L. Mises
March 14, 1944

The Main Issues in Present-Day Monetary Controversies

Introductory Remarks

This is not a systematic presentation of the problems of money and credit. Neither is it a complete exposition of the theories and doctrines dealt with. The aim of this paper is merely to enumerate certain topics which should not be neglected in the chapter on money and credit.

A. The Purchasing Power Controversy.

I. Is money "neutral?"

The older economists believed that - other things being equal - changes in the supply or demand of money make all commodity prices and wage rates simultaneously rise or fall in exact proportion to these changes. The price "level" changes, but the relations among the prices of individual commodities and services remain the same. Those mathematical economists whose theorising culminates in the formulation of an equation of exchange still maintain this thesis.

Modern economic analysis rejects this assumption. The changes in the supply or demand of money do not affect all individuals at the same time and to the same extent. In case of an inflation, for instance, the additional quantity of money does not find its way at first into the pockets of all individuals, not every individual of those benefited first gets the same amount, and not every individual reacts to the same additional quantity in the same way. Consequently the prices of various commodities and services rise neither at the same time nor to the same extent. This non-simultaneousness and unevenness of the price changes brough about results in a shift of income and wealth from some groups of the population to other groups. Monetary fluctuations are, even apart from their repercussions on all contracts stipulating deferred payments, not neutral. They are a source of economic and social change.

II. Are changes in the purchasing power of money measurable?

Even if we were prepared to leave out of consideration the non-simultaneousness and unevenness of the price changes brought about by changes in the supply or demand of money, we must realize that the index-number method does not provide a faithful criterion for the measurement of changes in the purchasing-power of the monetary unit. Economic conditions are not rigid, they are - also apart from any changes occurring in monetary matters - continuously changing. New commodities appear, old commodities disappear. The quality of the various commodities is subject to change. Tastes, wants and desires are changing and with them the valuation of the various goods. A motor-car of 1940 and a motor-car of 1940

2 ?

are entirely different things. Where were, twenty-five years ago, vitamins, refrigerators, talking pictures? How different is the role played today in the average American household by canned-food, rayon and radio sets? How much do clothes and shoes change from one year to the next? Even standard foods like milk, butter, meat and vegetables have in the last decades improved in quality to such an extent that it is impermissible to take them as equivalent with those marketed in the past. A method which tacitly assumes that nothing else had changed in the economic system than the quantity of money available is utterly illusory. The chairman of our committee has provided us with the results of an investigation undertaken in his corporation. According to this information only a fraction of the products manufactured today are of the same kind as the goods manufactured a few years ago. This is a typical case, more or less representative for all American processing industries.

Besides, mathematics provide us with various methods for the computation of averages from a given set of figures. Each of these methods has, with regard to the problem in question, some merits and some defects. Each of them yields different results. As it is impossible to declare one of these methods as the only adequate one and to discard all the others as manifestly unsuitable, it is obvious that the index number approach does not provide an undisputable and incontested solution. That could command general recognition

III. <u>Is it possible to adjust monetary manipulation to a non-arbitrary standard?</u>

The advocates of a manipulated currency pretend to aim at the stability of the monetary unit's purchasing power. They fail, however, to realize that in a changing economic world the concept of stable purchasing power is devoid of any real meaning.

The three main objections to be raised against the proposals for a manipulated currency are:

a. The various methods suggested for a measurement of changes in the monetary unit's purchasing power are arbitrary. Their results are contested by all those whose material interests would be hurt if they were to be used as a basis of monetary manipulation. In advocating the application of a certain index number system the results of which happen at the moment to provide a quasi-scientific justification of their particular interests, every pressure group and political party will always be in a position to cite the doctrine of some economists and statisticians. On the other hand their adversaries will quote dissenting opinions of no less renowned experts. There is no means to free a tabular standard from the faults of purely arbitrary and party-ridden bias.

b. It is impossible to know beforehand to what extent and at what date a definite amount of inflation or deflation (increase or reduction in the quantity of money and credit) will increase or reduce the prices of various commodities and services.

c. Apart from other deficiencies the proposals for stabilization are faulty because they are based on the idea of money's neutrality. They all suggest methods to undo changes in purchasing power already effected. If there has been an inflation, they wish to deflate to the same extent and vice versa. They do not realize that by this procedure they do not undo the social consequences (i.e., the shift of income and wealth from some groups to others) but simply add to them the social consequences of a new change. If a man has been hurt by being run over by an automobile it is no remedy to let the car go back over him in the opposite direction.

IV. The case against flexible parities.

If the purchasing power of an individual country's domestic currency changes, while the other countries' currencies do not change at all or not to the same extent, foreign trade is affected. As a rule foreign exchange rates are at an early stage of the inflationary or deflationary process adjusted to the new state of domestic money supply, while the prices of some commodities and services still lag behind for a time. As long as the inflationary or deflationary changes have not exhausted all their effects on the structure of prices, the comparatively low or high state of some prices results - in the case of inflation - in encouraging exports and discouraging imports, and - in case of deflation - in encouraging imports and discouraging exports. From the viewpoint of mercantilist fallacies a fall of the domestic monetary unit's purchasing power is therefore considered as a very fortunate occurrence.

What really happens is this: the country exports more than it did before and it gets, as compensation for these increased exports, a smaller amount of foreign products. Exports are, as it were, subsidized and imports penalized to the burden of the natives. The inflation is by and large, tantamount to a tax imposed upon the domestic consumers in order to cheapen the consumption of domestic products by foreigners.

Nowadays currency devaluation is mostly advocated as a remedy against the rigidity of wage rates. People are afraid of fighting openly the inappropriate policies of labor unions. They resort to an indirect attack. They hope that currency devaluation will, notwithstanding the rise of domestic commodity prices, not raise money wage rates and thus reduce real wage rates. Lord Keynes believes, that "a gradual and automatic lowering of real wages as a result of rising prices" would not be "strongly resisted" by labor. He does not see that wage rates are rigid only on the downside, not on the upside, too.

V. The case for the gold standard.

The gold standard is not perfect. No human institution is.

The main argument in favor of the gold standard is that it renders the formation of the monetary unit's purchasing power independent of arbitrary action on the part of governments, political parties and pressure groups. It places a check upon inflationary policies. And is the only standard which can possibly become an international, a world standard.

B. The Credit Controversy.

I. The Banking Principle.

Some economists of the Banking School ventured to deny flatly that changes in the quantity of money available can affect prices and interest rates. They introduced into their reasoning "hoards" as a deus ex machina. The amount of money kept in these mythical hoards changes in such a way as to neutralize automatically changes in the quantity of money. A surplus of money is swallowed by these hoards; a deficiency of money is made good by a restriction of the amount hoarded. This fable has been long since abandoned.

The bulk of the older Banking School economists and all contemporary representatives of this school do not deny that an increase in the quantity of money (metallic money, government paper money, unredeemable bank notes and deposit currency) must - other things being equal - result in a general rise of prices. The core of their teachings is: Short term credits granted on the part of commercial banks out of bank notes or deposits created for this purpose do not affect prices and interest rates provided they do not exceed "the needs of trade." Such loans provide the debtor with the funds required for the production and the marketing of goods. They are self-liquidating. If the purchased raw materials are made up and sold or if the buyer of products settles his balance, the loan is paid off and the bank notes or deposits disappear again. An actual need has brought them into existence. With the cessation of this need they go off the stage. The amount of credit of this type which the market can absorb is determined by the volume of production and business activity. It is beyond the power of the banks to alter this volume. No credit expansion is to be feared if the banks strictly abide by the rule to limit their lending to satisfy the demand of producers or merchants for short term credit.

The reasoning of the Banking School misses the essential problem. It is obvious that no credit expansion takes place if the banks keep the total amount of their lending at the same level. But if a new bank enters the field or if an existing bank embarks upon the granting of additional credit above the amount of its previous credits, credit expansion results.

It is not true that the volume of credit which the banks are in a position to grant if strictly abiding by the aforementioned rules is independent of the bank's policy. The market is always in a position to absorb a surplus of credit supply. An increase in the supply of credit brings about a tendency toward a lowering of the rate of interest. With the lower rate of interest many projects appear attractive that did not appear so with a higher rate. The lowering of the rate of interest encourages the expansion of precisely those business activities which - according to the banking doctrine - are viewed as proper instances for the granting of bank credit. Thus the credit expansion automatically increases the "needs of the trade." It stimulates business activities because it cheapens the exchange of future purchasing power for present purchasing power. While the supply of capital goods remained unaltered, there is now a greater demand for them on the part of business. Prices must consequently rise. A boom starts.

II. <u>The Currency Principle.</u>

The currency School intended to provide an explanation of the recurrence of economic crises. They first observed that the root cause of the depression is the preceding boom, and substituted for the study of crises the study of the trade cycle.

Their reasoning ran this way: If the British banks expand credit while conditions in the other countries remain unchanged, British prices are rising and those on the world market lag behind them. Consequently there is an excess of British imports over exports. As the surplus of imported goods cannot be paid for by shipping bank notes, the importers must export gold. Hence gold is withdrawn from the banks, their reserves are dwindling. This "external drain" forces upon the banks a restriction of their lending activities. The artificial boom comes to an end and gives way to a depression.

The main fault of the Currency School was that it dealt with bank notes only and did not realize that deposits subject to check are only technically different from bank notes, while their economic significance is equal to that of bank notes. This failure vitiated the English Bank Act of 1844. But it is easy to rectify this error by a simple extension of the theory.

III. The Austrian Theory of the Trade Cycle.

The Currency Theory did not consider the problem of the consequences of credit expansion within an isolated country or of a synchronous credit expansion in all countries. It did not enter into a discussion of the way in which the market and the whole apparatus of production and distribution react to credit expansion. This task was accomplished by the Austrian theory.

The rate of interest established on a market not hampered by credit expansion, says the Austrian theory, separates those business projects which can be carried out under the existing state of the supply of capital goods and consumers' preferences from those that cannot. With the lowering of the rate of interest, brought about by credit expansion, the entrepreneurs embark upon projects for the realization of which the available amount of factors of production does not suffice.* They are deceived by the

* It is necessary to keep in mind that interest rates, in the course of a credit expansion, are - with the exception of the very beginning of the process - not always low when compared with the level which business used to consider as normal. But they are always low when measured by the standard which they would have to reach in a period of progressive inflation and its corollary, a general rise of prices, since they would have to include at such a time a compensation for the depreciation of the money unit going on in the period of the loan.

appearance of a non-existing richness in the supply of material factors of production. They behave like a master-builder who has overrated the amount of building material available, has used up too much for the foundations and cannot complete his plan on account of a lack of material. Some of the new projects will never be finished, others, when finished will be useless for lack of the plants producing the required complementary producers' goods, others will not yield an adequate return on the capital invested.

It is true, the banks (or the governments) are in a position to prolong the boom for some time by injecting progressively increasing quantities of bank notes and deposits. But the artificially created prosperity cannot last for ever. Sooner or later it must come to an end. There are only two alternatives:

a. The banks do not stop and go on expanding credit at a progressively accelerated pace. But the spell of inflation breaks once the public has the conviction that the banks and the authorities are resolved not to stop. If no limit of the inflation and consequently of the general rise of prices can be foreseen, a general <u>Flucht in die Sachwerte</u> starts. Everybody becomes aware of the fact that to hold cash and balances with the banks involves loss and that he does better to buy and store goods. Everybody is anxious to get rid of money and to exchange it for some commodities no matter how much he must pay for them. Prices are running away, the purchasing power of the monetary unit drops to zero. The national currency system cracks.

B. As a rule the banks do not let things go so far. They stop sooner by restricting credit. Then the day of reckoning dawns. The illusions disappear, people begin again to see reality as it is. The blunders committed in the boom become visible.

In every case the slump is unavoidable. There is no means to make permanent a boom created by credit expansion and inflation.

The slump does not destroy values, but merely illusions. It does not make people poorer, it merely makes them aware of the impoverishment brought about by the malinvestment of the boom. Not the depression is an evil, but the preceding boom. The depression is the process of adjustment of economic conditions to the real state of affairs. The fall of prices and wage rates is the preliminary step toward recovery and future real prosperity. He who wants to prevent the recurrenc of economic crises must prevent the resumption of credit expansion.

In short: Credit expansion is doomed to failure at any rate. There is no means to substitute fictitious capital created by monetary and credit manipulation for non-existing capital goods. The only method to increase a nation's wealth and income is to save and to accumulate more real capital goods.

The rate of interest is a market phenomenon. In the long run its height does not depend on the supply of money and credit. It is determined by the difference in the valuation of present goods and future goods. An increase in the supply of money and credit lowers the rate of interest only temporarily. In bringing about malinvestment it finally results in a reduction in the amount of capital goods available. The economy has to pay heavily for the orgy of the artificial boom.

IV. The Socialists' Rejection of the Austrian Theory.

In the eyes of the socialists there is no such thing as a scarcity of material factors of production. Mankind could enjoy a life in plenty. Scarcity is merely an outcome of the capitalist mode of production and distribution. Economic crises are an evil inherent in capitalism. They have nothing at all to do with the endeavors to expand credit and to lower the rate of interest by bank manipulation.

The consistent supporters of these tenets blithely assert that interest is a purely monetary phenomenon that could not exist in a barter economy. (Such were, for instance the ideas of Silvio Gesell, the Minister of Finance of the short-lived communist Soviet-Regime in Munich; Lord Keynes is full of praise for Gesell and calls him an "unduly neglected prophet.") Others are less outspoken and cling to a more cautious language. But a faulty doctrine does not gain anything from the fact that its advocates lack the courage to profess frankly all the conclusions which must be drawn logically from the principles they have espoused.

Whoever does not share the opinion that the rate of interest is only a monetary phenomenon is under the necessity to demonstrate the mechanism by which that level of the rate of interest, which corresponds to the whole structure of market conditions, reestablishes itself when temporarily disarranged by an easy money policy. The only solution of this problem provided up to now is that of the Austrian theory.

All those economists who want to explain the trade cycle as caused by other factors than credit expansion must admit that no boom could arise if the amount of money and credit available were not increased. This implies that they cannot help admitting the fundamental thesis of the Austrian theory.

V. Salvation Through Credit Manipulation.

Consistent supporters of the doctrine that the rate of interest is a monetary phenomenon only and that there is no harm in the endeavors to abolish it by credit manipulation, cannot help approving plans to establish the millenium by a reform of the monetary and banking system. The best known of the older projects of this type was that of the French socialist,Proudhon, the man who coined the phrase: Property is theft.

Such ideas are very popular with many successful businessmen. The Belgian,Ernest Solvey, advocated "social comptabilism," a system hardly distinguished from that of Proudhon. The late Th. A. Edison and Mr. Henry Ford suggested, more than twenty years ago, that the construction of motor roads be financed by the issue of additional paper money in order to avoid the payment of interest to the banks or the public.

The present-day variety of this old superstition is embodied in the doctrine of unbalanced budgets and government spending. As far as the government procures the means required for spending by taxing the citizens and by borrowing from the public, its spending curtails the individuals' capacity to invest to the same extent that it increases that of the government. As far as the government borrows from the commercial banks or issues additional paper money, it embarks upon credit expansion and inflation.

In the early stages of every instance of credit expansion and inflation there is always optimism. People do not want to pay attention to the warning voices of the economists. They stubbornly insist that their present situation has nothing in common with the boom periods of the past and that the theorists are wrong in predicting the breakdown of the "prosperity." But when the crisis comes, people become desperate, then they impeach not the faulty monetary and credit policies but the capitalist system as such.

C. The Foreign Exchange Controversy.

I. The Purchasing Power Parity Theory.

The exchange ratio between two different kinds of money tends to correspond to the exchange ratio between each of them and commodities and services. It is usual to call this ratio the static or natural ratio. If this exchange ratio between two kinds of money is disturbed, people will start operations - buying and selling - in order to profit from existing discrepancies. These transactions tend to reestablish the natural ratio.

It does not make any difference whether the two kinds of money are used in the same country simultaneously (as was the case under the old parallel standard) or whether each country uses one of them only. The natural rate of foreign exchange is determined by the purchasing power of each of the two kinds of money.

If a payment has to be effected in a distant place, the transaction is burdened with the cost of shipping the money. These costs are avoided if claims and debts of various people in the two places can be cleared. If complete settlement of all payments due can be achieved in this way, no actual shipping of money is required. If an unsettled surplus turns up, it must be settled by transfers from place to place.

The balance of payments does not determine the exchange ratio. It only determines how much of the cost of shipping money can be saved. If the two places or countries in question use the same precious metal as the standard, the balance of payments determines the fluctuations of the rate of exchange <u>within the rigid limits set by the cost of shipping money</u> (gold points or shipping points.)

II. <u>The balance of payment theory.</u>

The balance of payment theory asserts that foreign exchange rates are determined by the balance of payments.

This doctrine fails to realize that the amount of foreign trade depends on the price structure.

If Atlantis imports from Thule a commodity

A, for the unit of which 2 Ducats must be paid in Atlantis, the commodity must be sold in Thule at the equivalent of 2 Ducats in its local currency, i.e., 10 Florins. If, without any inflation in Thule, the price of the Ducat goes up to 3 Florins, the importation of A must drop or stop altogether, because at the price of 15 Florins the demand for A in Thule shrinks or disappears altogether. A rise of foreign exchange rates which does not correspond to a rise of domestic prices (a fall of the purchasing power of the domestic currency) has thus the tendency to render the country's balance of payment "favorable."

But, object the supporters of the balance of payment theory, things are certainly different if A is a vital necessity for the citizens of Thule. Then they must import A no matter how much its price goes up. This, too, is a fallacy. If the individual citizens of Thule spend more Florins for the purchase of A, they must, if there is no domestic inflation, restrict their buying of other commodities either domestic or imported. In the first case the prices of these domestic commodities drop and they become available for export. In the second case the amount of foreign exchange that would have been absorbed by the importation of other goods becomes available for the purchase of A.

Only if there is domestic inflation in Thule, a rise of the price of A (in Florins) does not hinder the importation of A, as soon as the price of A (in Thule) is affected by the general rise of prices.

III. The requirements of foreign exchange stability.

There is but one means to keep a nation's domestic currency at par with gold and the sound currency of other countries to abstain from credit expansion and inflation.