptions are widened by incorporating the concept of time "so that cyclical fluctuations would follow from these as a necessary consequence, just as the general propositions of the theory of price followed from the narrower assumptions of equilibrium theory" (Hayek [1933] 1966, 30; Hayek [1933] 1966, 93; Klausinger 2013, 12–15).

3. Friedrich A. Lutz's Contribution to the Debate

Friedrich A. Lutz's habilitation thesis *Das Konjunkturproblem in der Nationalökonomie* represents the last highlight of this debate (Rühl 1994, 188). Lutz started studying economics at Berlin and was the first doctoral student of Walter Eucken during Eucken's brief tenure at Tübingen (1925–1927) with his thesis *Der Kampf um den Kapitalbegriff in der neuesten Zeit* (1927). As already mentioned, Eucken was a member of the "German Ricardians" who were seeking to emancipate themselves from the descriptive methods of the Historical School. The University of Freiburg justified his appointment as a professor of economics by arguing that Eucken would promote such abstract, theoretical thinking at Freiburg.[34] There, Lutz defended

[34] Initially, the University of Freiburg tried to attract Schumpeter, who in turn declined and stayed at Bonn. The university appointed Eucken, who was third on the list (Brintzinger 1996, 38–39).

the habilitation thesis *Das Konjunkturproblem in der Nationalökonomie* (1932) under Eucken. The habilitation was published four years after the meeting of the Verein für Socialpolitik in Zurich in 1928, the climax of the business cycle debate. Lutz thus became Eucken's first student entitled to teach at university (Brintzinger 1996, 76 and 45; Veit-Bachmann 2003, 12).

3.1 Friedrich A. Lutz and the Formation of the Freiburg School of Economics

However, this was not the first thesis written in the context of the debate and supervised by Eucken. His student, Leonhard Miksch (1901–1950) wrote a doctoral thesis *Gibt es eine allgemeine Überproduktion?* (1929). This was a fundamental problem in Löwe's thesis because "[i]f a business cycle theory cannot be built, the 'general over – production' will not only drive the economy but also economic theory into a crisis" (1997, 175). Famous from Hayek's footnote ([1933] 1966, 42) which was cited by Lucas (1977), Miksch (1929, 5–13) studied how the concept of equilibrium had evolved from Jean B. Say's and James Mill's writings to the research program of the Lausanne School. In the context of this study, Miksch discussed how the Classics explained the problem of general overproduction. He rejected the idea that there is an inherent reason within the exchange process that causes the overproduction and thus the crisis, i. e. a disequilibrium. Hence, the tendency towards equilibrium is an underlying assumption of markets (Arena 1994, 211). However, money and particularly credit are factors that facilitate the exchange process, but which can also disturb the coordination mechanism and give rise to overproduction (Köhler 2019, 23). In this sense, Miksch joined the faction of monetary business theorists during the debate. He derived the methodological message that the concept of equilibrium and the variation method are two necessary tools of analysis. In this sense, he criticized the Historical School for its call to abandon equilibrium reasoning in arguing that because it had been deployed by the Classics, it thus represented an abstract approach detached from reality (Miksch 1929, 93– 95).[35]

[35] For more about the intellectual legacy of Leonhard Miksch, see Berndt and Goldschmidt (2005).

The methods of the Classics became the cornerstone of his teacher's intellectual legacy and particularly of his criticism towards the Historical School and statistical research that was becoming dominant at the time. This is evident in the culmination of Eucken's research program, in *The Foundations of Economics* (1950), which expanded this criticism and aimed to reformulate the methods of the Classics (Watkins 1953, 131–132). Eucken's criticism was interpreted as "part of a general reaction against the nineteenth century's deification of history" where "the belief that what is right is what is agreeable to the historical process and that what is wrong is what the historical process will not allow to succeed…" (*ibid.*, 132). Eucken delineated the conflict between the methods of the Classics, which he denoted as rationalistic, and the Historical School as well as statistical research, described as empiricist, in his essay "Was leistet die nationalökonomische Theorie" ([1934] 1954). This essay can be considered programmatic for the Freiburg School (Goldschmidt 2013, 136). It was the introduction of a new series, *Probleme der theoretischen Nationalökonomie*, edited and published by Eucken. As a "German Ricardian," he described that this series aimed to apply the deductive approach of the classical economists in the explanation of economic problems (Eucken [1934] 1954, 51). The application will be understood by discussing Lutz's habilitation thesis, which makes up the second volume of the series.

Lutz's treatise consists of six chapters. The first four chapters deal with the historical development of the methods used to define the subject of inquiry in the context of business cycle research and its solutions. In the last two chapters, Lutz formulated his contribution to the tension between the business cycle and the equilibrium approach, the central topic of the business cycle debate. In the first chapter "The Business Cycle Problem within the Framework of the Classical Theories," Lutz discussed how the Classics dealt with the problem of crisis. Here, Lutz delineated the nexus between his and Miksch's thesis, namely that he focuses on the methodological question concerning the tools of analysis whereas Miksch concentrates on the content of classical economists' theories. The second chapter "The Mixture between Theoretical Analysis and Unanalyzed Facts: The Hybrid Theories"[36] discussed the theories of Clément Juglar, Gustav Cassel, Albert Aftalion and of the Historical School. The third chapter "Return to, and Extension of, the Pure Theory"[37] discusses the theories of Joseph A. Schumpeter, Friedrich A. Hayek, and Adolf Löwe, whereby the fourth chapter "Complete Abandonment of the Theory and Turning to the Facts: The Statistical Business Cycle Research" gives an extensive account of the statistical and econometric research prevalent at the time of Wesley Mitchell, Ernst Wagemann, and Ragnar Frisch.

Of particular interest are the first four chapters because they were not intended to be a contribution to the history of economic thought, but rather a study of how the crisis problem of the Classics had turned into the complex business cycle theories in the early 1930s, and how the methods to solve these problems had changed (Lutz 1932, 138). Lutz represented the change in the subject of inquiry and the methods as an evolutionary process where "[e]ach step led almost inevitably to the next one" (Lutz 2002, 212). According to Eucken (1932, 5), to discuss the history of the business cycle research as an evolutionary process represents an innovative contribution compared to the descriptive accounts of Eugen v. Bergmann,[38] Arthur Spiethoff,[39] and Wesley Mitchell,[40] because in this way Lutz was able to show that the course of business cycle research was not random or arbitrary, but rather closely related to the general development of scientific methods. A tantamount juxtaposition between Bergmann's *Die Wirtschaftskrisen:*

[36] Hybrid theories is the translation of "Mischtheorien" in Lutz (2002, 231).

[37] As translated in Lutz (2002, 177).

[38] Eugen Woldemar Konstantin v. Bergmann (1857–1919) is a largely forgotten economist whose book *Die Wirtschaftskrisen: Geschichte der nationalökonomischen Krisentheorien* (1895) was referred to by Schumpeter as an extensive treatment of business cycle theories.

[39] Arthur Spiethoff (1873–1957) was a leading business cycle theorist. As a doctoral student of Gustav v. Schmoller, he was also one of the most prominent representatives of the Historical School.

[40] Wesley Mitchell (1874–1948) was a US economist and one of the most prominent statisticians who contributed to business cycle research.

Geschichte der nationalökonomischen Krisentheorien (1895) and Lutz's thesis was carried out by Joseph A. Schumpeter in his *History of Economic Analysis*, where he underscored the analytical superiority of Lutz's thesis over Bergmann's book (1954, 739).

3.2 Friedrich A. Lutz's Response to the Debate

Lutz evaluated the main messages of the business cycle debate in the third chapter "Return to, and Extension of, the Pure Theory" (2002, 177). He justified the title by hinting at the efforts of the debate participants to pursue more precision in their theoretical works, thereby emancipating themselves from the descriptive methods of the Historical School and returning "to the path already trodden by the classical economists" (*ibid.*, 178). First, they attempted to construct a deductive theory of the business cycle tantamount to the methods of the Classics who also developed deductive explanations of observed phenomena. Second, these attempts gave rise to methodological discussions about the role of analytical tools like equilibrium, convergence towards equilibrium, and the variation method. Such discussions were characteristic for the systematic thinking of the Classics which stand in complete contrast to the research program of the Historical School because the latter had abandoned these tools with the aim of developing "realistic" theories (Lutz 1932, 75 and 82– 84).

Lutz accentuated the importance of Löwe's article because he called attention to a relevant antinomic problem between dynamic reality and the static nature of the dominant equilibrium theory. However, Lutz stressed that Löwe and the other debate participants had not formulated uniform concepts regarding the business cycle phenomenon (Lutz 1932, 82 – 84; Köster 2011, 255). Löwe concentrated on the solidarity and generality in the movement of economic magnitudes and their periodic reversal of direction. Lutz argued that these were two completely different problems and "the explanation of the first problem does not imply an explanation of the periodic reversal of direction and vice versa" (2002, 203). Lutz discerned within Löwe's concept that the notion of solidarity and generality in the movement of economic magnitudes represents the cornerstone of his understanding of business cycles.

However, according to Lutz, Löwe failed to define this systemic (endogenous) factor that causes this motion, since technological progress is just a change in a *datum*, such as occur with changes in needs and tastes or changes in knowledge. First, the reason for these changes is located outside of the exchange process. The changes should be considered as hypothetical, but not a necessary result of the exchange process and thus not subject to any economic law. Second, technological progress does not dissolve the static relationships postulated by the dominant equilibrium approach. Its impact on the economic system must be studied with the help of this approach because this allows the economist to ascertain how the change in the technological level affects the relationship between the dependent variables. Lutz (1932, 114–116) formulated that the roundaboutness of production and money are the factors that give rise to the downward cumulative process. In this response, Miksch's solution to the problem of overproduction could probably have played a fundamental role (1929, 93–96).

The second concept represents the focal point of the business cycle theories developed by Hayek and Schumpeter. They understood the business cycle as the inevitable and periodic recurrence of crises whereas the course of the crisis was not exactly understood as a cumulative downward process. In order to prove the periodic recurrence of crisis, Schumpeter and Hayek attempted to develop a dynamic system by incorporating these premises into the static system from which the cycle follows deductively. Lutz criticized Hayek's theory because the cycle is based on change in data (discrepancy between the natural and monetary interest) whose occurrence cannot be formulated as a necessary economic phenomenon. Furthermore, his theory relied on the slow reactionary mechanism of the modern capitalist system which does not allow the prompt reestablishment of equilibrium. This is the underlying explanation of how boom periods occur that inevitably turn out to crises (Hayek [1933] 1966, 139–140). Lutz criticized the assumption of a slow reactionary mechanism because this was not justified with economic reasoning. As a result, in Lutz's view (1932, 113), Hayek failed to construct the dynamic system he was pursuing.

Of particular interest is Lutz's critical account of Schumpeter's dynamic theory on two grounds. First, the static proprietor (*der statische Wirt*) was an assumption akin to irrational behavior that represented a violation of the assumptions underlying general economic theory. In Schumpeter's theory, however, the main purpose of the assumption was to attract entrepreneurs by swarms, rather than continuously, thus giving rise to wave-like fluctuations (2002, 194; Schumpeter [1934] 1949, 214). The static proprietor is an unrealistic but fundamentally necessary premise for Schumpeter's business cycle theory, because otherwise "he [Schumpeter, LG] could not have escaped the tendency towards equilibrium" (Lutz 2002, 209). The second problem was the assumption of the active entrepreneurs who enter the market with their new combinations and exploit profit opportunities. This is, according to Lutz, nothing other than technological progress, something that was already discussed as a change in *datum* and thus an unequivocal example for Schumpeter's failure to formulate an endogenous business cycle theory (Lutz 1932, 122– 126).

3.2.1 The Subject of Inquiry Itself is Problematic in Business Cycle Research

Lutz's criticism of the attempts to prove the periodic recurrence of crisis represents his most fruitful contribution to the business cycle debate. This is akin to today's criticism of business cycle theorists whose models attempt to mimic cyclical fluctuation, thereby neglecting the importance of the propagation mechanism (Dal Pont Legrand and Hagemann 2019). Lutz noted that the idea of periodic recurrence originates from the empirical research conducted by Clément Juglar through his statistical investigations. Juglar also formulated a critique of the Classics that they failed to understand that crises are always preceded by a boom, and that the former always recurs in periodic manner. Lutz's criticism is diametrically opposed to

Schumpeter's account that stressed the relevance of Juglar's research program and declared his concept of wave-like fluctuations as the undisputed problem of business cycle research (Schumpeter [1934] 1949, 214). However, Lutz criticized Juglar's methods on two levels. First, he disputed Juglar's "unconditional" observation that gave rise to the unjustified concept of wave-like fluctuations and thus provided the basis for the problematic subject of inquiry. Second, he suggested that Juglar treated the pure observation itself as sufficient to provide the general dynamic law describing the periodic recurrence of crises.[41]

Lutz's criticism of Juglar's methods should be understood as a part of his general criticism of the research methods prevailing in economics during the late 19th century. As Eucken underscored in his report, Lutz characterized that the evolution of methods deployed in crisis research did not take place randomly or in an arbitrary way, but rather that it was intimately related to the general development of scientific methods. In the second chapter, Lutz suggested that during the late 19th century science in general was pursuing more realism in its research, thereby emancipating itself from abstract theories of the Enlightenment. This influenced the methods of observation and the formulation of the subject of inquiry. Lutz dichotomized between those scientific strands using abstract theories as the methods of the Classics, the main representatives of the Enlightenment, and scientific strands pursuing more realism, the economists of the late 19th and early 20th centuries. The representatives of the Historical School belong to the latter group as well (Lutz 1932, 30 –35). In his report of Lutz's thesis, Eucken characterized Lutz's juxtaposition of the two methods of observation and formulation of subject of inquiry as "excellently worked out" (Eucken 1932, 6), a juxtaposition that was the cornerstone of Eucken's methodological essay "Was leistet die nationalökonomische Theorie?".

[41] Citing the crucial passage in Juglar's work in the original French: "Sans faire intervenir aucune théorie, aucune hypothèse, l'observation seule des faits a suffi pour dégager la loi des crises et de leur périodicité" (1889, XV).

In line with his teacher's essay, Lutz treated the methods of the Classics as a benchmark for his criticism of the research methods fundamental for the economics of the late 19th and early 20th centuries. This is unequivocal example for how Lutz's thesis was written in the context of Eucken's intellectual legacy oriented against, as Watkins formulated it, the "nineteenth century's deification of history." (Watkins 1953, 132). Lutz claimed that the Classics would never have formulated the research problem based on pure observation, something that had been promoted by Juglar. The classical economists formulated their research problems under consideration of the general economic system based on the premises of equilibrium and of a tendency towards equilibrium where Say's theorem plays a fundamental role. As discussed previously, these premises were explored extensively by Miksch (1929, 5–13). According to Lutz, the subject of inquiry represents an important thought process that should be carried out by the method of abstraction so that economists can explain the observed phenomenon in deductive manner. Or as Lutz put it, the observed phenomenon should be constructed in such a way so that it can be integrated into an already defined economic system entailing equilibrium. In this sense, the Classics elevated the crisis as a general economic problem by formulating it with terms and concepts deducible from this system. Probably influenced by Miksch's investigations, Lutz noted that the Classics described the crisis as a general sale at a loss which does not imply the impossibility to sell products, but rather that selling price is not able to cover costs. They attempted to explain the reason for this discrepancy in the same deductive way as the problem of prices and distribution (Lutz 1932, 3– 6; Miksch 1929, 2– 4).

In contrast, the representatives of the Historical School and the "realistic" strand in economics, such as Albert Aftalion, Gustav Cassel, and Mikhail Tugan-Baranowsky, strived for an "unbiased" and "unconditional" observation that was free from any theoretical dogma. This desire for realism required that one should start observing the phenomenon, describe this phenomenon occurring in different points of time and place, and finally compare the different descriptions. Thus, they intended to achieve a realistic formulation of the observed phenomenon that should serve as a basis for a realistic explanation. For Lutz, this method of observation and thus formulation of the subject of inquiry gave rise to the opposite effect. Instead of realistic formulation, the subject of inquiry moved away from any realism because of the subjectivity of researchers. They interpreted and elevated the observed phenomena into a theoretical question based either on superficial examination or on personal experience. Lacking an abstract theory which provided the criteria for the subject of inquiry was the penultimate problem (1932, 28–30; see also Eucken [1934] 1954, 50).

In Lutz's view, cyclical fluctuation exemplifies such subject of inquiry. Juglar formulated this from the pure observation without considering abstract theory, such as a theory of exchange process or of the equilibrating powers of markets. From the frequent occurrence of crisis, Juglar concluded that capitalism is prone to crisis and the periodic recurrence of crisis is its underlying feature. Had he conducted his observations based on market theory, and particularly the theory of exchange process developed by the Classics, Juglar could have realized that the factors causing disequilibrium lie outside of the exchange process, such as technological progress, the discovery of new markets, and changes in money supply (1932, 31– 34). The problem arose, however, when the notion of cyclical fluctuation was integrated into their research program by leading economists, including representatives of the Historical School who attempted to formulate "'metaphysics' of regular and systematic oscillations" (Rühl 1994, 178). All these attempts either ended up as pure descriptions of the observed phenomena or logical models completely detached from reality. They were not able to explain the severity of the Depression and thus provide the basis for economic policy (Lutz 1932, 79–81; 122– 125; 161– 165). This will be the subject of analysis in the next section.

3.2.2 The Problematic Subject of Inquiry – the Basis for Problematic Theories

Lutz's critical account of how the subject of inquiry was formulated based on pure observation explains his emphasis that the business cycle research is problematic, even the subject of inquiry itself (Lutz 1932, 40; Rühl 1997a, 243). Lutz (1933a, 91) concluded that this subject of inquiry had inevitably led to problematic solutions which did not expand our knowledge in understanding and explaining the crisis.[42] Lutz divided three strands according to the methods deployed in order to prove the periodic recurrence of crisis. The first is represented by the already discussed "realistic theories" – denoted by Lutz as "hybrid theories." Lutz integrated the methods of the Historical School and Gustav Cassel's and Emil Lederer's business cycle theories into these theories. They are a mixture of theoretical considerations and reference to unexplained facts; the latter were introduced with the mere aim to construct the desired dynamics showing the periodic recurrence of crisis.

Lutz characterized the next two strands as derivatives of the hybrid theories. The second strand tried to abandon descriptive elements and pursued the deductive explanation of the cycle. The already discussed theories of Hayek and Schumpeter belonged to this strand. In contrast to the hybrid theories, they formulated general premises from which the dynamic theory should follow logically. The third strand represents statistical research which, according to Lutz, abandoned theoretical considerations and concentrated on the descriptive part of the hybrid theories. Its main representatives were Wesley Mitchell, Ernst Wagemann, and Ragnar Frisch. Lutz (1932, 136–137) argued that statistical research can describe facts, something that is central to his solution to the business cycle problem; it is not, however, a substitute for the theoretical approach.

[42] He writes: "die Problemstellung schreibt die Lösungsmethode zwangsläufig vor" (Lutz 1933a, 91).

Lutz's ultimate verdict on the business cycle debate is that the construction of pure deductive business cycle theories, i. e. what Löwe, Hayek, and Schumpeter were actually pursuing, is possible. However, the result would be a perfectly logical model that would inevitably be based on unrealistic assumptions: "from that everything else follows logically" (Lutz 2002, 195). Consequently, they could achieve precision and some internal logic. However, these theories were bound to fail in explaining reality (Lutz 1932, 124–125). Later, Eucken would criticize such pure logical models as an "intellectual game like chess. Certain conditions are fixed and then deductive reasoning has a full field to play in" (1950, 349). In his reply to Gustav Clausing's critique, which had been an immediate response to the thesis, Lutz (1933a, 91) defined that to construct a dynamic theory showing the periodic recurrence of crisis is tantamount to developing a dynamic theory of periodic recurrence of wars, whereby in the commemorative volume for Arthur Spiethoff, Eucken (1933, 75) compared Spiethoff's standard conception of the cycle with the standard conception of the cycle of revolutions that should provide the basis for a dynamic theory of revolutions.

Lutz formulated that the Great Depression represented a test for the ability of business cycle theories to explain the phenomenon of crisis which none of them was able to pass. Not only Schumpeter's but also Gustav Cassel's and John M. Keynes's theories failed to explain the severity of the Depression. These economists either described the observed facts or deduced some theoretical insights from general economic theory in order to explain the observations, but never deployed their business cycle theories (Lutz 1932, 145–146). This failure to explain deep downturns is relevant even today, for example when economists emphasize the inability of DSGE models to analyze the persistence and amplitude of exogenous shocks (Stiglitz 2018). The persistence of the Depression might be one of the reasons why Lutz and subsequently Eucken abandoned business cycle theory as an instrument to discuss the phenomenon of crisis.

However, despite their criticism of the representatives of the Historical School, Lutz (1933a, 88–89) and Eucken ([1934] 1954, 46) stressed the relevance of their research program because their descriptions revealed the crisis as a unique historical process. Their descriptive accounts demonstrated the different duration of each crisis, on the one hand, and the different motion of the economic magnitudes during the crisis, on the other. For Lutz and Eucken, this is unequivocal proof that each crisis was caused by a specific factor pertaining to time and space. Lutz claimed that even though we can recognize that the boom period precedes the crisis and determines its severity, this is not sufficient to claim that the cycle itself is caused by a general factor from which we can develop a general law. Lutz exemplified this by delineating the differences between two boom periods 1903–1907 and 1926–1928 that gave rise to different courses of ensuing crises. Here, it was not only different impulses, but also the institutional frameworks at these points of time which gave rise to the individual course of crises (Lutz 1933a, 87). A similar comparison between two boom periods 1903–1907 and 1933–1939 would later be conducted by Eucken in order to show how the institutional framework can affect the economic process, which in turn determines the severity of economic crises. In this sense, Eucken justified the explanation of the observed phenomena with the help of economic orders (Eucken 1950, 251–252). The sociologists Wilhelm Meyer (2002, 302–303) and Hans Albert (2009, 95) stressed that this comparison was used by Eucken to demonstrate the fruitfulness of his concept of economic orders and thus to solve the central problem of the social sciences concerning the relationship between theory and history.

Consequently, Lutz claimed that the solution could not be found in developing a new dynamic theory with a general law of periodic recurrence, because periodic recurrences do not exist. Based on Carl Menger, Lutz suggested that only social phenomena which can be reduced to type, and typical relationships that require explanation, are conducive to general laws. The types can be the general nature of exchange, of prices, of rents, of interest rates, of supply, of demand etc. whereas the typical relationships can be how the increase in prices affects the supply, for example. Theoretical research ought to analyze the types and typical relationships. In contrast, historical research is concerned with the individual phenomenon by investigating its nature and the development within the context in which this phenomenon occurred (Lutz 1932, 3–4 and 163; Menger [1883] 1985, 35–40). From this, Lutz derived that the crisis is an individual phenomenon whose explanation should be carried out by historical and theoretical research, a dualism in explanation. Only in this way is one able to understand the persistence and deepness of the crisis.

4. Friedrich A. Lutz's Epistemological and Methodological Messages

4.1 The Epistemological Message – On the Subject of Inquiry

Lucas started his Kiel lecture with the question "Why is it that, in capitalist economies, aggregate variables undergo repeated fluctuations about trend, all of essentially the same character?" (1977, 7). Twenty-seven years later, in his presidential address to the American Economic Association, he proclaimed that

> "[m]acroeconomics was born as a distinct field in the 1940s, as a part of the intellectual response to the Great Depression. The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: Its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades" (Lucas 2003, 1).

Using Lutz's arguments, I claim the last financial crisis proved that Lucas was in both cases wrong: in 1977 he formulated the wrong subject of inquiry; in 2003 he formulated the wrong observation.

The question arises whether when he delivered his presidential address, he failed to record the aggregates that would have predicted the financial crisis of 2007– 2008. The latter was caused by the rapid development of securitization, in the form of mortgage-backed securities, which aimed at securitizing the credit provision to households with low creditworthiness. The credit provision was enhanced by lower interest rates in the Bill Clinton and George W. Bush administrations, encouraging homeownership through government housing policies (Hellwig 2009; The Financial Crisis Inquiry Commission 2011). Lutz would have said that all of these are changes in system fundamentals in the sense of economic theory, i. e. data: the securitization – change in technological level; the lower interest rate – change in money supply; the decision of Clinton administration – change in the laws. According to Lutz and the German-speaking economists during the interwar period, the reason for these changes cannot be predicted and explained deductively by the economic theory. They are not outcomes of any economic law because they do not arise from the exchange process, but outside of it. However, these changes should be studied separately within the static system in order to crystallize their impact on exchange relationships.

Pure observation without systemic thinking was the cornerstone of Lutz's critical discussion of Juglar's and the Historical School's method of how they formulated the subject of inquiry because from the frequent occurrence of crisis they concluded that this phenomenon is inherent to capitalism. For Lutz, the methodology of the Classics represented a closed scientific approach how to formulate the subject of inquiry. They formulated it via the method of abstraction method based upon a thought system whose premises are equilibrium and the tendency towards equilibrium. Lutz's claim might be perceived as tautological in that the Classics would have rejected the concept of periodic recurrence of crisis because their thought system did not entail its inclusion. However, Hayek argued in "Economics and Knowledge" that only if we assert that the market economy possesses the tendency towards equilibrium, then "economics ceases to be an exercise in pure logic and becomes an empirical science" (1937, 44). And Klausinger continued "the tendency towards equilibrium cannot be refuted a priori" (1990, 67). Hayek formulated this message during a period when leading socialists like Oskar Lange and Abba P. Lerner were advocating for market socialism. They claimed that if there is a market for consumer goods, then a market for producer goods is not necessary and should be abolished because their values can be calculated based on the capital goods used in the production of consumer goods. In this sense, the fluctuation of the production of producer goods would be controlled, and thus the business cycle would become obsolete (Boettke 2018, 128–129; Caldwell 2004, 218– 219).

Hayek's statement can be interpreted as the ultimate answer to Lutz's dilemma. Lutz's *epistemological message* could be that we are not supposed to prove why the exchange process is prone to crisis, but, on the contrary, why within a market order this process converges to equilibrium and secures efficiency in the use of resources. This would not only enable the economists to understand how markets work, but this would also allow us to formulate hypothetical cases based on the general theory of markets pointing out when they fail to achieve the state of equilibrium, i. e. the crisis. This exploration allows us to formulate and even study realistic assumptions, e. g. human behavior, the contextual knowledge of individuals (remember the ad-hoc assumption of rational expectations (Klausinger 1990) or the static proprietor in Schumpeter's theory with the aim to create the cycle), and the importance of institutions for facilitating the exchange process. From this, we can understand Lutz's message of what constitutes and how to deduce general economic phenomena: prices, wages, the interest rate, capital, money etc. that ought to be subject to deductive theory. Only in this way, as an interpretation of Lutz's thesis, can economists expand the theoretical knowledge which is fundamental for the explanation of observed phenomena. Consequently, the question is not why there is a periodic recurrence of crisis, but what the possible reasons for deep downturns could be.

4.2 The Methodological Message

4.2.1 The Pure Theoretical Approach – The Construction of Models

These general phenomena (the process of price formation, interest rate formation) should be explored with the help of different case studies, highlighting differences among competitive and monopolistic markets with or without technical peculiarities of production, durable goods, etc. (Lutz 1932, 152– 158; Eucken [1934] 1954, 7). Encouraging case studies is Lutz's *methodological message* and represents the first step how to explain a specific crisis. These case studies are tantamount to the ideal types later developed by Eucken that serve as models representing the preparatory work in order to explain the observed phenomenon (*ibid*., 7).[43]

Lutz (1932, 166–167) claimed that with the help of case studies, the economist should employ the variation method. This method, first discussed in Schumpeter's habilitation thesis (1908) and criticized by Löwe (1926) during the business cycle debate because it failed to explain the dynamic motion observed in reality, was implemented by Miksch (1929), and would later be deployed by Eucken's *Kapitaltheoretische Untersuchungen* ([1934] 1954, 132–188) and in *The Foundations of Economics* (1950, 253–255). This method is also the cornerstone of Hayek's capital analysis based on intertemporal equilibrium in *The Pure Theory of Capital* ([1941] 1950, 152; Lachmann 1937, 34–35).[44] Lutz and Eucken characterized the variation method as the thought experiment which allows for the study of the impact of data change on the existing

[43] Goldschmidt (2013) discusses the origins of the concept of ideal types in Eucken's intellectual legacy. Furthermore, on the relationship between Eucken's economic orders and the business cycle debate, see Blümle and Goldschmidt (2006).

[44] It should be mentioned that this method was also used by Mises ([1960] 1978, 117).

equilibrium, and thus on price, wage, interest rate formation in competitive, monopolistic markets, etc. The new data constellation determines the structural relationships among the economic variables, e. g. the price structure in the economy, and thus the new equilibrium system, whereas the process towards the new (final) state of equilibrium, the internal dynamic will be determined by the frictions (price rigidities, wage rigidities etc.) arising from the assumptions of the model (Lutz 1932, 144). Eucken emphasized the superiority of the variation method over the comparative statics carried out by the Classics (Eucken 1950, 253– 255; Lutz 1944, 214). Here is the crucial passage:

> "The method of variation is that breaking up hypothetical static state by varying one of the "outside" data for the system as a whole. Then one studies what alterations in the whole system of economic relationships have to follow, in which order they take place, and what frictions will take effect until a new static state is arrived at. We start, therefore, from a static condition in an exchange economy with a particular mixture of monopolistic and competitive markets and with a particular monetary system" (Eucken 1950, 253).

4.2.2 The Statistical Approach – A Concrete Explanation of Historical Events

These abstract models represent analytical instruments that should assist in dissecting a concrete historical event. "The aim is to *understand* the concrete situation, not merely to establish the facts" (Lutz 2002, 212; Lutz 1944, 211). Statistical research represents the second step in understanding a specific historical event. It describes the individual phenomenon, on the one hand, and the context within which this phenomenon occurred, on the other hand. The analysis of this phenomenon should be conducted with the help of the insights derived from the static system, however, within the observed conditions in the actual case, i. e. the context stated by statistics (Lutz 1932, 154–160). In other words, the economist should choose the case study which explains the observed variation in a *datum* in order to explain the observed phenomenon:

> “The ready-made theoretical clothes only have to be tried on the specific case and the ones that fit chosen, so to speak” (Lutz 2002, 214).

If the theoretically defined propositions do not match the phenomenon observed in reality, statistics must determine the specific accompanying factors, frictions or moments which occur simultaneously, even if it is independent of the change in *datum*. These accompanying factors can reinforce or counteract the impact of this change on the structural relationships within the system. This can explain why the theoretically stated influence diverges from that observed in reality. Statistics should also determine the magnitude of change in a *datum*. Therefore, statistics and theory are two complementary parts which Lutz (1944, 211) defined as dualism in explaining the individual phenomenon. While the theoretical model, with the help of the variation method, can identify the direction of movement of economic variables resulting from the change in a *datum*, statistical research can formulate the magnitude of this change on the economic system, i. e. the deepness of crisis (Lutz 1932, 155–157). In this manner, Lutz attempted to solve the antinomic problem with which the German-speaking business cycle theorists were occupied:

> “Above all, it [the analysis of the concrete progression of the business cycle, LG] also creates complete freedom for any researcher investigating concrete reality, removing the fetters that a general theory of the business cycle imposes on him. He no longer has to admit that the particular case under investigation is an exception which does not fit the theoretical schema, nor to interpret the facts to make them fit; he is free and can accept reality as it is” (Lutz 2002, 237).

5. Did Friedrich A. Lutz Win the Day?

Christof Rühl was considered the first scholar who discovered the importance of Lutz's habilitation thesis (Dal Pont Legrand and Hagemann 2013, 250). According to him, "[i]t seems fair to say that Lutz's criticism 'won' the day" (Rühl 1994, 200, fn. 27). But the question is whether this really is the case. The most notable reaction to Lutz' thesis is Hayek's Copenhagen lecture "Price Expectations, Monetary Disturbances and Malinvestments" delivered in 1933 ([1935] 1939). Hayek supported Lutz' argument to concentrate on the development of those areas of general economic theory, particularly money and capital, which were needed to explain an individual cycle rather than to develop a general theory of cyclical fluctuations. He agreed with Lutz that if economists wanted to gain knowledge in the field of money and capital, they must study these phenomena with the help of the static approach.[45] In this sense, he agreed with Lutz's critique of the attempts to develop a (new) dynamic approach serving as the basis for endogenous business cycle theories (*ibid*., 136–137). Five years after the Copenhagen lecture, Hayek still adhered to Lutz's argument when he participated in a discussion "Is the Trade Cycle a Myth" (1938) at the Royal Statistical Society (Rühl 1994, 190). There, he emphasized once again how important it is to study the problem of capital and money in order to explain a specific crisis "instead of a vain search after the common characteristics of all cycles" (Snow 1938, 579).

In contrast to Hayek's positive review, Lutz's idea to concentrate on an individual crisis was generally rejected by leading economists. Besides the already discussed review of Gustav Clausing (1933a), the reviews of Fritz Burchardt (1934), Adolf Löwe's closest collaborator (Hagemann 1994, 106), Oskar Lange (1934), and Erich Carell (1933), whose book

[45] Hayek discussed the contemporary attempts to develop new dynamic theories in order to explain the business cycle problem. Hayek reminded the reader how he also tried to solve the dynamic problem of business cycles based on the theory of equilibrium by incorporating money and time into the concept of equilibrium (*ibid.*, 137–138).

Sozialökonomische Theorie und Konjunkturproblem (1929) played a relevant role during the debate (Kuznets 1930, 390), did not share Lutz's idea of abandoning the business cycle as a subject of inquiry in economics. Along these critical reviews, Bernard F. Haley (1933) of Stanford University discussed the thesis in the *American Economic Review* summarizing Lutz's main ideas. Even though he did not comment on Lutz's central message, this review demonstrates how well American economists were aware of German economic research.

In contrast, Clausing criticized Lutz because he rejected the concept of the business cycle from the viewpoint of static theory in an unjustified way. Clausing claimed that cyclical fluctuations are inherent to the economic process in advanced capitalism. He even claimed that Lutz's requirement to abandon business cycle theory was tantamount to abandoning general economic theory and to reducing economic science into "price-value-rent" theory as Schumpeter had claimed (Clausing 1933a, 95– 96). Fritz Burchardt first paid tribute to Lutz's treatise because it demonstrated in a clear way how the subject of inquiry and the methods in the area of the business cycle research had changed throughout the history of economic analysis. However, he stressed that the regular appearance of crises required the construction of a general scheme. Burchardt acknowledged Lutz's claim that there was a potential danger that this approach would deprive economists from being able to explain a crisis. In order to avoid the danger of achieving a monism or constructing a too rigid scheme, this scheme should be further updated by statistical observations (Burchardt 1933, 100). Furthermore, Burchardt discussed critically that Lutz had only concentrated on the downward movement of the business cycle. For him, it is also important to construct the reversal from depression to upswing deductively in an analogous way to Lutz's preferred study of the movement from the upswing to depression. The explanation of these motions made equilibrium a problematic concept. Burchardt agreed with Lutz concerning the classical pattern of thinking, i. e. data variation, as a necessary analytical instrument; however, this data variation should also be studied in a dynamic system, "unemployment with generally unused capacity." (Burchardt 1933, 102). These had been unusual assumptions for the Classics, but they should be considered during the study of credit expansion or capital formation. So, they would ascertain completely different impact on the endogenous variables than in a static system (Burchardt 1933, 101–102).

Oskar Lange claimed that the frequent recurrence of crises necessitates dynamic theories à la Schumpeter or Marx.[46] Lange agreed with Lutz that Schumpeter's concept of the static proprietor was not perfectly formulated, because his distinction between static proprietor and active entrepreneur was more psychological than economical. The static proprietor acts based on given data, i. e. a given production function, whereas the active entrepreneur modifies his production function and thus sets economic development in motion. Despite this critical remark, Lange underscored that Lutz carried out a valuable discussion of the role of statistics in the research of business cycles. Lange even stressed that these chapters were "among the best known to the reviewer" (Lange 1934, 387, my translation). In contrast to Burchardt's criticism, Lange emphasized the relevance of Lutz's methodological message to study the changes in data with the help of equilibrium case studies as a preparatory step to study the business cycle: "The stimulus offered by the author in this direction cannot be overestimated" (Lange 1934, 387, my translation), even comparing it with the methodology of the later Noble Prize laureate Jan Tinbergen, who studied the prosses of equilibrium adjustment based on models with various time-lags.

The intellectual nexus between Lutz's methodological message and Tinbergen's research program was also underscored by Hans Bayer's article "Wirtschaftsentwicklung und Konjunkturstabilisierung" (1953). According to Bayer (*ibid*., 49– 53), Tinbergen and his student Jacques J. Polak showed in *Dynamics in Business Cycles* (1949) how important the

[46] He even praised Hayek's and Mises's monetary business cycle theories and recommended that they can be further expanded if it is shown how banks expand their loans based on profit prospects (Lange 1934, 386).

structure of the economy is for understanding the individual cycle, very much in line with Lutz's reasoning. In later work supporting Marx's theories as fundamental for the explanation of capitalism, Lange once again esteemed Lutz's achievements. He discussed these theories attempting to explain the periodic recurrence of the cycle based on equilibrium theory. Here, he distinguished between two strands: either by seeking the forces for periodic recurrences outside of the economic system, e. g. meteorological. Or the crisis is an accidental phenomenon, whose historical uniqueness necessitates the explanation with the help of the existing equilibrium system. The latter "has been argued very ably by Friedrich Lutz" (Lange 1935, 196, fn. 1).

6. Conclusion

This article focused on Friedrich A. Lutz's habilitation thesis *Das Konjunkturproblem in der Nationalökonomie* (1932) which was considered the last highlight in the German-language business cycle debate, contributing to the existing literature (Rühl 1994; Dal Pont Legrand and Hagemann 2013) by concentrating on Lutz's explicit criticism of how the concept of periodic recurrence of crises was formulated. As Eucken stated, Lutz aimed to delineate the development of crisis research in the context of the general development of scientific methods. The concept of periodic recurrence stems from the empiricism and historicism of the 19th century when science in general was striving for realism. For Lutz, Clément Juglar's "unconditional" observation led to the problematic definition of the research question, a definition that was accepted by the Historical School and those economists pursuing more "realism" in their research. According to Lutz, this problematic formulation provided the basis for methods that either ended up as mere descriptions, as hybrid theories of Gustav Cassel and Emil Lederer, or as pure logical theories, as that of Schumpeter. The descriptions and the logical theories deprived the economists to explain the severity of crises (Lutz 1932 145–147).

In order to avoid subjective formulations of research questions, Lutz referred to general equilibrium theory, and in particular the premise of tendencies towards equilibrium within the exchange process. This should be the benchmark for the formulation of these general phenomena (such as the formation of prices, wages, capital and money) that are conducive to deductive theory. This is the epistemological message that this paper derived from Lutz's thesis. Furthermore, there is a methodological message concerning the models that should be developed in order to explain these phenomena. These models represent general Walrasian equilibrium theorizing, reflecting the interdependences of the exchange relationships with whose help the formation of prices, wage, capital and money ought to be explained. The economist's task is to develop (dynamic) thought experiments by varying one of the data in the system in order to study its impact on the exchange relationships. The dynamics resulting from this change in data depend on case study-based specific frictions (price, wage rigidities etc.).

In this way, the economist is able to point out how the same change in one *datum* can have different effects on the economics. That these case studies would later be developed by Eucken as ideal types that should be used as a method to bridge the gulf between theory and reality constitutes Eucken's solution to the Great Antinomy. These case studies (or ideal types) represent preparatory work for explaining a concrete historical event. This explanation is supported by statistical research, because statistics describe the observed phenomenon, i. e. crisis, and determines the accompanying frictions and moments occurring with the observed phenomenon. The general theory and the concrete explanation comprise Lutz's methodological message how to study each historical event. In conclusion, it really only was Hayek who accepted Lutz's main messages. This might have been the reason why Lutz was invited to spend the academic year 1934–1935 at the London School of Economics, where he established life-long contacts, among others with Hayek and Lionel Robbins. However, considering the reactions of the other German-speaking economists, it is hardly discernible whether Lutz really "won the day."

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IV. Walter Eucken's Concept of Economic Order and Business Cycle Analysis*

Abstract:

Walter Eucken formulated his concept of economic order as a solution to the tension between theoretical approaches and empirical observation that had constituted the conflict between the Austrian School of Economics and the German Historical School. Previous literature has established the linkage between the German language business cycle debate of the late 1920s and Eucken's concept of economic order. This paper discusses how his concept of economic order can help to understand the severity of economic crises and thus concentrates on the elements constituting the economic order, i. e. its ideal types, with whose help Eucken aimed to derive hypothetical propositions. Based on the writings of his students Leonhard Miksch and Friedrich A. Lutz who underscored the role of equilibrium in business cycle research, this paper suggests that abstract theory of economic crises should employ ideal types as models and thus study how exogenous shocks affect the endogenous economic variables. The subject of inquiry should be oriented to the process of equilibrium reestablishment. Crucial for this paper is that the equilibrium reestablishment depends on institutional factors. This method to explain economic crises represents the link which connects the business cycle debate of the 1920s and 1930s to the subsequent emergence of the ordoliberal theory of institutions and orders.

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1. Introduction

Vincent Ostrom (1919–2012), the co-founder of the Bloomington School jointly with the later Nobel Prize laureate Elinor Ostrom (1933–2012), was probably one of the leading Anglo-Saxon economists who integrated Walter Eucken's methodological approach into his own research program (Kolev 2019). Ostrom (1999) underscored the relevance of Eucken's "stove heating his study" (Ostrom 1999, 409) in context of how scientists use the language in order to "address the problems impinging on members of societies [...]" (Ostrom 1999, 394). The stove exemplifies the working mechanism of the market process because it is a result of and its operation depends on the complicated coordination process of actions of individuals participating in the production, the distribution and the use of the stove and its supply of fuel (Eucken [1940] 1950b, 18). According to Ostrom, Eucken delineated two modes regarding how economists address this complex reality. The first one was advocated by the theoreticians who construct abstract models. The second one reflects the research method of economic historians whose descriptions were oriented to realistic representation of how economy works. Ostrom recognized the antinomy that Eucken pointed out between the highly abstract models deviating from explaining the reality, and the pure descriptions failing to conduct a theoretical explanation (Ostrom 1999, 409).

This antinomy was bridged by construction of ideal types that constitute Eucken's economic orders. Eucken scholarship claimed that in this sense, he provided a solution to a long-standing debate on methods (Methodenstreit) between the Austrian School of Economics (promoting the abstract theoretical approach) and the German Historical School (heralding descriptive methods) (e. g. Lutz 1944, 211; Lutz 1950, 5–7). Within Eucken scholarship, Blümle and Goldschmidt (2006) and Goldschmidt (2013) provide a historical account of how social problems of his time and intellectual figures such as Max Weber, Rudolf Eucken and Edmund Husserl played a crucial role in formation of the ideal types. Furthermore, Blümle and

Goldschmidt (2006) illustrate that the business cycle problem, which occupied the minds of the younger German-speaking economists in the late 1920s, had a significant impact on the development of Eucken's research questions. The current paper recognizes that a pivotal result of their study is Eucken's transformation regarding the applicability of business cycle research in the explanation of economic crises. They juxtapose his paper delivered at the 1928 meeting of the Verein für Socialpolitik, where he established the links between credit creation and cyclical fluctuations, and his later contribution to *Spiethoff Festschrift* (1933) where he rejects business cycle research as a method to explain crisis. The critique culminated in his *Die Grundlagen der Nationalökonomie* (1940) (translated as *The Foundations of Economics* [1940] 1950b). Blümle and Goldschmidt hypothesize that in this sense Eucken received relevant impulses from his student Friedrich A. Lutz (1901–1975). Eucken pleaded for the study of crisis, as a particular state of the economy at given point of time and space, whose severity is intimately determined by the economic order (Blümle and Goldschmidt 2006, 554–555).

The current paper discusses how the concept of ideal types can explain the persistence of crisis. It establishes the nexus between the business cycle contributions of two of Eucken's students, Leonhard Miksch and Friedrich A. Lutz, and his concept of ideal types. In this sense, the present study contributes to the main findings of Blümle and Goldschmidt (2006). Furthermore, the current study aims to contribute to recent discussions about the failure of modern macroeconomic models represented by the Dynamic Stochastic General Equilibrium (DSGE) models to explain the severity of crises (Blanchard 2016; Stiglitz 2018). This paper claims that in this context it is necessary to renew the dichotomy between impulse, initial shocks, and the propagation mechanism, i. e. the problem of how the economic system reacts to these shocks. According to macroeconomists, current business cycle research neglects the propagation mechanism and places too much weight on the cyclicality of the impulse (Dal Pont Legrand

and Hagemann 2019, 25). This paper aims to demonstrate that Eucken's economic orders can provide a valuable contribution to the theory of the propagation mechanism.

In order to achieve this, the paper is divided into five sections. Section 2 elucidates on how the communication on persistence of crisis has changed by delineating the difference between the modern macroeconomic modelling and the interwar interpretation of crisis. Here, Miksch's and Lutz's business cycle contributions will be contextualized. Section 3 discusses the evolution of Eucken's vision regarding the applicability of business cycles to explain the emergence and intensity of crises. Section 4 discusses how Eucken's construction of ideal types could be deployed in discussing the severity of crises. Section 5 discusses what kind of implications can be derived for current macroeconomic discussions from Eucken's approach. Section 6 concludes und summarizes the central ideas of the paper.

2. The Shift in Methodology of Business Cycle Analysis

When Robert Lucas revitalized business cycle research, he raised the question "Why is it that, in capitalist economies, aggregate variables undergo repeated fluctuations about trend, all of essentially the same character?" (1977, 7). This question has occupied economists since the late 19th and early 20th centuries. Even Joseph A. Schumpeter formulated in a similar way that "[a]nalyzing business cycles means neither more nor less than analyzing the economic process of the capitalist era" (1939, v). Even though the question has not changed, the methods adopted to answer it have transformed. Dal Pont Legrand and Hagemann (2019) claim that the modern macroeconomic models follow the methods of Eugen Slutzky and Ragnar Frisch rather than those of Friedrich A. Hayek and John R. Hicks etc. The current section delineates the methodological transformation of business cycle approach from the interwar period to the new classical theories. The latter provided the basis for recent development of business cycle analysis (Landmann 2015).

2.1 From Schumpeter's Instability of Capitalism to the "Relevance" of the Shock

Schumpeter identified the business cycle theory as nothing else than an analysis of the economic process during the capitalistic era. He considered the economic growth of capitalistic system as contingent on cyclical fluctuations. Expressed in modern language, Schumpeter (1928) considered the long-run path as a statistical average of cyclical fluctuations (Rühl 1994, 169 and 181–182). In order to formulate a business cycle theory, Schumpeter first distinguished between the static Walrasian system of general equilibrium and Karl Marx's dynamic theory. He postulated that the Walrasian system describes processes that would take place in an economy of static nature. In this context, the equilibrium was understood as an attractor or gravitational point, towards which the economic system adjusts once one of the system fundamentals changes. In contrast, Marx's dynamic theory describes the long-run evolution of the capitalism whose instability arises from the internal antagonistic forces of capitalism. Based on the latter, Schumpeter promoted endogenous theory where technical progress is this systemic change responsible for the wave-like movement. The cyclical upswing arising from new technique and organizational improvement gives rise to a shift of the attractor, the task of dynamic theory, whereas static theory should explain how the system adjusts to the new gravitational point. This wave-like movement is, however, pivotal for the long-run economic growth of the capitalism (Schumpeter [1934] 1949, viii; Rühl 1994, 181–182; Louçã 2015, 178).

Schumpeter's endogenous business cycle theory became a difficult task to fulfill for the later mathematical economists (Louçã 2001, 34). Particularly Ragnar Frisch's analysis of the cycle gave rise to tensions and intense letter exchange between him and his senior Austrian colleague (Louçã 2015, 180). Frisch also distinguished between dynamics and statics in his paper "Statikk og dynamikk i den økonomiske teori" (1929) which was considered fundamental for the future development of economics (Brunner 1950, 26). This provided the basis for the separation between propagation mechanism and impulse in his "Propagation Problems and Impulse Problems in Dynamic Economics" (1933). The propagation reflects "the structural properties of the swinging system" (Frisch 1933, 171) which was mathematized by a system of deterministic differential equations (Duarte and Hoover 2012, 229). In other words, the long-term path is independently determined from the cycle. The cyclical fluctuations were not constructed as a result of internal forces, which is the cornerstone of Schumpeter's business cycle theory, but from erratic shocks whose occurrence lack economic explanation. These shocks interpreted as impulses have to maintain the system oscillate (Frisch 1933, 171; Lines 1990, 359–360; Andvig 1992, 388; Louçã 2015, 178–179).

Eugen Slutzky (1880–1948) even moved further by completely abandoning such deterministic system. Slutzky as a pioneer of time-series analysis claimed that the shocks should be not of periodic nature in order to create the cycle. The cyclical process can arise as a consequence of a summation of mutually independent random causes. It was alleged by Lines (1990) that from a methodological point of view Lucas followed Slutzky's "The Summation of Random Causes as the Source of Cyclic Processes" (1937) rather than Frisch (1933) because Lucas based his explanation of business cycle on the cumulative effect of random shocks. Fundamental here is that a moving average process transforms random disturbances into a correlated series of expectations. With the help of neoclassical growth theory, Lucas aimed to show how this gives rise to cyclical fluctuations in real quantities, such as production and employment (Lines 1990, 360). So, shocks became the center of analysis whereas particularly with the triumph of the real business cycle theories the endogeneity of propagation mechanism lost its relevance (Dal Pont Legrand and Hagemann 2019, 18–19).

2.2 The "German Ricardians" and Deductive Business Cycle Theory

This empirical explanation of the cycle is diametrically opposed to the approach pursued by the younger German-speaking economists calling themselves "German-Ricardians". This group was founded by Alexander Rüstow, Emil Lederer, Adolf Löwe, Walter Eucken, Friedrich A. Hayek, Ludwig von Mises etc. in the mid-1920s. They attempted to emancipate themselves from the inductive methods of the Historical School (Janssen [1998] 2012, 38–39).[47] For the "German Ricardians", if the reason for the cycle does not arise from economic or institutional factors of the capitalism, then one would raise the question why business cycle at all (Rühl 1996, 220). This indicates how Schumpeter's understanding of endogenous business cycle theory played a crucial role in the formation of their research program. A notable example for Schumpeter's influence provided Adolf Löwe's paper "Wie ist Konjunkturtheorie überhaupt möglich?" (1926).[48] This paper gave rise to a business cycle debate in the late 1920s (Hagemann 1994, 102; Dal Pont Legrand and Hagemann 2010, 201). It began with criticism of the empirical business cycle research that he described as "by no means only a late blossom of the historical school" (Löwe 1997, 246):

> "Yet all this conceded, one must still conclude that our insight into the *theoretical* interconnections of economic cycles and into the structural laws of circulation has not been enriched at all by all these phase descriptions and calculations of correlation" (Löwe 1997, 246; italics in original).

[47] Some historians of economic thought (e. g. Caldwell 2004, 83–100; Köster 2011, 51–59) hold the view that the relevance of Historical School declined by the end of the First World War. I do not question their views. I only refer to idea that the Historical School and especially Schmoller were considered as the scapegoat that the younger scholars in the 1920s criticized (Köster 2011, 56). This was reflected on letter exchange between Rüstow and Eucken which discussed the attempts how to break with the methods of the Historical School (Janssen [1998] 2012, 38). Second, Eucken ([1938] 2018; 1940) concentrated his efforts on criticizing the Historical School's methods of how they interpreted the history (Goldschmidt 2016) which indicates the struggle of German economists to emancipate themselves from the still dominant Historical School.

[48] For the English translation, see Löwe (1997).

Arguing for deductive explanations of cyclical fluctuations based on Schumpeter's distinction between statics and dynamics, Löwe recognized that existing economic theory based on static propositions deduced from the general equilibrium theory does not allow for the construction of the necessary dynamic theory which should reflect the observed cyclical fluctuations. Löwe rejected the idea of independent long-run trend towards which the capitalistic system converges. He even went further by claiming that long-run trend is not discernable whereby the growth of capitalism can be depicted as an upward wave-like curve (Rühl 1994, 183). This is the reason why Löwe demanded the abandonment of existing equilibrium theory and the formulation of dynamic assumptions from which a deductive business cycle theory could logically follow (Löwe 1926, 192–193).

Friedrich A. Hayek, another participant in the debate, joined Löwe's criticism of the empirical business cycle research as a method for deduction of knowledge (Hayek [1933] 1966, 27).[49] Hayek also accepted Schumpeter's distinction between statics and dynamics, and thus agreed with Löwe about the necessity of dynamic business cycle theory (Klausinger 2013, 13–14). In contrast to Löwe, Hayek interpreted equilibrium as a necessary benchmark to study cyclical fluctuations. This is not coincidental, because Ludwig v. Mises, Hayek's mentor and life-long friend, incorporated the concept of equilibrium into his arguments against socialism in *Die Gemeinwirtschaft* (1922).[50] Mises was able to convince the younger German-speaking economists, in particular, concerning the impossibility of socialism due to the lack of markets (Ebenstein 2003, 45–46). Markets are central institutions which facilitate exchange among members of a society. Exchange relationships are expressed by money prices, which in turn allow economic agents to plan and calculate the economic feasibility of their undertakings.

[49] This passage does not claim that Hayek rejected the statistical research per se. According to Hayek, empirical research can "afford merely a verification of existing theories; they cannot, in themselves, provide new insight into the causes or the necessity of the Trade Cycle" (Hayek [1933] 1966, 27).

[50] For the English translation, see Mises ([1951] 1962).

With his economic calculation argument, Mises aims to show that equilibrium (Beharrungszustand), which he understood as a social optimum with full employment of labor and production factors, can only be established in a free market system (1922, 151–152 and 198–199). In order to prove this, Mises formulated a "dynamic model" with whose help he discussed how six changes in data (system fundamentals) influence the market system (1922, 184). The existence of prices makes economic calculation feasible, so that economic agents can adjust to the changes in data in such a way that equilibrium is reestablished. In contrast, the socialist system due to the lack of economic calculation is unable to cope with the changes which give rise to permanent disequilibrium (1922, 190 and 192).

Mises's explanation that markets adjust to the changes in data assumes predetermined state of rest, and presupposes an independent and stable growth path (Mises 1922, 151). This could be one of the reasons why Hayek accepted that prices are fundamental for the markets to clear once system fundamental changes. Hayek asserted that the equilibrium theory already explained with the help of static laws how prices determine the production structure of the economy, but in order to prepare the equilibrium for explanation of the business cycle its assumptions should be "widened" by incorporating the concept of time (Hayek [1933] 1966, 28–30). Regarding the construction of dynamics, Hayek adopted Mises's theory (1924) that credit creation causes the disturbance of equilibrium by affecting the formation of relative prices and thus the production structure in the economy. Hayek's business cycle theory can be interpreted in the context of Frisch's dynamic understanding where credit creation represents the impulse but also a part of the propagation mechanism (Dal Pont Legrand and Hagemann 2019, 9).

Two students of Walter Eucken, Leonhard Miksch (1901–1950) and Friedrich A. Lutz (1901–1975), contributed with doctoral *Gibt es eine allgemeine Überproduktion?* (1929) and habilitation thesis *Das Konjunkturproblem in der Nationalökonomie* (1932) to the business cycle debate respectively. Miksch's dissertation thesis represents a detailed historical account of how classical economists, J. B. Say and James Mill, described the natural tendencies of markets towards equilibrium as predetermined state of rest. Based on an historical account, Miksch claimed that the exchange process itself is not prone to disequilibrium, but changes in the money supply play a central role for the disturbance of equilibrium (Miksch 1929, 96). Miksch was this member of Freiburg School who had focused on the theory of equilibrium since the beginning of his intellectual career (Berndt and Goldschmidt 2000, 47). His historical account was incorporated by Hayek into the English edition of his habilitation thesis *Monetary Theory and the Trade Cycl*e ([1933] 1966) with the aim to point out how the tendency towards equilibrium remained a focal point in the research program of classical and neoclassical economists. (Hayek [1933] 1966, 42; Arena 1994, 211).

Friedrich A. Lutz's habilitation thesis was considered to be the final verdict in the business cycle debate in the late 1920s (Rühl 1994, 188).[51] He accepted Miksch's and Hayek's interpretation of equilibrium as a benchmark to study the business cycle. Lutz's most important contribution to the debate is his criticism of the methodology by which the business cycle problem was formulated (Grudev 2019, 11). He criticized Clément Juglar for the superficial observation from which he derived the periodic recurrence of crises (Lutz 1932, 33–34). Lutz claimed that the crisis is an individual economic phenomenon whose severity should be the subject of inquiry. In this sense, he denied the existence of any metaphysical reason for its periodic recurrence (Rühl 1994, 178). In order to attain a theoretical explanation of crisis, equilibrium theory ought to provide the basis for the theoretical explanation of the individual phenomenon. Lutz's solution can be translated into Frisch's dynamic understanding where the modelling of the propagation and equilibrating forces of the system should be the fundamental task. This is the cornerstone of models aiming to show how the economic system reacts to the impulse. This reaction should be studied by explaining the reestablishment of the equilibrium

[51] Unless stated otherwise all translations from German are mine.

whereby the adjustment process depends on institutional factors. In Lutz's view, focusing on the periodic recurrence of the impulse neglected the fundamental problem of economics – the severity of crisis (Lutz 1932, 166–171).

Lutz's message took a central place in Hayek's Copenhagen lecture "Price Expectations, Monetary Disturbances and Malinvestments" ([1935] 1975). There, Hayek first criticized the quest for dynamic models and even claimed that we are not supposed to "jump into something entirely new and different" (Hayek [1935] 1975, 137), but to develop existing equilibrium theory in order to explain dynamic phenomena such as the business cycle:

> "As has recently been shown very convincingly by Dr. Lutz, our task is not to construct a separate theory of the trade cycle, that is of a construction of a detailed scheme which will fit all actual trade cycles, but rather a development of those sections of general theory which we need in the analysis of particular cycles" (Hayek [1935] 1975, 138).

It is notable that Hayek delivered this lecture in *Socialøkonomisk Samfund*, the Danish Socioeconomic Society, and that it was published in the Danish economic journal *Nationaløkonomisk Tidsskrift*. Exactly in the same society and journal, Frisch delivered and published respectively his paper "Statikk og dynamikk i den økonomiske teori" (1929),[52] which was considered as the first outstanding distinction between dynamic and static approaches and which provided future endeavors oriented to develop a dynamic economic theory (Andvig 1992, 388) – endeavors that Hayek probably had in mind when he criticized contemporary attempts to construct such theories. Hayek's reference to Eucken's students can be considered as an indication of future collaboration between him and the later founder of the Freiburg School. In this vein, the question arises how Eucken integrated the achievements of his students into his research program.

[52] For the English translation of the first three sections, see Frisch (1992).

3 Eucken's Criticism of Business Cycle Concept

3.1 Eucken and the 1928 Meeting of Verein für Socialpolitik

In contrast to his later ordoliberal colleagues Wilhelm Röpke, Friedrich A. Hayek and even Alfred Müller-Armack, Walter Eucken did not produce any substantial work in business cycle theory.[53] Eucken's early writings in technical economics were oriented to the problem of inflation and monetary theory which tried to break with the dominant descriptive approach of the Historical School (Klinckowstroem 2000, 69; Lenel [1989] 2008, 295–296).[54] As stated previously, the emancipation from this School was institutionalized in the mid-1920s when the younger, theoretically-minded economists, in particular, established a group calling themselves the "German-Ricardians"[55] where Eucken played a leading role (Janssen [1998] 2012, 39). In this sense, they not only signaled their purpose to revitalize the deductive approach of the classical economist David Ricardo (Janssen 2012 [1998], 38), but also to provoke their senior colleagues from the Historical School who treated Ricardo's theories as the epitome of abstraction detached from reality (e. g. Schmoller 1893, 74).

[53] Hayek as an ordoliberal was discussed in Stefan Kolev's dissertation thesis ([2013] 2017). On the relevance of Röpke's and Müller-Armack's roles in the development of ordoliberalism, see Kolev, Goldschmidt, and Zweynert (2019); Goldschmidt and Wohlgemuth (2008). The following works in the area of business cycles are representative for the three authors Wilhelm Röpke (1922, 1926, 1932, 1936), Friedrich A. Hayek (1929, 1931, 1939) and Alfred Müller-Armack; as Müller (1923, 1925, 1926) and as Müller-Armack (1929).

[54] According to Caldwell, one of the facts that contributed to the decline of the Historical School is its failure to counteract German economic policy that led to hyperinflation (Caldwell 2004, 95).

[55] The list of the planned members contained Joseph A. Schumpeter, Emil Lederer, Adolf Löwe, Walter Eucken, Alexander Rüstow, Wilhelm Röpke and the Austrians Ludwig v. Mises and Friedrich A. Hayek. One of the reasons why the group failed to become a long-standing factor was Schumpeter's decline to join the group and particularly his paper "Gustav v. Schmoller und die Probleme von heute" (1926) praising Schmoller's methods. For the young Ricardians, this gave rise to disappointment whereby in a letter from Eucken (1926) to Alexander Rüstow, Eucken expressed his indignation because the paper is a "hymn of praise and at the same time a scandal!" (Walter Eucken to Alexander Rüstow. Tübingen, 12. August 1926 cited from Dathe and Hedtke 2018, 6; Köster 2011, 227).

In the "theoretically" oriented 1920s, one of the central topics, as already discussed, was business cycle theory, which the younger economists pursued in a deductive way akin to the approach by classical economists (Lutz 1932, 122). Even though Eucken did not contribute with any methodological articles oriented explicitly at the debates and particularly Löwe's challenge, he was not spared from heated discussions. Their highlight was a meeting in 1928 as a part of a Zurich conference organized by the Verein für Socialpolitik (Köster 2011, 241). The discussion topic was "Credit and Cycle" whose main questions divided the young Ricardians into two groups: Hayek and Mises attributed the ultimate cause of the cycle to commercial banks' credit creation, whereas Löwe and Emil Lederer recognized technical progress as the primary – and credit creation as an accompanying – reason for the dynamic phenomenon (Boese 1929, 365–366; Köster 2011, 255). Besides this empirical difference, a further empirical difference divided the participants. Whereas the Austrians believed in the equilibrating forces of the market order, Löwe postulated the instability and inherent tendencies towards disequilibrium as the underlying features of capitalism (Hagemann 1994, 105).

During this meeting, Eucken delivered a paper asserting the primary role of credit creation in the business cycle. He interpreted the changes in speed of investment activities constitute the cyclical fluctuations. The explanation started from a state of depression with the aim to show that commercial banks can turn the economy from a state of unemployment and unutilized production factors to a state of economic expansion. Eucken hypothesized that if banks increase their credit provision and this exceeds savings in the community, then this gives rise to the utilization of machines and labor (Eucken 1929, 301–305 and 387). This stands in complete contrast to nonmonetary theories, particularly by Gustav Cassel, arguing that stocks of commodities and savings are accumulated during a depression. This gives rise to a surplus of capital and thus a decrease in the interest rate, which raises the speed of investment and creates the boom period (Eucken [1940] 1950b, 244; Lutz 1932, 61–65 and 72).

With his contribution, Eucken clearly positioned himself within the group of the Austrians (Blümle and Goldschmidt 2006, 554). This of course gave rise to Löwe's critical reaction claiming that monetary business cycle theories failed to prove the systematic nature of the cycle (Hagemann 1999, 444). Even Löwe viewed Eucken's explanation as circular reasoning because he derived from a state of depression the upswing with the aim to show how this upswing turns into a depression. This means that Eucken assumed what he actually was supposed to explain (e. g., Löwe 1997, 254–257). The occurrence of depression should be the actual result of deductive reasoning and thus of the explanation (Löwe 1929, 336–337). This criticism is indicative of the content of the methodological debates in the late 1920s: "Eucken abandoned the fundamental problem of business cycle theory at the moment he began his analysis from the depression. By expressly refusing to base his further derivations on a mental state of equilibrium, he inevitably introduced assumptions into his further discussion which, in the context of a genuine theory of business cycles, themselves require explanation" (Löwe 1929, 336; my translation). Translated into plain English, Löwe interpreted that scientific explanation should be based on indisputable assumptions that serve as an axiomatic point from which theoretical explanation should follow as a logical consequence of these premises. At that moment, when deductive explanation is interrupted with "unexplained facts" (i. e. "foreign elements"), as in Eucken's case, then this loses its scientific character. Hayek described Spiethoff's business cycle theory in an analogous way:

> "At each stage of his exposition he calls in experience to back him up [...] Consequently it never becomes clear why these phenomena *must* always occur as they are described [...]. In other words the latter [his exposition, LG], [...] does not qualify as a theory in the rigid sense of the word, for it does not set out those conditions in whose presence events *must* follow a scientifically determined course" (Hayek [1933] 1966, 88–89).

In his response to Löwe's critique, Eucken stressed, first, that he did not intend to formulate a complete business cycle theory and, second, by starting from a state of depression he aimed at underscoring the role of credit creation in the cycle. This reasoning is of fundamental importance in Eucken's and even in Hayek's later research program (1939) because by starting from a depression, a state of disequilibrium, they pursued the question whether the static laws postulated by general economic theory are still in effect. Even Hayek discussed whether increase in credit creation always gives rise to unstable boom by distorting the relative prices and thus giving rise to misallocation of factors. Hayek admitted that credit creation can contribute to recovery "where there is still very considerable unemployment" (Hayek [1939] 1975, 57) and the early stage of this recovery does not jeopardize the stability of the economy (Hayek [1939] 1975, 42, 52–56; Eucken 1929, 387).

3.2 Eucken after "Was leistet die nationalökonomische Theorie?"

Joseph A. Schumpeter formulated that the pre-analytic cognitive act precedes analytic efforts and thus supplies raw material for one's analytic work. He characterized this pre-analytic cognitive act as vision (Schumpeter 1954, 41; Leijonhufvud 1968, 10). This paper argues that the concept of periodic recurrence of crisis is not compatible with Eucken's later vision of reality that he first explicitly formulated in his programmatic essay "Was leistet die nationalökonomische Theorie?" ([1934] 1954). This vision is oriented against a deterministic understanding of history per se, particularly against the Hegelian concept of history as a rational process and the idea that united John Stuart Mill, Auguste Comte and Karl Marx, namely that the course of history is predetermined from one stage to another (Watkins 1953, 132).

In similar way argued Goldschmidt (2016) that Eucken's emancipation from the Historical School should be understood by focusing on his epistemological position rather than methodological approach. Eucken criticized the Historical School not because it pursued history, but because it lacked the theoretical approach to explain history and thus to grasp the development of the economic and social events. This epistemological position sheds light on Eucken's interpretation of the business cycle theories. They also fail to grasp the economic dynamics as real economic process by forcing the perceived dynamics into "a corset of theoretical assumptions" (Goldschmidt 2016, 187–190). The study of this corset was the cornerstone of Lutz's thesis whereby his defense against Clausing's criticism (Clausing 1933) contains such a choice of words that can be recognized in Eucken's criticism of the business cycle (Eucken 1933, 75; Lutz 1933b, 164–165).

During the 1928 meeting, Eucken presented an article focusing on the relationship between credit and cycle. In this article, he did not criticize the business cycle theories and even referred to Spiethoff's and Schumpeter's theories (Eucken 1929; Dathe and Hedtke 2018, 7). This suggests that Eucken still had not formulated his critical interpretation of the business cycle theories in context of his epistemological position towards how to interpret history. Had Eucken formulated it earlier, this would have been a valuable contribution towards the business cycle debate. And considering the content of the methodological discussions, a history of this debate, by paraphrasing Schumpeter's words, "[...] is substantially a history of wasted energies, which could have been put to better use." (Schumpeter 1954, 814).[56] This means that instead of concentrating on advancement of economic theory and thus acquiring better understanding of economic phenomena as crisis, unemployment etc., the younger economists "wasted" their energies in abstract methodological debates. This became outstanding problem when during the Great Depression the participants were unable to explain its intensity and thus failed to recommend political measures to combat its severity (Köster 2011, 265–268).

Eucken's essay in *Spiethoff Festschrift* (1933) represents his first critical statement towards the business cycle theory to which Lutz's thesis undoubtedly provided essential impulses (Blümle

[56] Schumpeter's quotation was addressed at the Methodenstreit between the Austrian School and German Historical School (Schumpeter 1954, 814).

and Goldschmidt 2006, 555; Goldschmidt 2016, 190). Eucken criticized the perception of periodic recurrence of crisis whereby this criticism was oriented against Spiethoff's standard concept of cycle (Musterkreislauf) (for the same criticism see also Lutz 1933a, 89). Eucken asserted that each crisis is a historical phenomenon tantamount to revolutions – the French Revolution of 1789, the revolutions in 1848 or the October Revolution in 1917. The revolutions are characterized by certain similarities in their course which can help explain future revolutions. However, their occurrence depends on the political, economic and historical situation of a given nation during the discussed historical period. This does not allow historians to "squeeze" all revolutions into a "general theory of revolutions".[57] A similar logic should be applied in explaining the occurrence and severity of crises. Eucken claimed that they may show similar characteristics, but nothing justifies the assertion that any particular reason gives rise to their periodic occurrence (Eucken 1933, 75).

In the programmatic essay "Was leistet die nationalökonomische Theorie?" ([1934] 1954), Eucken discusses the problem of cyclical fluctuation in the context of how to ascertain when a phenomenon is conducive to deductive theory (Eucken [1934] 1954, 15–20). Eucken, in line with his student Lutz, postulated that the uniformity of observed phenomena is a fundamental prerequisite for deductive (abstract) theory (Eucken [1934] 1954, 18; Lutz 1932, 163). In this essay, Eucken distinguishes between abstract theory and concrete theoretical explanation (not description) (Eucken [1934] 1954, 31), whereby he understands abstract theory in Carl Menger's sense, which should be oriented to discover "laws which lie behind the succession of economic events" (Lutz 1944, 211; Eucken [1934] 1954, 31). Each crisis fails to demonstrate such uniformity; thus, there cannot be a metaphysical law lying behind the occurrence of crisis.

[57] Lutz employed analogous words in his defense against Clausing's criticism. Lutz claimed a general business cycle theory would resemble "a general theory of wars that would reveal once and for all the cause of the wars" (1933a, 89).

In this sense, the periodic occurrence of this phenomenon cannot be reduced to an abstract theory whereby the crisis should be subject to concrete theoretical explanation (Eucken [1934] 1954, 18).

An extensive criticism of business cycle research culminated in his book The Foundations of Economics where the chapter "Economic development" concentrates particularly on how the concept of business cycle contributed to the "unjustified" distinction between dynamics and statics in economics (Eucken [1940] 1944, 236).[58] Eucken considered business cycle theories as dynamic theories that are unable to explain the reality:

> "The conclusion we come to is that it is pointless to try to construct a "normal" cycle of upswing, crisis, and depression in the hope of arriving at a theory and explanation of the trade cycle. To do so would be to lose sight of the real economic world behind a theoretical scheme. In studying the trade cycle one must not withdraw from the facts, but penetrate into them. The comparison of different fluctuations is very useful, not for the purpose of constructing a normal cycle, but in order to bring out the special characteristics of each, which must be the first step in one's work" (Eucken [1940] 1950b, 256).[59]

In Eucken's view any theoretical attempts to construct the periodic recurrence of crisis presume a deterministic understanding of history: "There is no single necessary and inevitable course in the fluctuations which follows its own laws" (Eucken [1940] 1950b, 246). Business cycle theorists treat the investment process in the economy independently that once started gives rise to a definite course "like a chemical process which after a certain mixture has been made

[58] Eucken's request to abandon the distinction between statics and dynamics disappeared in later editions. See e.g., Eucken [1940] 1950a.

[59] See also Lutz: "Then the elaboration of a scheme of the economic cycle that is supposed to explain the theory means a violation of the facts, an unrealistic approach that must be rejected" (Lutz 1933a, 89; my translation).

necessarily develops in a certain way" (Eucken [1940] 1950b, 246). In order to develop this theory, business cycle theorists pressed the observed changes in everyday life into a single uniform type of cycle or, as Eucken said, normal cycle (Eucken [1940] 1950b, 329). The concept of cycle is based on general propositions regarding "allegedly regularly repeated movements in everyday economic life" (Eucken [1940] 1950b, 246) whereby non-economic factors influencing the economic process have been neglected (Eucken [1940] 1950b, 247). His student Lutz convincingly showed that this perception of economic development was the reason for the construction of such theories which were inevitably based either on unrealistic assumptions or on assumptions whose occurrence is not necessary in economic theory (Lutz 1932, 79–81, 121–125). The astonishingly topical consequence of this is that it does not matter how logical models are; their creators are unable the explain the severity of depression (Lutz 1932, 159; Rühl 1997, 277)

Eucken postulated that economic history clearly demonstrates that such determinate changes in everyday life are not vindicated. The emergence and intensity of economic crises are two parts of a historically unique event. In line with his student Lutz, he did not reject the idea of a structural relationship between expansion and depression, but "every boom and depression [...] must be seen in its particular temporal and national setting" (Eucken [1940] 1950b, 246). For Lutz and Eucken, the reasons which give rise to booms are outside of the exchange process, whereas the intensity of boom and ensuing depression depend on the economic order and its institutional framework within which the exchange process takes place. The comparison of upswing periods between 1903–1907 and 1933–1939 is fundamental for Eucken's demonstration how his concept of economic orders was oriented to bridge the gulf between theory and history (Meyer 2002, 302–303; Albert 2009, 95). Eucken viewed the order as distinct in time and place whereby the elements constituting each economic order, the ideal types, are general and should provide the basis for theoretical explanation.

My paper formulates another essential reasoning related with the business cycle concept which is in conflict with Eucken's normative approach. It raises the hypothesis that quests for general laws proving the periodic recurrence of crisis share a predetermined understanding of economic development tantamount to historicists who believe in the general law of evolution. The problem of historicism is not only its determinacy (pessimistic or optimistic) in the development of history, but also the perception that nothing can be changed, and each phenomenon is the inevitable result of social development (Popper 1944, 102). If we translate this onto economics, we can assert that the crisis was considered the inevitable phenomenon underlying
the nature of capitalism.

For Schumpeter, the crisis was a necessary economic period that should be endured and he even interpreted the Great Depression without fearing criticism "that in the breakdown there was promise of a harvest" (Schumpeter [1941] 1991, 351), which should provide the basis for new recovery (Dal Pont Legrand and Hagemann 2017, 22). In the same line, Hayek reasoned that crisis is a necessary clean-up process from imbalances occurring during the boom whereas government interventions only prolong the painful period (Hayek [1935] 1967, 96–97). Such interpretations, as history teaches, neglect how the severity of crisis is able to exert a disastrous impact on the fundamentals of a free society. This was the cornerstone of Röpke's papers and books during the Great Depression (Röpke 1931; 1933; 1936). The relevance of Röpke's statement was later acknowledged by Hayek, who claimed that

> "[t]here may be desperate situations in which it may indeed be necessary to increase employment at all costs, even if it be only for a short period-perhaps the situation in which Dr. Bruning found himself in Germany in 1932 was such a situation in which desperate means would have been justified" (Hayek [1939] 1975, 64).

After the Second World War, the opposite economic policy was prescribed, in particular, by Paul Samuelson in the context of his neoclassical synthesis. Based on John M. Keynes's intellectual legacy that markets are prone to crisis and unemployment, Samuelson asserted that Keynesian counter-cyclical fiscal and monetary policy can secure equilibrium in the market economy, be preventive against crises, and thus cycles can be mitigated (Landmann 2015, 4–6). Both extremes are not compatible with Eucken's normative approach of a competitive order. Eucken recognized that a deep economic crisis can jeopardize the existing competitive order, something that he observed in the late 1930s and early 1940s. He pleaded that each measure combating economic crisis should be undertaken in the context of general constitutional decisions (ordnungspolitischen Entscheidungen) (Eucken [1952] 2004, 312). On the other hand, Eucken rejected any preventive economic policy in the sense of the neoclassical synthesis which he defined as economic policy of the experiments. Instead of dampening the cycle, Eucken asserted that such policy can even have the opposite effect by intensifying the disproportionality in the economy (Eucken [1952] 2004, 309–311).

4. Eucken's Solution – the Construction of Ideal Types

The paper started with Ostrom's description of the stove which is a result of the division of labor. From the observation of stove, Eucken deduced the question "How is this process with its far-reaching division of labor controlled in its entirety, so that everyone comes by the goods on which his existence depends?" (Eucken [1940] 1950b, 18). The coordination of individual plans is a fundamental condition of the successful working of the exchange economy whereas the crisis was understood as a disturbance of the coordination process. In this vein, Eucken described the crisis as a disequilibrium phenomenon with unemployment and unutilized production factors. The adjustment process towards equilibrium depends on the institutional framework determining the economic order. At an abstract level, the restoration of equilibrium should be studied with the help of ideal types, the constituting elements of the economic order (Goldschmidt 2016, 191–192).

These ideal types can be translated in Ragnar Frisch’s sense as a propagation mechanism (Stackelberg 1940, 276). Eucken formulated that with help of changes in data, one has to study how equilibrium is disturbed and how depending on the ideal type this equilibrium is restored (e. g., Eucken [1940] 1950b, 257; Stackelberg 1940, 276). This model thinking was suggested by Lutz in his habilitation thesis as a preparatory method to explain the severity of crisis. This section concentrates on this model thinking and is divided into two parts based on Mary Morgan’s reasoning how models should be utilized (2012, 225–227). The first one discusses the ingredients in order to construct the models; the second discusses the external (the manipulation of the model) and internal dynamics (the deductive reasoning) of the ideal types.

4.1 The Construction of Ideal Types

Let us recall Löwe’s critique of Eucken’s paper at the meeting of the Verein für Socialpolitik where he underlined that in Eucken’s explanation “the starting point of the entire deduction [...] is itself in need of an explanation” (Löwe 1929, 336). The paper stresses that ideal types can be interpreted as Eucken’s response to Löwe’s criticism, because they are the undisputable starting point of deduction. This becomes clear in *The Foundations of Economics* where ideal types “are not photographs or pictures and are not intended to be [...] We have shown that because they represent simple and clear sets of conditions they serve as a basis for arriving at theoretical conclusions, that is, general propositions about necessary relationships.” (Eucken [1940] 1950b, 222). Eucken first referred to the necessity of ideal types in the introductory essay “Was leistet die nationalökonomische Theorie?” that “The conditions set by the researcher must therefore be reductions of the actual data to pure cases and cannot by any means be chosen in an arbitrary or biased way.” (Eucken [1934] 1954, 20, as translated in Goldschmidt 2013, 134).

Eucken’s description of ideal types suggests that he had the same meaning in mind as Carl Menger. The latter formulated ideal types by portraying economic man, and thus developed a concept of the individual or “human economy” (Morgan 2012, 142). This is diametrically opposed to the notion of national economy representing the cornerstone of the Historical School’s research program (Morgan 2012, 142). Eucken based his analysis on the concept of human economy in *Kapitaltheoretische Untersuchungen* defined as Robinson Crusoe economy ([1934] 1954, 57; Machlup 1935, 335). This human economy conducts its planning procedure by considering five data (human wants, natural resources, labor capacity, stock of finished and semifinished consumers’ goods, and technical knowledge), three empirical rules, representing the knowledge of the planning individual, and the risk arising from the gap between (subjective) planning data and (objective) factual data ([1934] 1954, 57–62 and 68–85; Machlup 1935, 334–335). Here, Eucken distinguished between the human economy, which later represents the purest planning unit, and the economy on a macroeconomic level whose data are akin to the human economy; however there is a sixth *datum* – the social and legal organization of society ([1934] 1954, 64–65; Eucken [1940] 1950b, 178–205). These six data that influence the static economy was the cornerstone of Mises’s “dynamic” theory in *Die Gemeinwirtschaft* (Mises 1922, 184).[60]

From the planning procedure of the individual, Eucken constructed ideal types (Stackelberg 1940, 267).[61] “The individual plan and its formulation must be the first objective [...] if we are to determine systematically what are the pure structural elements” (Eucken [1940] 1950b, 118). With the help of “pointedly distinguishing abstraction”, Eucken formulated two pure ideal types. The paper suggests that Eucken carried out his abstraction procedure based on the question ‘who formulates the plan?’ (Grossekettler 1989, 44). If, on the one hand, a single authority formulates a plan and the economy has to follow it “from the beginning to the end”,

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[60] In a similar manner, Hayek distinguished between data the individual knows and what the economist knows in terms of the economy (1937, 39).

[61] “Economic reality requires that analysis must start from the study of the individual economic unit, as Thünen did with so much success.” (Eucken [1940] 1950b, 196).

then Eucken derived the ideal type “centrally administered economy”. If, one the other hand, several or many individuals formulate their own plans where the plan of each individual represents “small part of whole process of social community”, then Eucken constructed the ideal type of the “exchange economy” (Eucken [1940] 1950b, 118).

The different economic systems, the centrally planned economy and the exchange economy, are fundamental (or pure) elements. They are “purely ideal types each representing one single aspect of a group of cases” (Eucken [1940] 1950b, 173). From the two pure elements, Eucken derived several variants. The variants of the centrally administered economy are constructed according to the degree of authoritarian centralization that prevails (Eucken [1940] 1950b, 119–128). Furthermore, the variants of the exchange economy are constructed according to the market forms, within which the exchange takes place. Central for the exchange process is the coordination which, according to Eucken, is facilitated by the price mechanism and the medium of exchange, i. e. money, (Eucken [1940] 1950b, 130–131) much in line with the Austrians Hayek and Mises (Eucken [1940] 1950b, 150).[62] Here, he underlined that two factors are incorporated into the planning procedure: the expected reactions of the other side of the market and of the competitors. The consideration of these reactions depends on the power of the economic agent, which determines two extreme market forms: monopoly and competition (Eucken [1940] 1950b, 146).

It is central to emphasize that the problem of how individuals incorporate the reaction of the other market participants into their planning procedure was a focal point in the discussions in the early 1930s. This was a challenge raised by Oskar Morgenstern in his paper “Vollkommene

[62] “How does this co-ordination of individual plans and economics actions and thereby of the whole economic process come about under an exchange economy, past or present, in the real world? This is the question with which the study of the economic system of an exchange economy, and the discovery of its forms, has to start” (Eucken [1940] 1950b, 130).

Voraussicht und wirtschaftliches Gleichgewicht" (1935), where he criticized the notion of equilibrium because it assumes perfect foresight on the side of the economic agents. They do not only foresee perfectly well the future underlying variables (data), but also the behavior of the individuals with whom they decide to interact (Morgenstern 1935, 339–340). To this challenge, Hayek responded with two papers "Price Expectations, Monetary Disturbances and Malinvestments" ([1935] 1975) and "Economics and Knowledge" (1937) (Innocenti and Zappia 2005, 74; Leonard 2010, 158). It remains questionable and should be a subject to future research whether this challenge played any role in Eucken's construction of ideal types.

4.2 The External and Internal Dynamics of Ideal Types

My paper interprets that the purpose of ideal types as models is to determine which economic magnitudes are parametric and thus affect the internal dynamic of the model. This is central to the context of the manipulation of the model. According to Morgan (2012), models should be able to be manipulated and from this manipulation one has to be able to deduce a hypothesis. The manipulation of the model represents the external dynamic whereas deductive reasoning represents the internal dynamic of the model.

The *external dynamic* in Eucken's models is derived from hypothetical change in one of the six objective data in a way that is similar to Mises's *Die Gemeinwirtschaft* (1922, 184). In his review of Eucken's *The Foundations of Economics*, Raymond T. Bye (1892–1976) underscored the relevance of hypothetical change in one of the data: "It is through changes in the data and (not through changes in economic laws or attributes to human beings)" (1952, 288) that Eucken studied how historical forces exercise impact on ideal types. This is a central step in studying the relationship between history and theory (Bye 1952, 288). This method, defined as the variation method, was used by Eucken in his investigations carried out in *Kapitaltheoretische Untersuchungen* (Eucken [1934] 1954, 132–133; Machlup 1935, 332). This method was first discussed by Schumpeter (1908), and it was the focal point in the writings of German academics

(Lederer 1922, 2–7) whose main concerns were the conditions under which the new state of equilibrium would be attained (Hayek [1935] 1975, 139; Lutz 1932). In line with Hayek, Eucken described the change in a datum as a dynamic problem that should occupy economists' minds by answering how individuals adapt their plans to this change, and how this affects the pattern of motion of economic variables. Even Eucken stated: "Economic activity is adaptation" (Eucken [1952] 2004, 5–7, my translation; Lachmann 1937, 34–35).

Eucken discussed explicitly the variation method in his *The Foundations of Economics* and suggested the study of transition from one state of equilibrium to another as a superior thought experiment compared to the comparative statics by classical economists. The main reason for this is that the variation method enables theorists to point out how the adjustment process towards a new static state depends on the structure of the ideal type. This is the preparatory step to explain the adjustment process in the observed economic order (Eucken [1940] 1950b, 255).[63] In this vein, Eucken criticized economists such as Keynes and Pigou who did not study the reestablishment of equilibrium after the shock disturbed equilibrium, halting their investigations shortly before this reestablishment should occur (Eucken [1940] 1950b, 254; Blümle and Goldschmidt 2006, 556).

The *internal dynamic* represents deductive reasoning that dissects the process of transition from one state of equilibrium to another. This adjustment (transition) process shows how an ideal type – depending on its (institutional) structure – reacts to change in data. Each ideal type "possesses" its own propagation mechanism that translates the impulse into the economic system. This propagation mechanism shows the explosiveness of the system due to parameters determining the behavior of the economic variables (Frisch 1933, 181–197). In Eucken's work, however, this "explosiveness" should result from institutional assumptions that determine the

[63] Landmann (1976), discussed comparative statics as the dominant approach of the Classics (1976, 164).

parameter and thus reaction of economic variables to change in data. The economic variables in monopolistic ideal types, Eucken believed, would react slowly compared to economic variables within competitive ideal types (Eucken [1940] 1950b, 259; Stackelberg 1940, 274–276). As a result, Eucken's ideal types react with different adjustment speeds, which are determined by institutional factors. In this sense, Eucken suggested an economic analysis akin to that of classical economists which examines the succession of disequilibrium states until equilibrium is reestablished (Eucken [1940] 1950b, 255; Leijonhufvud 1968, 36).[64] The current paper interprets that the Walrasian *tâtonnement* process in Eucken's research program depends on the specific ideal type. For example, if there is a change in datum, such as the level of technical progress, the entrepreneur would decrease his prices in order to attract more consumers in the competitive ideal type, whereas the monopolistic entrepreneur would not be willing to change his position. This rigidity of prices due to market form is the reason for different adjustment processes towards equilibrium.

Despite his criticism of business cycle research, Eucken argued that we ought not neglect its achievements, because this research had formulated important relationships among economic magnitudes. However, theories have to be reformulated because they actually examine the variation of a specific datum within an invariant economic order (Lutz 1932, 165). The main reason for this is that different systems can lead to different symptoms during the cycle: the cycle in the centrally administered economy is expressed by changes in consumption whereas the cycle in the exchange economy is reflected by changes in employment. In this sense, Eucken distinguished between three real types (different from ideal types). First, the economic system

[64] Andreas Predöhl compared Eucken's approach with Schumpeter's understanding of dynamics with the aim to delineate the difference between static and dynamic theory. Predöhl emphasized that static theory is based on isolated abstraction exactly as Eucken formulated it. This theory incorporates realistic assumptions into the equilibrium system with the aim to create instruments to explain reality. Even though the problem of time is central – because of the reactive mechanism – these models remain non-historical (Predöhl 1950,. 20).

consisting of many individual units where exchange is not well developed. Here, the change in datum can have a disastrous effect. The second type is a well-developed exchange economy where prices play central role for the coordination mechanism, bringing about mutual adjustment by means of prices. And the third type of a centrally administered economy where its administration plans the investment rate of the economy (Eucken [1940] 1950b, 258–262).

Eucken's ideal types can explain the conflict between his research program and Keynes's intellectual legacy. Keynes was pursuing a general model with whose help he aimed to explain unemployment. Fundamental for this model was the income-expenditure theory where the multiplier effect and the marginal propensity to consume are central ingredients for the internal dynamic of the model (Patinkin 1979, 11). In this sense, Keynes attempted to break with the Classics who explained the persistence of the Great Depression as a result of institutional factors as price or wage rigidities. This is the reason why Leijonhufvud considered the emphasis on institutional factors by leading Keynesians to constitute heresy within Keynesianism (Leijonhufvud 1968, 37; Samuelson 1950, 147). However, such institutional factors are a focal point in Eucken's ideal types. In other words, in Keynes's view Eucken was a typical classical economist discussing the persistence of crisis due to institutional factors. In this vein, Eucken ([1952] 2004, 310–311; [1940] 1950b, 261–262) still adhered to his explanation of the Great Depression delivered during the discussions of the so-called Lautenbach plan that rigid prices do not allow for a fast adjustment to equilibrium (Borchardt and Schötz 1991, 146).[65] Such an interpretation of the persistence of the Great Depression provided the basis for another Austrian, Gottfried Haberler, to criticize Keynes that the latter did not study the problem of unemployment in a competitive economic system where the flexibility of wages and prices, in

[65] More about Wilhelm Lautenbach's intellectual legacy and his role during the Great Depression (Landmann 1981).

particular, would contribute to the recovery of full employment and thus equilibrium (Haberler 1950, 175–176).

5. The Implications for Current Business Cycle Research

Rühl (1994) and Dal Pont Legrand and Hagemann (2013) issued the hypothesis that Lutz's thesis could be considered as the precursor of equilibrium business cycle theories. Based on the discussion of Eucken's ideal types, this paper hypothesizes that Lutz's equilibrium models diverge from Lucas' model thinking. Lucas' treatment of the coordination process as a self-evident fact gave rise to the neglect of the coordinating function of markets in later business cycle research. In particular, the Real Business Cycle (RBC) concentrated on how the economy, understood as Robinson Crusoe, reacts to exogenous shocks expressed by changes in productivity where the issue of the propagation mechanism was completely driven out of the research program (Landmann 2015, 14; Rühl 1994, 197; Dal Pont Legrand and Hagemann 2019, 23–24).

The most recent history of business cycle research proved Lutz's fears that a concentration on the cycle would neglect the theoretical study of the severity economic crises. Lutz's solution to the business cycle was to concentrate on the process of economic crisis, as a disequilibrium process, and how the equilibrium, understood as a social optimum entailing the full employment of factors, would be reestablished. The explanation should be conducted with the help of abstract models taking into account institutional factors. As discussed in the previous section, Eucken developed ideal types aiming to study how institutional factors determine the reactive ability of the economy to exogenous shocks. The propositions derived from this abstract theory should help explain the crisis and thus develop theoretical explanations of the individual phenomenon. In this endeavor, Eucken aimed to achieve something that was not far away from

Mises's *Die Gemeinwirtschaft* (1922). Mises aimed to show that not every economic system is able to handle exogenous shocks. It was precisely Mises's argument that socialism with its lack of markets and the absence of feasible economic calculation would be unable to reach equilibrium after exogenous shocks; this was the reason why German-speaking economists largely accepted the equilibrating forces of the market order.[66]

The relevance of institutions securing equilibrating forces was the cornerstone of Eucken's, Hayek's, and likely also Lutz's research programs. In Eucken's writings the price mechanism is central to facilitate the coordination process where the power of the market agents[67] can impair the working of this mechanism and thus the readjustment towards equilibrium. The adjustment of economic agents' plans to exogenous shock was also central for Hayek's concept of knowledge. This concept is oriented towards the question how individuals learn what they need to learn, and how they utilize existing knowledge in order to readjust to changes in planning data. Hayek recognized that institutions play a fundamental role for the communication of knowledge. In this vein, equilibrium is not result of the rationality of economic agents, but the institutional framework within which interaction takes place (Klausinger 1990, 65–67). Consequently, Hayek and Eucken did not consider the coordinative and thus equilibrating forces of the market orders as a self-evident fact, as Lucas did, but it was rather the cornerstone of their research program (e. g., Boettke 2018, 82).

Even though Eucken's ideal types have many drawbacks, his approach of ideal types aiming to model the coordination mechanism under different institutional regimes can contribute to understanding the deepness of crisis. The latter should be considered as a disequilibrium

[66] Eucken augmented Mises's argument in his "Theory of Centrally Administered Economy". This work discussed the economic policy during the period of 1933–1945, which entailed more and more elements of central planning. One of the main arguments was the decreased ability of the economy to react to exogenous shocks (Eucken 1948, 188–189).

[67] Regarding the problem of the "power" in Eucken's intellectual legacy see Kolev ([2013] 2017).

problem whereby the transition to the new equilibrium depends on institutional factors. The focal point is how agents would react to this disturbance and in which manner institutions facilitate this adjustment process. These are important implications for current business cycle research.

6. Conclusion

This article concentrated on how Eucken's economic orders can contribute to an explanation of the severity of economic crises. The concept of economic orders aimed to bridge the gulf between theory and history. Eucken exemplified the fruitfulness of his approach by discussing the intensity of different economic crises. In this sense, Eucken adopted essential insights by Lutz who had criticized the business cycle approach and pleaded instead for the study of individual crises. The current article suggested that this can be understood in the context of the impulse-propagation dichotomy in Ragnar Frisch's sense, namely the concept that crisis is a disequilibrium problem. There, the economic order determines the propagation mechanism whereby the adjustment to equilibrium depends on the structure of the system. According to Eucken, the economic order is individual, but the consisting elements of economic order characterized as ideal types provide the general devices with whose help hypotheses about economic relationships can be deduced. I discussed the relevance of the ideal types in two steps. First, I discussed their construction which is based on planning by the individual agent. This construction determines the parameters of the model. Secondly, based on Morgan (2012), I distinguished between external and internal dynamics of the models. The external dynamics, i. e. the manipulability of the model, is represented by the variation method. Here, Eucken discussed how a change in datum should affect the economic relationships within the ideal type. This change in datum is the impulse in Eucken's model and is a central step in studying the relationship between history and theory. The internal dynamics illustrate the transition process which demonstrates how the equilibrium is reestablished in the ideal type. The reestablishment process is determined by the (institutional) parameters inherent to each ideal type, representing its propagation.

With the internal dynamic, Eucken demonstrated that he did not change his mind regarding the explanation of the Great Depression, namely that institutional factors delayed the adjustment process – an explanation that he delivered at the conference discussing the Lautenbach plan. Exactly this explanation of the Great Depression is diametrically opposed to Keynes's general model (1936), which postulates that institutional factors are not the reason for the persistency of the Depression. With such a general model, Keynes aimed to explain the instability of capitalism. This methodological approach stands in conflict with Eucken's because the latter suggested that reality cannot be explained with only one model (Ostrom 2014). Even though Eucken's model thinking possesses many drawbacks, it contains an important message regarding the incorporation of institutional factors into the coordination problem which is central to understanding the severity of crisis. These are implications which should be considered in future business cycle theory trying to explain the persistence of shocks.

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V. Emigration with a Pulled Handbrake:

Friedrich A. Lutz's Internal Methodenstreit[*]

Abstract

My paper reconstructs the path of German economist Friedrich A. Lutz (1901–1975) to American economics. The correspondence with his former teacher Walter Eucken, the founder of the Freiburg School, constitutes a crucial and yet unexplored source for the paper. Through Lutz's case, I demonstrate the growing gulf between German and Anglo-Saxon economics during the late 1930s. In his native Germany, Lutz was trained in methodologically and institutionally focused economics, which differed fundamentally from the mathematical economics dominating Anglo-Saxon academia. He realized that an academic career in the US would be impossible if he did not adapt to the new methods, and if he did not abandon the methods of the German tradition. This gave rise to his internal Methodenstreit. After the emigration in 1938, he constantly experienced doubts and tensions because he was convinced that without considering institutions, mathematical economics was doomed to fail to explain the occurrence and essence of macroeconomic phenomena. Despite his stellar career at Princeton, it was only after 1953 at Zurich, where he taught history and theory of socioeconomics for the rest of his life, that Lutz could reconcile this internal Methodenstreit.

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1. Introduction

Friedrich August Lutz (1901–1975) made a stellar career as a professor of money and banking at Princeton. According to his Princeton file: "Professor Lutz [was] an outstanding scholar in three fields – economic theory, money and banking, and international trade and finance. He [had] an international reputation in all three fields."[68] Lutz's path to international reputation was anything but easy. As a student of Walter Eucken (1891–1950), he was pre-occupied with methodological struggles against the still dominant Historical School in his native Germany and attempted to establish a communication with the Anglo-Saxon economic community. The Historical School's hostility to abstract-deductive theory isolated German economic research more and more from the developments of Anglo-Saxon economics.

My paper is a case study of how a German economist educated in an academic environment still dominated by the Historical School became part of American economics. This contributes to the research about the process and consequences of German-speaking economists' emigration to the US in the late 1930s and early 1940s (Hagemann 1997; Hagemann 2005). Among others, Paul Samuelson emphasized that the development of American economics was "enormously accelerated by importation of scholars from Hitlerian Europe" (Samuelson 1988, 319). I demonstrate that emigration to the US gave rise to Lutz's internal Methodenstreit. He was unable to fully accept the new mathematical methods: on the one hand, because he did not possess the mathematical skills: on the other, he disapproved of this mathematical treatment because it neglected the relevance of institutions for explaining macroeconomic phenomena. Lutz realized that a research program like the one of the Freiburg School, or of German economic thought more generally, heavily based on methodological and institutional considerations, was "out of fashion" in Anglo-Saxon economics. This was the primary reasons

[68] Alumni and Faculty Offprint Collection, Folder "Lutz, Friedrich" (Box 29, Folder 12), Princeton University.

why after the Second World War, Lutz came back to Europe to continue his research in the ordoliberal tradition.

The paper delineates three reasons why Lutz's case study should be relevant for the transatlantic history of economics during the interwar period:

1) First, his publications in the area of monetary economics, monetary policy, and international monetary theory established him as an expert in the field of money and banking. The American Economic Association appointed Lutz as a co-editor with the Chicago economist Lloyd Mints of the selection committee for the volume *Readings in Monetary Theory* whose purpose was to republish the leading papers in this area (American Economic Association 1951).
2) Second, Lutz was very well connected to top-tier American economists, and this connectivity was the reason why Hayek thought of Lutz when envisaging the appropriate person to write the US version of *The Road to Serfdom* (Caldwell 2011, 303). Further evidence for his connectivity services through Lutz's membership in the Bellagio Group, where William J. Fellner, Gottfried Haberler, Peter B. Kenen, Charles P. Kindleberger, Fritz Machlup and Robert A. Mundell discussed topical theoretical and practical problems of international monetary policy (Dal Pont Legrand and Hagemann 2013, 249).
3) Third, he has been remembered as an inspiring teacher who was able to explain complex phenomena in a clear and straightforward manner, something that his student and the later Fed Chairman Paul Volcker described as formative for his decision to start studying monetary economics (Silber 2013, 17).

Lutz did not leave behind any archives, his library was integrated into the Walter Eucken Institute in Freiburg. The only archival source about Lutz's life is the correspondence with his teacher Eucken.[69] The correspondence covers the period 1927–1950 which only became accessible several years ago with the processing of the Walter Eucken Papers at Thüringer Universitäts- und Landesbibliothek at the University of Jena.

2. The German Methodological Years

Lutz was born on December 29, 1901 in Saarburg (now Sarrebourg) in Alsace-Lorraine, then at the Western periphery of the German Empire – two years after Friedrich A. Hayek and Wilhelm Röpke, and one year before his future Princeton colleague Oskar Morgenstern. Lutz belonged to this "fin-de-siècle generation" born on the eve of the new century. The tragedies of Great War and the instability of the Weimar Republic shaped his economic and political thinking (Kolev and Köhler 2021, 8–9). Lutz's father, also named Friedrich Lutz, was a brewery owner and had died two months before his birth. Young Friedrich grew up with his mother Amélie Lutz, née Metzger, and four siblings. The First World War brought many tragedies to Lutz's family. He, who was too young to be drawn into the war, lost his elder brother on the battlefield and his native Saarburg which became part of victorious France. The strong German sentiments in Lutz's family could not accept the new French administration, so they left for Stuttgart in 1919 (Veit-Bachmann 2003, 10).

Lutz started his study of economics at the University of Heidelberg in 1920. One year later, he moved to Berlin where the German Historical School was still dominating the academic landscape. During his Berlin years 1921–1925, the acquaintance with the young lecturer Walter Eucken became formative for Lutz (Veit-Bachmann 2002, 158; Kolev and Köhler 2021, 18–20). In 1925, Eucken was appointed professor of economics at the University of Tübingen not

[69] Walter Eucken Papers, Folder "Friedrich A. Lutz", Thüringer Universitäts- und Landesbibliothek, University of Jena.

far from Stuttgart and accepted Lutz as his first doctoral student. In 1925, Lutz defended his doctoral thesis *The Current Disputes on Capital Theory* (1927).[70] The thesis provides a short glimpse at how Lutz conducted research in the history of economics. He classified economists according to the method they adopted to study the origin and purpose of capital. This approach to history of economics that focused on issues of methodology would become fateful for Lutz's later career. After defending his thesis, Lutz moved to Berlin where, upon Eucken's intermediation, he worked in the department for economic policy of the Mechanical Engineering Industry Association, headed by Eucken's friend and later ordoliberal fellow Alexander Rüstow (1885–1963). Meanwhile, Eucken was appointed professor of economics at the University of Freiburg in 1927. Lutz accepted a position as a research assistant at Eucken's chair in 1929 when he focused on his habilitation thesis (Brintzinger 1996, 45; Veit-Bachmann 2003, 12–13).

As Eucken's assistant, Lutz joined his teacher's quest against the Historical School. The roots of his teacher's hostility can be traced back to Berlin years 1921–1925, when Eucken was a young lecturer and functioning as the managing editor of *Schmollers Jahrbuch*. He broke with the legacy of the Historical School whose descriptive methods were oriented at collecting economic facts about specific industries or countries without any theoretical considerations. For example, Eucken's dissertation thesis described the cartels in the maritime industry (1914), while his habilitation thesis discussed the global nitrogen supply (1921). As a lecturer, Eucken focused on price and currency theory based on abstract economic thinking (Klinckowstroem 2000, 62–66; Veit-Bachmann 2002, 158), most probably using Gustav Cassel's *Theory of Social Economics* (1918). This book introduced the Walrasian system to non-mathematicians and was considered a standard textbook in the 1920s, helping many German young scholars to break with the Historical School (Predöhl 1972, 11; Köster 2011, 28, 101–102).

[70] Unless stated otherwise, all translations from German are mine.

This emancipation process was institutionalized during the late 1920s when Eucken and Rüstow founded a group of young economists who called themselves "German Ricardians". The name did not mean they adopted Ricardo's labor theory of value or any specific part of Ricardo's intellectual legacy (Janssen [1998] 2012, 38); rather they intended to reconnect German economics to abstract economic theory and provoked the representatives of the Historical School, who saw in Ricardo the epitome of abstractness and detachment from reality (Schmoller [1893] 1949, 74; Köster 2011, 56). For them, the descriptive methods of the Historical School failed to shed light on economic reality and, in particular, to explain the occurrence and essence of what we nowadays denote as macroeconomic phenomena. Lutz remembered later as professor at Zurich that the mere collection of facts had made the Historical School economists unable to explain and combat the hyperinflation in 1921–1923. They not only failed to identify the reasons for it, but, most importantly, were unable to provide any substantial recommendations for economic policy to combat the disastrous phenomenon (Barkai 1991, 38–39). In Lutz's memory, the younger scholars never forgave the Historical School this fatal moment of incompetence (Lutz 1971, 62–63).

Yet an irreconcilable hostility emerged among the Ricardians about what abstract economic theory was supposed to answer and thus what methods should be applied (Köster 2011, 222–223). Two socialist economists, Adolf Löwe (1893–1995) and Emil Lederer (1882–1939), pleaded for the foundation of a new (dynamic) economic approach that could explain the instability of capitalism. The most notable expression of this position was the one in Löwe (1926) which Simon Kuznets assessed as "brilliant" (Kuznets 1930, 128, fn. 1; Hagemann 1994, 106). According to Löwe, the existing (static) laws of economic theory failed to explain the dynamics of capitalism which was prone to excessive booms and depressions. In his eyes, booms and depressions reflected the inherent tendency of capitalism to disequilibrium where prices and quantities moved simultaneously upwards (during the boom) and downwards (during the depression) and, most importantly, the aforementioned directions of economic magnitudes changed on a regular basis. This observation stood in diametrical opposition to an economic theory which deduced its logic from the clearing function of markets by constructing such relationships among prices and quantities that equilibrium was always established. Market-oriented economists such as the Austrians Ludwig von Mises and Friedrich A. Hayek trusted in the equilibrating forces of markets and stressed the relevance of the existing Walrasian economic theory. They identified the one-sided change in money supply as the ultimate reason for disturbance of the coordination mechanism of markets (Klausinger 2013, 13–15; Grudev 2020, 22–25). Hayek's habilitation thesis *Monetary Theory and the Trade Cycle* (1929) represented the most notable response to Löwe's criticism (Hagemann 1996, 102; Hagemann 2002, ix; Klausinger 2013, 12–13). In the English edition [1933a] 1966, Hayek introduced a footnote to clarify for the English audience that he understood under equilibrium "the natural tendency of economic system to clear markets" (Arena 1994, 211), which should be the benchmark to study the cycle as a disequilibrium phenomenon (Hayek [1933a] 1966, 42).

The incorporation of this footnote indicated one of the earliest steps towards future cooperation between Hayek and the members of Freiburg School. Hayek cited Leonhard Miksch's dissertation thesis *Is There a General Overproduction?* (1929) supervised by Walter Eucken. Miksch was another talented student of Eucken who was a close friend of Lutz and also played a formative role in the foundation of Freiburg School (Goldschmidt and Berndt 2005). Miksch's thesis was positively reviewed by Hayek in the Viennese *Zeitschrift für Nationalökonomie* (Hayek 1930), which itself evolved into a fundamental platform for business cycle and capital theory debates with relevant contributions to general equilibrium theory (Hagemann 1997, 13). Hayek's review applauded the relevance of Miksch's research for its history of economics perspective on equilibrium concept and his attempts to point out how money disturbed the equilibrating forces of markets. He agreed with Miksch that the idea of equilibrium underlining

Say's Law was the fundamental benchmark to construct a business cycle theory. There were no other factors inherent in the exchange process that disturbed Say's Law, other than changes in money supply that could damage the equilibrating forces of markets. Hayek identified in Miksch an ally against the dominant non-monetary explanation of business cycle in the German-speaking area such as Löwe's one (Hayek 1930, 626; Grudev 2020, 24).

Three years after publication of Miksch's thesis, Lutz also contributed to the debate with his habilitation thesis *The Business Cycle Problem in Economics* (1932). He accused the participants of spending too much energy in proving why and what gave rise to the periodic recurrence of crisis, instead of concentrating on why crises could reach disastrous dimensions (Rühl 1994, 188–189; Hagemann 2002, xvi –xviii). The habilitation thesis shared Eucken's epistemological position about interpreting individual historical events, as economic crises, as well as Miksch's and Hayek's understanding of money in context of equilibrating forces of markets (Grudev 2019, 8; Grudev 2020, 24).

Lutz and Eucken criticized business cycle theory because its approach reflected an irreconcilable conflict between squeezing all individual events into a general scheme and developing abstract theory oriented to explain the reason for these events. There was a division of labor between teacher and student. The teacher saw in business cycle research an example of historicism originating from Karl Marx's works that tried to formulate a general dynamic law of capitalism with whose help business cycle theorists hoped to deliver an explanation of the periodic recurrence of crisis (Eucken [1940] 1950, 246, 329; Goldschmidt 2016, 190; Grudev 2020, 28–32). The student conducted a vast history of economics study from the founder of business cycle research Clément Juglar to the most recent works of Ragnar Frisch and Nikolay Kondratieff, and pointed out that business cycle theorists failed to explain the crisis as a necessary consequence of the instability of capitalism. Either their attempts ended up as descriptions, as in the case of Juglar and Cassel, or the wave-like movement was replicated by mathematical formulas, as in the case of Frisch or Kondratieff (Lutz 1932, 32–35, 135; Grudev 2019, 8–11).

Lutz concluded that each crisis represented a unique historical event that should be explained in its historical setting. This was not a concession to the Historical School, but a quest to construct ideal types as models for explaining macroeconomic phenomena. In this context, the equilibrium approach was the fundamental benchmark to study how exogenous factors could affect the relationship among microeconomic variables. The aim of these models was to ascertain how the reestablishment of equilibrium depended on the institutional factors. Translated into plain English, the models should identify the set of institutions surrounding the exchange process among individuals. The same ideal types should be applied to different instances in time and space. The task of the economist was to show how exogenous shocks affected the exchange process among individuals within different institutional frameworks. Lutz intended to demonstrate that the institutional framework determined the speed of recovery from an economic crisis (Lutz 1932, 160–165; Grudev 2019, 16–19).

Lutz's main message demonstrated that he did not completely abandon the achievements of the Historical School, because their descriptive accounts understood the crisis as an individual phenomenon. However, without the theoretical instruments of the ideal type, economists were unable to explain the occurrence and essence of macroeconomic phenomena. Lutz's thesis indicated that it was written in the context of the Eucken–Hayek generation which deployed economic sociology as developed by Friedrich Wieser and Max Weber, a research program aiming at the reconciliation of the battle fields left behind by the Methodenstreit between Schmoller and Menger. The initial debate focused on the irreconcilable dichotomy between history and theory, and the in-(variability) of the categories of political economy. The Weber–Wieser generation introduced economic sociology as an intermediary layer to overcome the bipartite divisions of "theory-or-history / abstractness-or-concreteness / deduction-orinduction" (Kolev 2020, 48). My paper argues that Lutz promoted the employment of economic sociology and economic history in explanation of macroeconomic phenomena by combining sociology and history with theory.

Almost immediately after the book's publication, Hayek endorsed Lutz's main message in his 1933 Copenhagen lecture.

> "As has recently been shown very convincingly by Dr. Lutz, our task is not to construct a separate theory of the trade cycle, that is of a construction of a detailed scheme which will fit all actual trade cycles, but rather a development of those sections of general theory which we need in the analysis of particular cycles which often differ from one another very considerably." (Hayek [1933b] 1975, 138).

Hayek summarized Lutz's critique of all attempts to construct dynamic theories aiming to explain the business cycle phenomenon (Hayek [1933b] 1975, 136). This criticism of dynamic theories was conducted at the meeting of the Danish Economic Association (*Socialøkonomisk Samfund*) and was later published in German in the Danish journal *Nationaløkonomisk Tidsskrift* (Hayek [1933b] 1975, 135 fn. 1), where Frisch published his pathbreaking paper "Statikk og dynamikk". Now we can understand whom Hayek had in mind when he criticized the new attempts to explain dynamic phenomena:

> "What we all seek is therefore not a jump into something entirely new and different but a development of our fundamental theoretical apparatus which will enable us to explain dynamic phenomena." (Hayek [1933b] 1975, 137).

While Lutz's most relevant contribution was the proof that there was no reason to assume a general recurrence of crises, in my opinion his response to the first part of Löwe's vision of capitalism where prices and quantities move simultaneously, constituted the weakest side of his thesis. Lutz shared the view of his colleague Miksch that monetary factors gave rise to this simultaneous motion. However, Lutz discussed this only on seven pages (Lutz 1932, 106–113). Whether in the context of an individual treatment of a crisis this represented a concession that monetary factors actually played the primary role was not clearly indicated by Lutz. Very soon, however, money and the monetary institutional framework would gain the dominant role in Lutz's mature research program.

3. The Encounter with English High Theory

Lutz gained his habilitation after delivering the inaugural lecture "Current Problems of the German Mechanical Engineering" on February 29, 1932,[71] which qualified him for a professorship. He became Eucken's first student who was granted the right to lecture at the university, the venia legendi (Brintzinger 1996, 45). As a lecturer at Freiburg, Lutz taught "Current Disputes in Monetary Policy", "Currency and Money", "Problems of Business Cycle Theory" as well as statistical tutorials (Brintzinger 1996, 46). In this respect, one can identify a further division of labor between his teacher and him: Eucken concentrated on this part of institutional framework that shaped market forms in which exchange took place, while Lutz concentrated on this part of institutional framework that shaped the forms of means of exchange, money, "which the individual economic units used to facilitate their transactions" (Eucken [1940] 1950, 159). The influence of the institutional framework on the market forms of exchange and means of exchange are two fundamental pillars of Eucken's concept of economic orders (Eucken [1940] 1950, 119–173). These two pillars are of particular relevance when one aims to investigate the severity of economic crises (Albert 2009, 95; Grudev 2020, 28–32).

[71] Faculty of Law and State Sciences 1920–1963 Collection, Folder "Friedrich A. Lutz" (Box 110, Folder 373), University of Freiburg Archives.

A fundamental milestone for the division of labor between student and teacher, and thus for the formation of the Freiburg School, was Lutz's Rockefeller Fellowship in England. Lutz joined those young scholars from Central Europe who regarded the Followship as a welcome opportunity to study Anglo-Saxon economics and to establish contacts with their peers in England and the US (Syga-Dubois 2019, 1–10). In the summer of 1934, Lutz applied for the Fellowship with the aim to expand his knowledge of English monetary theory and banking. He planned to spend the academic year 1934/1935 in London at LSE where he should concentrate on the practical aspects, and three months at Cambridge where he should focus on the theoretical foundations (Syga-Dubois 2019, 751).

Instrumental in Lutz's decision to give priority to LSE was Hayek's doctoral student Vera Smith (1912–1976) whom he had met in Freiburg in 1934 and whom he married in 1937 (Hayek 1983, 362; Cubitt 2006, 78). This decision to spend the prevailing part of the Rockefeller year at LSE was regarded as unusual by German scholars, as visible from his letters to August Wilhelm Fehling (1896–1964), a historian who was responsible for selecting the German students eligible for Rockefeller Fellowships during 1925–1936. His sympathetic ear and desire to help the young scholars allowed Lutz to be more honest about his choice. Fehling advised him to spend the academic year at Cambridge because at LSE:

> "The conditions for a German have become more difficult because of the attitude of some members of the faculty, especially in your field, and because of the emigrants, that the self-assertion requires all too great strength." (Fehling to Lutz, 22.09.1934).[72]

Lutz responded that he had already heard similar accounts of LSE's academic environment. He had no intentions to "jump" into the LSE community, but to seek contacts with people from

[72] August Wilhelm Fehling Papers, Folder "Friedrich A. Lutz" (Box 1106, Folder 40), German Federal Archives Koblenz

practical life. He even voiced that he intended to avoid any contacts with emigrants (Syga-Dubois 2019, 544). In this way, he could concentrate on his monetary and currency research (Lutz to Fehling 25.09.1934). Vera Smith probably played a pivotal role in Lutz's acclimating in London. Smith herself experienced the formation of the Economics Department at LSE under the influence of Lionel Robbins (Howson 2010, 166). Her academic career was intimately related to LSE's academic environment, as her former colleague John R. Hicks remembered (Hicks 1984, 55). At the age of 18, in 1930, she started her study of economics at LSE and graduated with the doctoral thesis "Free Banking, or, A Reconsideration of the Historical and Analytical Basis of Central Banking" (1935) under Hayek's supervision (Haberler 1984, 47). This provided the basis for her book *The Rationale of Central Banking and the Free Banking Alternative* ([1936] 1990), which later on was reviewed favorably by economists with affinities for the Austrian School (Schwartz 1984; Yeager 1990; Zelmanovitz 2019).

Hayek showed great respect for Smith as an economist (Hayek 1983, 362). This was the reason why he gave her his manuscript of the unfinished project about the history of monetary theory that he had started for a volume on money and credit in the *Grundriß der Sozialökonomik* (*Outline of Social Economics*), an encyclopedia initiated around 1910 by Max Weber, whose aim was to collect the dispersed knowledge of German political economy (Hennecke 2000, 92; Klausinger 2013, 9; Kolev 2018, 12–17). Hayek advised Smith to go to Freiburg and deepen her knowledge of German monetary theory. Recommending Freiburg was hardly a coincidence. As already mentioned, Hayek knew that Eucken's students Lutz and Miksch focused on the monetary explanation of the business cycle. Furthermore, Eucken and his Freiburg colleague Karl Diehl (1864–1943) established themselves as leading monetary theorists in Germany (Ellis [1934] 1937, 91–92, 224–230). Hayek himself met both economists at the 1928 meeting of the Verein für Socialpolitik in Zurich where, in a session chaired by Diehl and attended by Mises and Hayek as discussants, Eucken presented a paper about the relationship between commercial bank credit creation and the business cycle (Eucken 1929). The presentation clearly indicated that the Freiburg economist sided with the Austrians who insisted on monetary explanation of the business cycle (Blümle and Goldschmidt 2006, 554; Vanberg 2013, 94; Grudev 2020, 25–28).

Smith benefited from her short stay at Freiburg. A glimpse at Smith's dissertation indicates that Lutz might have helped his future wife in the chapters "Development of Central Banking in Germany" and "The Discussions in Germany". The writing of these chapters resulted from Smith's intensive reading of literature about German banking and monetary system, which probably took place at Freiburg because in later letters from England, Lutz bemoaned that such literature was hardly available at LSE or Cambridge. Furthermore, the readings required profound skills in German, on top of that they were mostly written in Fraktur, the typesetting used in German-language countries until the beginning of the Second World War.

After finishing these chapters, "She came back bringing Lutz to London, and after a while they married." (Hayek 1983, 362). Lutz was "brought" to LSE on October 1, 1934 (Lutz to Eucken, 02.10.1934), in the middle of a period that was later described by Hayek as "the most exciting period in the development of economic theory" (Hayek [1963] 1995, 49). This specific notion of economic theory stood in complete contrast to Lutz's research interests originating from his habilitation period, and also indicated the ever larger and unbridgeable gulf between German and Anglo-Saxon thought which emerged in the course of the 1930s. The development of Anglo-Saxon thought was documented by G. L. S. Shackle in *The Years of High Theory* ([1967] 1973). In the late 1920s and early 1930s, Shackle dichotomized two main branches: value theory with its main representatives Sraffa and Hicks, and monetary theory with its main representatives Myrdal and Keynes (Shackle [1967] 1973, 12).[73]

Lutz experienced the dominance of Hicks at LSE. His contributions to value theory and mathematical economics struck Lutz as an abstract mathematical treatment that deprived the students from grasping the interdependences among institutions and the relevance of the institutional approach to the economic process:

> "I am glad that I am a bit older and experienced in economics, otherwise I would have fallen a victim to the scam and considered investigations of demand curves and such things as the ideal. The students whom I often talk to also seem to me to be on entirely the wrong track, everywhere one sees them drawing curves and debating about them […] If I could do mathematics, I would write a critique of the mathematical school – it seems to me extraordinarily important, because if the edifice of Walras is a palace in which one cannot live, then what is being done here now ceases to be a palace at all, a lot of rooms and ornaments with no regard for the building as a whole." (Lutz to Eucken, 09.11.1934)

He characterized this kind of economics as "mathematical detail research" (mathematische Detailforschung). In the same letter, Lutz gave as an example Hicks's "A Reconsideration of the Theory of Value I" (1934) that Hicks had produced with the mathematical economist R. G. D Allen, so that Eucken could get a "vague impression of what Hicks is actually doing" (Lutz to Eucken, 09.11.1934). Shackle characterized this paper as "the real achievement" whose aim "was to make known the indifference-map to the Anglo-Saxon world" (Shackle [1967] 1973, 9). The concept of indifference curves had been unknown to Lutz before, so Hicks's paper was

[73] This dichotomy was already discernable in Hicks's essay "A Suggestion for Simplifying the Theory of Money" (1935), where Hicks claimed that "[t]o anyone who comes over from the theory of value to the theory of money, there are a number of things which are rather startling." (Hicks 1935, 1).

undoubtedly terra nova for the German economist. In one of his reports to the Rockefeller Foundation, Lutz lamented how difficult the contact was with the LSE scholars because they considered monetary and currency issues “out of fashion”, whereas “I am not interested in demand curves and refinement of value theory” (Lutz to Fehling 10.11.1937).

Lutz was interested in deepening his knowledge of the English monetary system, and in this endeavor, he decided not to rely on the LSE economists (Lutz to Fehling, 15.09.1934). He imagined continuing the envisioned research program he had initiated with his habilitation thesis, namely to explore how the monetary institutional framework could affect the depth of economic crises. Lutz found refuge in Philip B. Whale’s seminar on money and banking. Whale started as a lecturer in commerce at LSE and had been lecturing on currency and banking since the academic year 1926/1927 (Howson 2011, 168). In Lutz’s eyes, he was the only expert on monetary theory at LSE. Whale even provided Lutz with a letter of recommendation for Cambridge addressed to Keynes and D. H. Robertson (Lutz to Eucken, 27.04.1937). Lutz attended Whale’s seminars where he presented several papers. His first paper focused on the German banking system and was based on his lecture notes from Freiburg (Lutz to Eucken, 07.02.1935). The most notable paper was “Gold Standard and Economic Order” (Lutz to Fehling, 10.11.1934), with which Lutz made his first steps towards monetary institutional analysis and thus joined his future wife’s research program. The two economists were united in the quest for an institutional framework that could check the money supply by controlling the creation of bank deposits and could thus abolish excessive economic booms and crises (Haberler 1984, 47).

Along with “Gold Standard and Economic Order” (1935a) that was published in the German *Weltwirtschaftliches Archiv*, during his English period Lutz produced the papers “On the English Money Market” (1935b) and “On the Velocity of Money” (1936a) where he stressed the interdependences between the monetary institutional framework and the other elements of the economic order. In Lutz's assessment, the severity of the economic crisis depended crucially on these interdependences. These papers would provide the basis for his future analysis of the 1931 banking crisis (Lutz 1936b), a book, that was among the earliest volumes of the Freiburg School's series "Order of the Economy".

4. Lutz's Disappointed Expectations and the Inevitability of Emigration

Upon Lutz's return to Freiburg in 1935, Eucken proudly wrote in a letter to his mother, the painter and artist Irene Eucken (1863–1941):

> "Lutz, who has returned from England, is indeed developing excellently. He is now a leading younger economist. It is true that a kind of Eucken school is now developing. I did not even try to do that. But it became clear to me during my visit to Berlin in September that this is the case, that a certain school exists." (Dathe and Goldschmidt 2003, 64).

This close intellectual nexus, however, would make Lutz's academic career in Nazi Germany virtually impossible. Before he left for England, Lutz witnessed how his teacher was involved in several debates with the newly established regime. The first surfaced by the diametrical position that Eucken took against Freiburg's newly elected rector in 1933, Martin Heidegger. Eucken did not conceal his disagreements with Heidegger during the senate sessions and became the voice of a latent opposition at Freiburg (Brintzinger 1996, 82 –83; Klinckowstroem 2000, 85–86; Goldschmidt 2013, 142; Köhler and Kolev 2013, 218). The Nazis envisaged Heidegger as the right person that could enforce Nazi ideology in the traditionally independent German university. In this endeavor, Heidegger sought support from young academics, scholars and even students with whose help he tried to overcome the professorial resistance against his policy (Grunenberg [2008] 2016, 189). The conflict between Heidegger and the professors escalated when Heidegger intervened in the appointment procedure within the Faculty of Law and State Sciences, in which Eucken played a dominant role. Heidegger thwarted the faculty's plans to appoint Adolf Lampe, an economist who oscillated around the Freiburg School (Kolev and Köhler 2021, 11), as a successor to Karl Diehl's chair, and favored an economist associated to the Nazi party, Carl Arnhold. This opposition was the final tipping point towards Heidegger's decision to resign from the position of rector (Brintzinger 1996, 100–101; Klinckowstroem 2000, 85–86; Goldschmidt 2013, 142).

Another debate initiated by Eucken targeted the intellectual tendencies prevailing in academia as promoted by the Nazi regime. Eucken and the legal scholars at Freiburg Franz Böhm (1895–1977) and Hans Großmann-Doerth (1884–1944) launched a book series entitled "The Order of the Economy" which eventually contained five volumes. This series was introduced with a manifesto-like pronouncement "Our Task" (Böhm, Eucken and Grossmann-Doerth [1936] 1989), a document which is commonly considered to signal to the outside the Freiburg School's founding (Goldschmidt and Wohlgemuth 2008, 21). The manifesto criticized the current state of German jurisprudence and economics which were both still dominated by historicism. This tendency was an immediate consequence of the emigration of especially those German economists like Löwe, Lederer, Röpke and Rüstow who, during the 1920s and early 1930s, had contributed to the stronger theoretical orientation of German economics (Hagemann 1997; Janssen [1998] 2012).[74]

The Freiburg scholars might have recognized that these characteristics of German economics turned out to be a double-edged sword. On the one hand, they recognized that the Marshallian

[74] Erich Schneider, one of Schumpeter's doctoral students at Bonn and among the most prominent Keynesian economists in postwar Germany, remembered that Schumpeter's appointment to the University of Bonn was treated as a sensation by Bonn students. In Schumpeter's orbit, they could study the theories of Böhm-Bawerk, Cournot, Edgeworth, Marshall and Fisher and not only hear their names (Janssen [1998] 2012, 64–65; Dal Pont Legrand and Hagemann 2013, 250).

legacy dominating English economic thought deprived the students from grasping the relevance of institutions for the economic process (Eucken [1940] 1950, 206). On the other hand, without a strong theoretical core, German economics had been soaking in the nationalist and historically relativist tendencies dominating the political landscape of the Weimar Republic (Janssen [1998] 2012, 133–154; Köster 2011, 121–123, 152; Goldschmidt and Hesse 2013, 143–144).[75] This gave rise to the formation of a group of economists who called for a new foundation of German economics independent from the so-called "liberalistic" English economics. Such parochial and nationalist thinking was not on the minds of the German Ricardians where Lutz and his teacher Eucken were involved. The nationalist economists who were rather in the minority during the Weimar Republic were promoted during the Nazi regime whereas almost all members of the German Ricardians were forced to emigrate for racial or political reasons. This transformed the academic environment and diminished the chances for an academic career for those economists who sought the contact with Anglo-Saxon economics or research in neoclassical economics more generally (Rieter and Schmolz 1993, 91–96; Janssen [1998] 2012, 159–165; Hagemann 1997, 10).[76]

Lutz became a victim of these tendencies. His fellowship in England and his association with the Eucken circle in Nazi Germany closed most of the doors to academia. Particularly his book *Fundamental Problem of Monetary Constitution* ([1936] 1962) as the second volume in Eucken's series "Order of the Economy" represented a unique document of the unbridgeable

[75] Goldschmidt and Hesse have published a translated letter from Eucken to Hayek, where Eucken described the intellectual tendencies in the Weimar Republic (Goldschmidt and Hesse 2013, 143–144).

[76] Hayek expressed his indignation in *The Road to Serfdom* how, "with few exceptions", German scholars and scientists joined the doctrine of the Nazis which "[i]s one of the most depressing and shameful spectacles in the whole history of the rise of National-Socialism" (Hayek [1944] 2006, 196). These few exceptions could be the scholars at the University of Freiburg because later Hayek remembered that Freiburg was among the few German universities during the Nazi regime which was able to preserve the independence of its intellectual life (Hayek 1983, 362).

gulf between his research and the "new German economics". Lutz argued that the monetary institutional framework was responsible for how Germany and the US experienced the deep banking crises. This stood in contrast to the resilience of the English monetary system during the 1931 banking crisis. He traced the source to Peel's Act of 1844 that required the Bank of England to separate money issue and credit provision. Lutz argued that a similar act should be employed in Germany, based on the 100% reserve money proposal promoted by Chicago Plan, where the central bank had full control of the money supply, while commercial banks only concentrated on the qualitative selection of credit borrowers (Lutz [1936] 1962, 86–102).

Critical reviews from Nazi economists did not wait long. In *FinanzArchiv*, one of the leading German journals, Lutz was criticized for having misinterpreted the reasons for the severe banking crisis in Germany. The reviewer Siegfried Faßbender, whose most famous book National Socialist Economics and Peoples' Freedom (1943) clearly indicated his political sentiments, was certain that a monetary institutional framework such as the English one would not have saved the German economy from disaster. This had been not an economic event, but a "political attempt to ruin us financially" (Faßbender 1939, 159).[77] Taking into account the political rhetoric in Germany in the late 1930s, we can imagine that the victorious countries from the Great War were considered responsible for the deliberate destruction of the German economy. Such political rhetoric was diametrically opposed to Lutz's institutional analysis. In his London paper "Gold Standard and Economic Order" (1935), he supported the gold standard as the monetary institutional arrangement that corresponded to a free market economy. In this way, Lutz took a rather provocative stand because he was fully conscious of the political dimensions of this problem. He raised the questions:

[77] Even though the review was published in 1939, Faßbender should have occupied the minds of Eucken and Lutz much earlier, because in one of his first letters from the US, Lutz asked "Who is actually Faßbender?" (Lutz to Eucken, 19.07.1937).

> "Does a particular monetary constitution not only correspond to a particular economic order, but is this order itself perhaps also dependent on a particular political order? Does the economic equilibrium of the free-market economy presuppose a political equilibrium? We do not have to answer these questions here." (1935, 247).[78]

These were bold questions during the Nazi dictatorship, given the intolerance of the Nazis regarding any doubts about their vision of the political order (Bernholz 1989, 196; Veit-Bachmann 2003, 29–30).

Hence, it was not a surprise that Lutz was deprived of an academic career in Germany. Even in his later letters from the US, he described that he had lost hopes for university or other academic positions in Hamburg, Leipzig, Kiel and Berlin. There was only one extant anonymous 1938 report delivered to the Nazi Party which claimed that Lutz belonged to "those type of lecturers that we National Socialists would not wish for" (Syga-Dubois 2019, 636). Lutz himself was aware of his teacher's explanation when the University of Leipzig refused to appoint Eucken in 1935. Eucken explained to his mother that he did not have any expectation of appointment at all, because he was considered a "liberalist" (Dathe and Goldschmidt 2003, 64). Lutz's research program was also labelled as "liberalist" by the dominating economics in Germany at the time. Such a hostile academic environment could be regarded as the primary reason why Lutz applied for another Rockefeller Fellowship in December 1936. This time, he intended to spend the academic year 1937/1938 in the US with his future wife Vera. The positive outcome of Lutz's application was met by Eucken's benign regret, since in his eyes, Lutz's emigration would weaken the influence of the emerging Freiburg School (Dathe and Goldschmidt 2003, 64).

[78] The first sentence was translated by Bernholz 1989, 196.

On March 15, 1937, Lutz returned to London to marry Vera Smith.[79] Lutz's letters confirm that Hayek and Robbins fully supported their marriage and their decision to move to the US. Lutz informed his teacher that Hayek and Robbins were writing letters of recommendation to a "mass of people for our sake" (Lutz to Eucken, 15.03.1937). One example is the letter from Hayek to his Austrian colleague Gottfried Haberler:

> "In about fourteen days Dr. Lutz, a particularly nice German from Freiburg, will depart for America as a Rockefeller Fellow, after he will marry my disciple V. C. Smith ("The Rationale of Central Banking"). Both are really nice and clever people, unfortunately he has now utterly no possibility for an academic career in Germany, because he is anti-Nazi as is the whole Eucken circle. He was proposed for the chair in Hamburg, but did not get it, and confidentially he was told that he would have no chance ever to get a chair under the regime, because the political report on him had been unfavorable." (Hayek to Haberler 11.03.1937).[80]

5. Trying to Release the Handbrake of Emigration

Based on Lutz's letters from US, this section claims that it was the trip to the US when Lutz realized how research in modern economics, which deplorably neglected the role of monetary institutions, was nevertheless indispensable for him if he wanted to start an academic career at

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[79] The marriage was not without any sacrifices. According to the 1914 British Nationality and Status of Aliens Act, if a British woman married an alien man, she became an alien and lost her nationality (Baldwin 2001, 522). This was the case with Vera Smith. Two weeks before their marriage, Lutz gave an account of really dramatic scenes: Vera suffered from stomachache which Lutz interpreted as a result of her nervous condition. Her mother tried to convince her not to marry. Lutz even described himself as some bride kidnapper from barbaric lands (*Frauenräuber aus barbarischen Landen*) (Lutz to Eucken, 15.03.1937).

[80] Friedrich A. Hayek Papers, Folder "Gottfried Haberler" (Box 94, Folder 6), Hoover Institution, Stanford University.

Anglo-Saxon universities, but this was not the economics that Lutz hoped to concentrate his efforts and energy on. First, he did not "possess" the mathematical skills. Second, he believed that pure economic theory which neglected the role of institutions could not explain the occurrence and essence of macroeconomic phenomena. These tensions of his internal Methodenstreit did not remain unnoticed for Harvard economist John van Sickle (1892–1975) who was the associate director of the Division of Social Sciences in the Rockefeller Foundation and played an instrumental role in the integration of German émigrés into the American academic environment (Berman 1983, 106; Craver 1986, 209). In December 1937, while Lutz was finishing his three-month stay at Harvard, van Sickle reflected in his diary (Syga-Dubois 2019, 544) how Lutz wanted to continue his teaching activity in Germany, how he was even nominated for the three universities Hamburg, Hanover and Halle. The Nazi party, however, vetoed any potential appointment. Van Sickle described Lutz as:

> "[…] obviously very depressed and wondered whether he can both continue to teach and keep his self-respect: He is an extremely sensitive and appealing type of person and I feel grave misgivings about his future." (van Sickle 10.12.1937).[81]

I assess this period as the culmination of Lutz's inner antagonisms: He asked himself whether he would go back to Germany, where he would have been able to conduct research about monetary theory and institutional analysis in the tradition of Weberian socioeconomics, but in order to make academic career he ought to betray his principles and support the ideas of the Nazis. Curiously, Lutz was not formally expelled from Freiburg. His official status was a lecturer on leave (*beurlaubter Privatdozent*) and he remained faculty member of the University of Freiburg – a status that was confirmed by the French Military Government in September 1945 (Brintzinger 1996, 48). In this context one can understand the inner conflict which

[81] Officers' Diaries, Diarist: "John Van Sickle" (Record Group12, Box 482), Rockefeller Archive Center.

escalated in Lutz's letters from Harvard that contained a déjà-vu from the LSE period. He complained yet again that what had been taught in America was being completely different from the economics at German universities: "They treat things as self-evident, which we have never heard of." (Lutz to Eucken, undated letter from Cambridge, Mass.). In the very same letter, he described the difference between partial and general equilibrium and how "fashionable" the Edgeworth-Pareto indifference curves had become.

His inner antagonism had surfaced some weeks earlier, at Chicago, which was the first university visited by the freshly married couple. They spent three months in a city "free of fantasy or charm" where Vera felt "offended by America" (Kolev and Köhler 2021, 21). The couple met Frank Knight, Henry Simons and Jacob Viner. In one of his letters, Lutz lamented that he felt as a bad economist in their circle. They were able to cite whole passages from Edgeworth, Marshall, Keynes or Hawtrey and, based on these passages, conduct extensive discussions. Lutz was confronted with theories of economists whose names he should know, but to whom he had never associated his research program so far (Janssen [1998] 2012, 64). With some envy, Lutz described that his wife was able to participate in the conversations actively, which made Knight and Simons more interested in her: "I feel like 'prince consort'" (Lutz to Eucken, 07.04.1937). Apparently, the education at LSE allowed her to integrate more easily into American economics. Vera's colleague Ronald Coase remembered that he copied out her notes of Robbins's lectures "General Principles of Economic Analysis" which helped him become familiar with Robbins's approach (Coase 1988, 34). Vera herself worked as a research assistant for Hugh Dalton during the academic year 1934–1935, (Yeager 1990, xiii), and the same Hugh Dalton was formative for Hicks's construction of indifference curves in his 1934 paper with R. G. D. Allen (Hicks 1979, 196). Still, Lutz found some relief: "I have the advantage of that I can ask Vera who knows all these things" (Lutz to Eucken, undated letter from Cambridge, Mass.). Thus Vera probably played *the* decisive role for Friedrich's becoming familiar with Anglo-Saxon economics.

The most notable result of Vera's help and at the same time of Lutz's inner antagonisms was his first paper in English, "The Outcome of the Saving-Investment Discussion" (1938) which critically discussed Keynes's *General Theory*.[82] With relief, he wrote to his teacher that "I finished the paper with God's and Vera's not exclusively lingual help" (Lutz to Eucken, 24.12.1937).[83] This betrays that Vera not only anglicized his paper, something which she would still do for his works in the later years at Princeton (Lutz to Eucken, 12.03.1946),[84] but that she might also have helped him with the economic theory that he was criticizing. Lutz submitted the paper to the *Quarterly Journal of Economics* when they were at Harvard, but he did not imagine that his paper would be accepted, let alone have any success. As a member of the board of editors of *QJE*, Alvin Hansen warned Lutz that the journal received many papers on Keynes's book, so that the chances for acceptance were low (Lutz to Eucken, 17.01.1938). Lutz himself admitted to his teacher that the whole world was writing about the saving-investment problem. In case it was not accepted, Lutz pondered translating it into German. He even regretted that the paper was not originally written in German, which would have allowed him to submit it to a German journal. In the same letter, he still yearned for a position in Germany (Lutz to Eucken,

[82] Before this paper, Lutz published "A Note on Gold Movements" (1937) in the *Review of Economic Studies*. This was his wife's translation of "Neue Goldwährung" (1937) which Lutz finished at Chicago in June 1937 (Lutz to Eucken, 15.10.1937). Many German-speaking economists relied on Vera's translation skills: among others, Wilhelm Röpke for *Crises and Cycles* (1936), Oskar Morgenstern for *The Limits of Economics* (1937) and Fritz Machlup for *The Stock Market, Credit and Capital Formation* (1940) (Haberler 1984, 52–53). She was supposed to translate Walter Eucken's *The Foundations of Economics* (1940), but the war and the anti-German sentiments thwarted Lutz's efforts to find a publisher for the book. It was translated by Terence W. Hutchison (1912–2007) in 1949 and published in 1950.

[83] The original German: "Ich habe meinen Aufsatz über „Development and Outcome of the Saving/Investment Discussion" mit Gottes und Vera's nicht nur sprachlicher Hilfe beendet." (Lutz to Eucken, 24.12.1937).

[84] "My English still needs to be checked and edited by my wife – at least this is her opinion." (Lutz to Eucken, 12.03.1946).

24.12.1937) which prolonged Lutz's inner conflict whether emigration had been the right decision. However, Lutz knew that even if he obtained a position in Germany, he and his wife would live in constant fear that he would suffer the same fate as his former Freiburg colleague Franz Böhm who was dismissed from the University of Jena after voicing disagreement with the Nazis (Vanberg 2008, 43–44).

With the unexpected success of the saving-investment paper, Lutz made a grand entrance into American economics. This paper and Abba Lerner's response to it were later republished in the section "Saving, Investment and National Income" as a part of *Readings in Business Cycle Theory* (1944), commissioned by the American Economic Association. As a chair of the selecting committee, Haberler argued that these papers elucidated on the relationship between saving, consumption, investment and national income in the context of business cycle analysis. The students "should become familiar with the logical pitfalls and the opportunities of terminological tangles and controversies provided by the existence of overlapping alternative definitions" (Haberler 1944, xv).

Lutz's paper juxtaposed the saving and investment concepts of Keynes, Robertson and the Stockholm School and outlined which of these concepts were more appropriate to explain the Wicksellian cumulative process and how it could be used as a benchmark for monetary policy. This largely methodological paper was undoubtedly an outcome of his skills acquired at Freiburg to discuss comparatively different methods applied to macroeconomic phenomena, skills he had proven in his dissertation about capital and his habilitation thesis about business cycle. In several letters, Lutz expressed his desire to publish an edited version of the habilitation thesis which would also consider the Keynesian system (Lutz to Eucken, 18.12.1946). He probably intended to base this discussion on the main findings of his saving-investment paper. While this undertaking never happened, Haberler endorsed Lutz's main message about the compatibility between the Swedish ex-ante and Robertson period analysis as analytical tools to explain the business cycle in the second enlarged edition of his *Prosperity and Depression* ([1937] 1946, 188). Furthermore, the Swiss business cycle theorists Walter A. Jöhr (1910–1987) included Lutz's critical discussion on how the Keynesian model could fit into the methods applied to the business cycle in his highly inluential work *Konjunkturschwankungen* (Jöhr 1952, 232 –234). This is a further piece of evidence that Lutz's paper occupied an intermediate position between the technical Anglo-Saxon economics and methodologically and institutionally focused German economics tradition. Perhaps as a career-tactical compromise, Lutz stopped emphasizing the central argument from his habilitation years that institutions mattered for the explanation of macroeconomic phenomena. This is an indication that he may have recognized the new tendencies in American economics during the "Keynesian Revolution".

The paper was published in the 1938 May issue of *QJE*, and the 1939 August issue launched a discussion about Lutz's arguments. Notable economists such as Abba Lerner (1939), Oskar Lange (1939) and Myra Curtis (1939) responded with extensive papers on Lutz's criticism. Lutz replied with a final comment (1939) from Princeton where he had just assumed his new job as instructor. In this debate, Myra Curtis (1886–1971) is perhaps the most interesting participant. She was a civil servant who, jointly with Hugh Townshend, Keynes's most radical interpreter, published *Modern Money* (1937) (Shackle [1967] 1973, 6, 228). This book was among the first textbooks on monetary theory and the monetary system in the Keynesian tradition (Hawtrey 1939, 94). Given Lutz's lifelong aspirations to finish a textbook on monetary theory (Veit-Bachmann 2003, 15), he should have felt particularly flattered by Curtis's comments. At the time, *QJE* had already turned into a battleground of Keynes's book, indicating that the "Keynesian Revolution" had become a rather Anglo-American phenomenon (Shackle [1967] 1973, 129–134; Myrdal 1972, 63). Leading economists such as Viner (1936), Leontief (1936), Robertson (1936) and Taussig (1936) reviewed critically *The General Theory*.

Keynes's response in the 1937 February issue (Keynes 1937) constituted a separate stage in "the years of high theory". Shackle dedicated a whole chapter to how "in the Quarterly Journal of Economics for February 1937 he [Keynes, LG] brushed aside the painstaking detail of his critics' incomprehension and attempted a final penetration of their minds" (Shackle [1967] 1973, 130). Shackle described 1937 as "the year of intensive Keynesian critical debate" when Keynes tried to tackle "our ignorance of the future" (Shackle [1967] 1973, 6).

In the context of these intensive Keynes debates, Lutz's paper represented an astonishing achievement. When *The General Theory* was published in March 1936, Lutz was at LSE. He wrote to Eucken that "Keynes's new book is *very* complicated. Hayek is of course not content with the book." (Lutz to Eucken, 10.03.1936, italics in the original). Lutz had already experienced the formation of Keynes's book. When at Cambridge, he participated in a discussion on monetary theory organized by Keynes himself and Lutz talked with Keynes "about a new book on monetary theory that [was] supposed to be published in the end of October 1935. But the message of this book [had] changed once again" (Lutz to Eucken, 20.05.1935). Had Lutz recorded all his memories in a book, this would probably qualify as a contribution to the history of economics.

6. Releasing the Handbrake of Emigration

The critique of Keynes's *The General Theory* opened for Lutz the doors to American economics (Veit-Bachmann 2003, 22). He expressed his satisfaction with the publication: "I thought it was very useful that the paper appeared in the Harvard Journal" (Lutz to Eucken, 17.01.1938). Lutz joined Princeton in September 1938 as a lecturer, became assistant professor in 1939 and associate professor in 1945. In 1943 he was affiliated with the Institute for Advanced Study, while from 1947 to 1953 he was a full professor of money and banking. During his Princeton period, Lutz did not forget his Freiburg origins. Immediately after publication of Eucken's largely methodological work *The Foundations of Economics* (1940), Lutz reviewed it in the *American Economic Review* (Lutz 1940) and, with a war related delay, in *Economica* (Lutz 1944; Veit-Bachmann 2002, 155). Several days after the publication in the AER, he organized a meeting of the Economic Club at Princeton whose purpose was to discuss Eucken's methodological message and thus popularize the Freiburg School's research program. With a huge regret, he wrote to Eucken that "it was impossible for me to convince the participants of the relevance of the issue. I was thoroughly discouraged". In the same letter, he described his failure to find a publisher for a translation of Eucken's book before the end of the war (Lutz to Eucken, 23.07.1940).

Perhaps it was this disappointment that convinced Lutz to focus on technical economics which he hoped could end his internal Methodenstreit. He published several papers about interest rate (1940; 1943; 1945) and investment theory (1945). The culmination was the collaborative book with his wife, *The Theory of Investment of the Firm* (Lutz and Lutz 1951). In this book, they integrated the notions of time and durable goods into a microeconomic theory of production. This provided the basis for their account of the firm's investment decisions towards maximizing its internal return on capital. Historically, these analytical instruments have been developed at LSE (Boulding 1953, 77; Haberler 1984, 52) – and were the same analytical tools that he had eschewed during his Fellowship year at LSE. Mark Blaug characterized the book as "instructive not only on the Ricardo's effect, but also on Wicksell's capital theory" (Blaug [1962] 2003, 548). Ricardo's effect was introduced by Hayek in his business cycle theory in order to explain what gave rise to change in the labor-intensity of production and how this change affected the business cycle (Kaldor 1942, 361; Gehrke 2001, 143). When the couple published their collaborative work, Hayek had already left technical economics after publishing *The Pure Theory of Capital* (1941) and "The Ricardo Effect" (1942). By the mid-1940s, Hayek had concentrated his efforts on institutional analysis – the cornerstone of *The Road to Serfdom* ([1944] 2006) that was very much in line with the contemporaneous institutional analysis of the Freiburg School (Köhler and Kolev 2013, 219; Kolev 2020, 3). As mentioned above, he thought of Lutz when envisaging the appropriate person to write the US version of *The Road to Serfdom* (Caldwell 2011, 303).

Despite his stellar career at Princeton, Lutz was one of the few economists who visited Europe immediately after the end of the war (Scherer 2000, 624–625). In his first letter to his teacher after the war, he described his successful career as a professor at Princeton and how he consulted the Fed about interest rate policy. Nonetheless, he was reluctant to stay at Princeton and still envisaged to return to Germany "I do not want to stay here forever" (Lutz to Eucken, 21.10.1945). He even rejected an appointment at Yale in spite of the higher salary, because at Princeton he was able to concentrate on his research (Lutz to Eucken, 12.03.1947). The ultimate return was preceded by frequent travels to Europe. The dean of the Department of Economics and Social Institutions at Princeton, James Douglas Brown (1898–1986), justified Lutz's frequent travels to Europe as:

> "[…] a strong pull to help reestablish economic scholarship in the German speaking area of Europe that led him to go back. He has always been German at heart – of the old school, not Hitlerite." (Brown to Lanier, 09.12.1953).[85]

Lutz visited his alma mater in 1948 as a guest professor and gave a lecture entitled "Theoretical Economics" which, perhaps ironically so, introduced Anglo-Saxon economics to German students. In 1950, his teacher suddenly died during a lecture series at LSE organized by Hayek and Robbins. Lutz came to replace Eucken for the academic year 1951/1952 and Freiburg offered him Eucken's chair. However, the negotiations between the faculty and Lutz took so

[85] Alumni and Faculty Offprint Collection, Folder "Lutz, Friedrich" (Box 29, Folder 12), Princeton University.

much time due to bureaucratic issues that they were prematurely broken, and Lutz returned to Princeton (Brintzinger 1996, 147).

In 1953, Lutz accepted a financially superior position at Zurich. The acceptance was hardly a surprise. In one of his first letters to Eucken after the war, Lutz voiced his wishes to find a position in Switzerland and asked Eucken whether he knew about vacant chairs there (Lutz to Eucken, 18.12.1946). In the same letter, he justified his choice with the better food-supply and housing situation compared to Germany. From summer 1953 until his passing in 1975, Lutz taught theory and history of socioeconomics at the University of Zurich (Ritzmann1976, 80). I claim that Lutz's professorship in socioeconomics ended his internal Methodenstreit, in a similar sense like Weber's socioeconomics had contributed to the reconciliation of the posterity of the Menger–Schmoller Methodenstreit (Kolev 2020, 7). During his period, he published several works on the history of economics and methodology, while his *The Theory of Interest* ([1968] 2016) has been considered as one of the most illuminating works on the history of interest rates (Blaug [1962] 2003, 547). Furthermore, Lutz concentrated his efforts and energy to popularize the Freiburg School's research program in postwar Europe. He contributed regularly to the *ORDO Yearbook of Economic and Social Order*: the journal was founded by Eucken and Böhm in 1948 and Lutz became its co-editor after the sudden passing of his teacher. Lutz stayed loyal to Freiburg and was among the founders and a life-long board member of the Walter Eucken Institute which is still popularizing Eucken's intellectual legacy (Veit-Bachmann 2003, 33–37; Hagemann 2008, 276–277).

The European period was equally productive for his wife. Given that Hayek's notes for Weber's *Grundriß der Sozialökonomik* were the basis for her doctoral thesis, I claim that in a broader sense she also started her academic career in the context of socioeconomics and became intellectually isolated after the emigration to the US, giving rise to her own internal Methodenstreit. Dean Brown noted:

> "A factor in his return, also, was his English wife, who never seemed entirely happy this side of the water. She is an economist in her own right, and seemed restless in a man's university despite a good job." (Brown to Lanier, 09.12.1953).[86]

A look at her publication lists conveys the impression that Vera also found peace after Friedrich's appointment at Zurich. Besides *The Rationale of Central Banking* and the book translations listed in footnote 14, Vera had not produced any substantial work before their first travel to postwar Europe in 1948. After Friedrich's appointment at Zurich, her list of publication expanded significantly by including an immense amount of works in technical economics and practical economic policy (Gusman 1984, 103–108). With the latter, she joined her husband's quest towards promoting the institutional framework of the competitive order à la Freiburg. In this respect, a geographic division of labor is discernable: Friedrich advised the Bank for International Settlement in Basel, along with the Swiss and German Central Banks, while Vera advised the Italian Central Bank and participated in discussions about French economic policy (Lutz 1962; 1969). Both of them were among the very early members of the Mont Pèlerin Society and Lutz was the only president of the Society who served two terms (Hartwell 1995, 145–146, 151–156). Friedrich died on October 4, 1975, in Zurich, Vera on August 20, 1976, both passed away in Zurich.

7. Conclusion

By reconstructing the development of Lutz's research program, my paper demonstrated how German economists educated in an academic environment still dominated by the Historical School experienced Anglo-Saxon economics during the 1930s. Lutz started his academic career with a habilitation thesis that criticized business cycle theory as an approach to explain the

[86] Alumni and Faculty Offprint Collection, Folder "Lutz, Friedrich" (Box 29, Folder 12), Princeton University.

emergence and persistence of economic crises. He recommended to concentrate on how the institutional framework surrounding the exchange process could affect the economic process. Hence, he argued for the construction of ideal types with whose help one could explain the occurrence and essence of macroeconomic phenomena. My paper claims that this Freiburg School approach stood in the tradition of Max Weber's socioeconomics that introduced economic sociology as an intermediary layer between economic theory and economic history, aiming at reconciling the Menger–Schmoller Methodenstreit battlefields (Kolev 2020, 47–48). Lutz's emphasis on the necessity of ideal types signified an attempt to combine not only theory and history, but to use ideal types of the framework as an exercise in economic sociology between theory and history.

During his first Rockefeller Fellowship at LSE, Lutz recognized that his research in socioeconomics was diametrically opposed to the Anglo-Saxon economics. He saw mathematical economics as an approach that was detached from reality. In his native Germany, however, the Nazi regime transformed German academia, which forced him to leave. In the US, he experienced the consolidation between American and English economic thought during the "Keynesian Revolution". He realized that an academic career in the New World would be virtually impossible if he did not acquire the mathematical skills necessary to conduct modern economic research. This gave rise to an internal Methodenstreit, during which he was full of moments of anxiety to release the handbrake of emigration, because he was aware of the immense efforts to learn these new methods skills, but most importantly, he was convinced that without the methodological consideration of institutions, mathematical economics was doomed to fail to explain the occurrence and essence of macroeconomic phenomena. With a methodological paper criticizing Keynes's *General Theory* published in *QJE,* Lutz adapted to the new tendencies in American economics and at the same time made a grand entrance into American economics. Lutz's paper took an intermediate position between the technical Anglo-

Saxon economics and methodologically and institutionally focused German economics tradition. He criticized Keynes's saving-investment concept on methodological grounds, but in those same years he stopped promoting the institutional analysis from his Freiburg years. In spite of a stellar career as a monetary theorist at Princeton and a connectivity with top-level American economics, it was only at Zurich, where he taught history and theory of socioeconomics, that Lutz found peace from the anxieties and tensions of his Methodenstreit.

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August Wilhelm Fehling Papers, German Federal Archives Koblenz

Friedrich A. von Hayek Papers, Hoover Institutions, Stanford University

Officers' Diaries, Diarist: John van Sickle, Rockefeller Foundation, Rockefeller Archive Center

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VI. A German Summary of the Doctoral Thesis

Meine Dissertation stellt eine historische Rekonstruktion der Krisenforschung der ordoliberalen Ökonomen Wilhelm Röpke, Walter Eucken und Friedrich A. Lutz in der Zwischenkriegszeit dar. Eine solche Rekonstruktion ist notwendig, da seit der Eurokrise im Jahre 2010 die Gefahr bestand, die deutsche wirtschaftspolitische Position in Bezug auf die verschuldeten südeuropäischen Länder als logische Fortsetzung und praktische Anwendung des intellektuellen Vermächtnisses des Ordoliberalismus im Allgemeinen und der Freiburger Schule im Besonderen zu interpretieren. Aus dogmenhistorischer Sicht ist eine solche Interpretation kritisch zu beurteilen, da sie der Botschaft der Forschungsprogramme unterschiedlicher Autoren nicht gerecht wird und außerdem zu viel Raum für eine subjektive Auslegung oder gar ahistorische Manipulation schafft. Meine Dissertation besteht aus vier Aufsätzen, deren Inhalt ich hier kompakt wiedergebe.

Mein erster Aufsatz befasst sich mit Wilhelm Röpkes Theorie der sekundären Depression. Laut Röpke übt die primäre Depression eine sinnvolle Reinigungsfunktion aus, die notwendig ist, um die Volkswirtschaft von im vorangegangenen Boom entstandenen blasenartigen Fehlinvestitionen zu bereinigen. Laut Röpke kann die Depression allerdings in bestimmten Fällen ihre Anpassungsfunktion verfehlen, so dass eine sich verstetigende sekundäre Depression als Folge einer gescheiterten primären Depression entstehen kann. Die sekundäre Depression stellt einen zerstörerischen Prozess dar, der sogar die Fundamente der freien Gesellschaftsordnung erschüttern kann. Röpke hat die Notwendigkeit einer „Initialzündung" unterstrichen, bei der der Staat mit einer koordinierten Fiskal- und Geldpolitik die Investitionen ankurbeln sollte, um die sekundäre Depression zu überwinden. Mein Aufsatz formuliert Antworten auf die Frage, wann die primäre Depression endet und wann die sekundäre entsteht. Dabei beeinflusst der Prozess der Entstehung und Entwicklung der blasenartigen Phänomene während des Booms die Struktur und die Dauer der primären Depression. Je länger die Boomphase dauert, desto höher ist die Wahrscheinlichkeit, dass eine primäre Reinigungsdepression zu einer sekundären degeneriert. Ich gelange zur Schlussfolgerung, dass Röpke nicht nur eine Innovation in Bezug auf den Verlauf der Depressionsphasen, sondern auch auf die Dynamik der Boomphase geleistet hat.

Mein zweiter Aufsatz setzt sich mit Friedrich A. Lutz' Habilitation auseinander, die eine dogmenhistorische Studie über die Entwicklung der Konjunkturforschung von den Klassikern bis zu den modernen Konjunkturtheorien der 1930er Jahre enthält. Ich gelange zur Schlussfolgerung, dass Lutz in seiner Habilitation eine epistemologische und methodologische Botschaft formuliert. Die epistemologische Botschaft lautete, dass im Mittelpunkt der Konjunkturforschung ein fragwürdiges Forschungsobjekt steht, bei dem versucht wird, die periodische Wiederkehr der ökonomischen Krisen als zwangsläufige Folge des Kapitalismus zu beweisen. Laut Lutz stellt die Krise keine für den Kapitalismus typische Phase dar, sondern ein individuelles historisches Ereignis, dessen Entstehung und Tiefe in ihrem historisch gegebenen institutionellen Rahmen allgemein zu erklären ist. Lutz' methodologische Botschaft fordert die Rückkehr zu den deduktiven Methoden der Klassiker, indem Modelle unter Berücksichtigung von institutionellen Faktoren zu bilden sind. Mit Hilfe der Änderung von exogenen Faktoren wie Geldmengenangebot, dem technischen Fortschritt oder der Sparneigung soll erforscht werden, wie diese Faktoren das ökonomische Gleichgewicht ändern und wie die institutionellen Faktoren die Wiederherstellung des Gleichgewichts beeinflussen. Somit soll theoretisch untersucht werden, wie Institutionen die Tiefe einer Depression bestimmen können. Mein Aufsatz gelangt zur Schlussfolgerung, dass Lutz als Schüler Walter Euckens eine methodologische Botschaft formuliert, die als Vorbereitung auf Euckens Denken in Ordnungen interpretiert werden kann.

Mein dritter Aufsatz konzentriert sich auf Euckens Kritik an den Konjunkturtheorien und seine Lösungsvorschläge, wie man Krisen allgemein in ihrem institutionellen Rahmen erklären soll. Eucken übt Kritik an der Konjunkturforschung, weil sie einen eigengesetzlich-zwangsläufigen Verlauf der Investitionen zu beweisen versucht. Er definiert, dass der Verlauf der Investitionen stark von der Wirtschaftsordnung abhängig ist. Euckens zentrales Anliegen ist es zu zeigen, dass je nach institutionellem Rahmen verschiedene Wirtschaftsordnungen entstehen, die sich in ihrer Anpassungsfähigkeit an exogene Schocks unterscheiden. Laut Eucken ist die Konzentration wirtschaftlicher Macht ein Resultat des institutionellen Rahmens, die wiederum die Anpassungsfähigkeit der Wirtschaftsakteure, die dieser Macht ausgesetzt sind, stark senkt. Mein Aufsatz gelangt zur Schlussfolgerung, dass Eucken durch den Begriff der Anpassungsfähigkeit der Wirtschaftsakteure beweisen wollte, dass die Tiefe der Großen Depression ein Resultat starker Machtkonzentration in den Händen bestimmter Gruppen darstellt. Die Macht dieser Gruppen senkt die Fähigkeit dieser Wirtschaftsakteure, die dieser Macht ausgesetzt sind, die Profitabilität ihrer wirtschaftlichen Tätigkeit nach dem Schock wiederherzustellen, was die Depression verschlimmert. Mit Hilfe der Wirtschaftsordnungen bezweckt Eucken, den beobachteten Wirtschaftsprozess in ihrer historisch individuellen Bedingtheit allgemein zu erklären und gleichzeitig als Instrument der theoretischen Analyse anzuwenden.

Mein vierter Aufsatz befasst sich mit Friedrich A. Lutz’ Lebensweg und Karriere. In England steht Lutz als Rockefeller Fellow in einem intensiven Briefwechsel mit Eucken, bei dem Lutz seinem Lehrer einen Einblick in die angelsächsische Wirtschaftsforschung gewährt. Lutz ist negativ überrascht von der ökonomischen Forschung an der London School of Economics, die er als „mathematische Detailforschung“ ohne Rücksicht auf den institutionellen Rahmen definiert. Diese Forschung steht in einem unüberwindbaren Gegensatz zu seiner eigenen Forschung genauso wie dem seines Lehrers. Aufgrund zahlreicher Einsprüche seitens der

NSDAP muss er seine Karriere in Deutschland aufgeben und in die USA immigrieren. Dort stellt er eine Art von Konsolidierung der ökonomischen Forschung im angelsächsischen Raum fest, bei der ihm deutlich wird, dass eine akademische Karriere ohne die notwendigen mathematischen Kenntnisse kaum möglich ist. Das erfordert eine immense Kraftanstrengung, die nach Lutz' Auffassung unnötig ist, da diese „mathematische Detailforschung" ohne die Berücksichtigung des jeweiligen institutionellen Rahmens an der Erklärung makroökonomischer Phänomene scheitern muss. So kommt sein eigener interner Methodenstreit auf, der erst bei seiner Berufung an der Princeton University an Intensität nachlässt. Trotz einer erfolgreichen Karriere als international anerkannter Geldtheoretiker und Währungsexperte nutzt Lutz die Gelegenheit, als Professor für theoretische und praktische Sozialökonomie sowie Geschichte der Sozialökonomie an der Universität Zürich nach Europa zurückzukehren und seinen internen Methodenstreit zu überwinden.

Meine Dissertation gelangt zur Schlussfolgerung, dass trotz unterschiedlicher Konjunkturverständnisse die drei ordoliberalen Ökonomen die Botschaft des österreichischen Ökonomen Eugen von Böhm-Bawerk aus dem Jahr 1896 als Grundlage ihrer Forschungsprogramme teilen: „Eine Krisentheorie kann nie die Untersuchung eines abgesonderten Theiles der socialwirtschaftlichen Phänomene sein, sondern sie ist, wenn sie nicht ein dilettantisches Unding sein soll, immer das letzte oder vorletzte Capitel eines geschriebenen oder ungeschriebenen socialwirtschaftlichen Systems, die reife Frucht der Erkenntnis sämtlicher socialwirtschaftlichen Vorgänge und ihres wechselwirkenden Zusammenhanges". Eine Botschaft, die auch heute nicht an Relevanz eingebüßt hat und von der aktuellen makroökonomischen Forschung stärker berücksichtigt werden soll.

Eidesstattliche Versicherung

Eidesstattliche Versicherung gemäß § 7 Absatz 1 Satz 3 Nr. 9 der Promotionsordnung der Albert-Ludwigs-Universität für die Wirtschafts- und Verhaltenswissenschaftliche Fakultät. Bei der eingereichten Dissertation zu dem Thema „Economic Order and Business Cycles: Four Essays on the Ordoliberal Economists Wilhelm Röpke, Walter Eucken and Friedrich A. Lutz“ handelt es sich um meine eigenständig erbrachte Leistung. Ich habe nur die angegebenen Quellen und Hilfsmittel benutzt und mich keiner unzulässigen Hilfe Dritter bedient. Insbesondere habe ich wörtlich oder sinngemäß aus anderen Werken übernommene Inhalte als solche kenntlich gemacht. Die Dissertation oder Teile davon habe ich bislang nicht an einer Hochschule des In- oder Auslands als Bestandteil einer Prüfungs- oder Qualifikationsleistung vorgelegt.

Die Richtigkeit der vorstehenden Erklärungen bestätige ich. Die Bedeutung der eidesstattlichen Versicherung und die strafrechtlichen Folgen einer unrichtigen oder unvollständigen eidesstattlichen Versicherung sind mir bekannt.

Ich versichere an Eides statt, dass ich nach bestem Wissen die reine Wahrheit erklärt und nichts verschwiegen habe.

Freiburg, 19. Mai 2022 ______________________________

Ort, Datum Unterschrift