

NEW AUSTRIAN ECONOMICS MANIFESTO

July 4, 2013

In a recent pamphlet Llewellyn H. Rockwell, President of the Mises Institute writes that we are all ceaselessly being bombarded by the media and college educators with propaganda to the effect

“that capitalism causes depressions and exploits the poor. That government is our salvation, and the bureaucrat a hero. That America owes its wealth to the Federal Reserve. That without massive regulation we’d be sunk...That cutting government even a smidgen and permitting free markets would be a disaster... John Maynard Keynes died more than 60 years ago, but his ideas still rule us from the grave: give government more power, and print more money...”

It is a pleasure to acknowledge that Mises University, the Mises Institute’s week-long summer program for students has done an outstanding service to society in flouting the conventional wisdom about government, and explaining the logic behind free enterprise.

Why then does the New Austrian School of Economics (NASOE) take issue with the Mises Institute? As this Manifesto explains, because post-Mises Austrian economics has ceased to be open to new ideas. It is trying to ossify Austrian economics at the level where Mises left it. It is inimical to the appearance of new knowledge as it flows directly from the founding principles of our school, unless stamped with its own *nihil obstat*. Discussion and criticism are discouraged and many a topic outright tabooed. There is a tendency to turn science into cult. As a result, post-Mises Austrian economics has failed to come up with a really potent theory that can offer an alternative to the mainstream. Nor can it draw up a comprehensive blueprint for the new economic order that will follow the collapse of the current global experiment with irredeemable currency. It claims a monopoly of ideas how the gold standard of the future ought to look like. It must be “one hundred percent”, or nothing. The last thing it would consider doing is to sponsor a conference that would entertain ideas other than its own.

The reason for these failings is that post-Mises economics has deviated from, or even abandoned the philosophy and methodology of the founder of the movement, Carl

Menger (1840-1921). To substantiate this charge here is a list of six errors, the first three of which are errors of commission; the last three are errors of omission.

- (1) Post-Mises Austrian economics embraced the Equilibrium Theory of Price and the concept of evenly rotating economy in spite of Menger who was the first economist defying Aristotle in pointing out that the price-phenomenon rests on disequilibrium rather than equilibrium. Far from being static, it is dynamic. As a result, price is not monolithic. It varies between two extremes, the higher asked and the lower bid price. These two extremes never coincide in the very nature of the case. Two separate analyses are required to see how asked and bid prices are formed, each on its own.

Supply-demand equilibrium is a spurious concept for a second reason, too. It leaves speculation out of consideration. The presence of speculative bid and offer that are often made on the spur of the moment, inevitably renders supply and demand undefinable. Supply and demand are *ad hominem* terms that must stay outside of scientific discourse.

- (2) Post-Mises Austrian economics also embraced the Quantity Theory of Money (QTM) even though Menger had never endorsed it. In fact, QTM goes against Menger's philosophy based on the concept of *marketability* that precludes a coherent definition of the quantity of money. It forces the theory of money to be a theory of *quality* as opposed to one of *quantity*. No economic theory ever succeeded in defining what the quantity of money in circulation could possibly mean.
- (3) Post-Mises Austrian economics dismissed Adam Smith's Real Bills Doctrine (RBD) as 'inflationary'. Doing it was another act of denying Menger who, in his encyclopaedic article *Geld* * suggested that a payments system complete with a bill market discounting bills would be 'very beneficial for the economy.' Discounting bills payable in gold coin during a gestation period not exceeding 13 weeks for the maturing consumer goods made an unprecedented expansion of production and employment possible in the nineteenth century. It would do so again in the twenty-first.

The victorious Entente powers did not allow the bill market to make a comeback at the end of World War I. To that extent they can justly be blamed for the ensuing Great Depression of the 1930's. The bill market is the clearing

house of the gold standard, as it were. It allows wages to be paid *before* the finished goods are bought by the ultimate consumer. It was not the gold standard *per se* that caused the Great Contraction, but the *castration* of the gold standard, in removing its clearing house.

The dismissal of RBD led to the fatal confusion between the rate of interest and the discount rate. It also confused the two inevitable sources of credit: savings and consumption. The rate of interest gages the *propensity to save* (the greater the propensity to save the lower is the rate of interest); the rate of discount gages the *propensity to consume* (the greater the propensity to consume the lower is the discount rate). Unlike the rate of interest, the discount rate *can* go to zero (as it did when people expected doomsday to occur on January 1, 1000). The propensity to consume and the propensity to save are *not* complementary because of the presence of a third, *the propensity to hoard*, especially as it becomes wide-spread and prominent during the terminal stage of the regime of irredeemable currency. Despite formal similarities, the rate of interest and the discount rate are fundamentally different with regard to their sources and effects.

(4) Post-Mises Austrian economics failed to develop a theory of interest in the spirit of Menger. In particular, it has nothing to say on the *origin of interest*, even though the *origin of money*, treated by Menger, could serve as a pattern. The rise of money is the result of an evolution, that of *marketability in the large* (also known as *saleability*). The rise of interest is the result of a similar evolution, that of *marketability in the small* (also known as *hoardability*). Money has appeared as *direct* exchange of goods gave way to *indirect* exchange. Likewise, interest appeared as *direct* conversion of wealth and income (namely hoarding and dishoarding) gave way to *indirect* conversion (namely buying and selling bonds in the bond market).

The latter event occurred much later, after Protestantism made interest taking and paying morally acceptable (previously proscribed by canonical and secular law). This led to the legal protection of gold bonds under contract law, and made bond trading possible. The bond market has displaced hoarding and dishoarding monetary metals as a means of converting income into wealth and wealth into income.

Furthermore, post-Mises Austrian economics failed to develop all the implications of the *Principle of Marginality*. In particular, time preference was curiously left out in spite of Böhm Bawerk's vision. It was never clarified that time preference makes sense only if *marginal time preference* is meant. Clearly, the Prodigal Son's time preference differs from that of Scrooge.

Marginal time preference is defined as the time preference of the *marginal saver*. The marginal saver is the first to sell his gold bond in protest against low interest rates as they are being pushed below the rate of marginal time preference by the government and its lackeys, the banks. He holds the gold coin until the banks relent and allow the rate of interest to return to the rate of marginal time preference. Relent they most assuredly will in consequence of the arbitrage between the gold market and the gold bond market. It is this very arbitrage that lends time preference teeth: it drains bank reserves from the banking system. As soon as the rate of interest returns to the rate of marginal time preference, the marginal saver will release the gold coin and buy back his gold bond *at a profit*. Post-Mises Austrian economics regrettably failed to reveal the essential nexus between gold and interest.

Incidentally, this also shows that mature and secure promises to pay gold coin (such as gold certificates issued by the U.S. Treasury before 1933) *do not* always substitute for the gold coin – refuting Mises' position. In selling his gold bond the marginal saver will refuse to take gold certificates in payment. He will insist on getting gold coins.

Just as marginal time preference serves as the *floor*, marginal productivity serves as the *ceiling* to limit the range within which the rate of interest may vary. *Marginal productivity* is defined as the productivity of the *marginal entrepreneur*. He is the first to sell his business as interest rates rise. He invests the proceeds in the bonds of more productive entrepreneurs and will hold them until the rate of interest falls back to the rate of marginal productivity. Fall back it must in response to the arbitrage between the bond market and the market for capital goods. At this point the marginal entrepreneur will sell his bonds *at a profit*, will buy a business enterprise and re-enter the rank of producers. Post-Mises Austrian economics regrettably missed the inevitable nexus between productivity and interest.

(5) Post-Mises Austrian economics failed to come up with a positive theory of the gold standard. The monetary metal, out of which the monetary unit is made, ought ideally have to have *constant marginal utility* – as postulated by Menger in a much overlooked sentence (*Geld*, 3rd edition*). Following Mises, latter day Austrian economists hold that the marginal utility of gold *cannot* be constant since it would imply infinite demand that is contradictory. Be that as it may, the objection is frivolous. Menger could just as well have said that gold had become the most marketable substance within the observation of man because its marginal utility declines at a rate lower than that of any other.

Post-Mises Austrian economics has, due to its rejection of Menger's postulate, missed gold's role as the only prophylactic against bad debt. That is the reason why the gold standard's longevity beats that of any other monetary system. No Babelian Tower of bad debt can be constructed under a gold standard.

(4) Finally, post-Mises Austrian economics neglected to study speculation in depth, especially as it has evolved after the American embargo of gold imposed in 1971, and the commencement of gold futures trading shortly thereafter. Consequently it has failed to identify the *gold basis* (defined as the spread between the dollar price of gold for delivery in the nearby future and that for delivery on the spot – a concept very much in the spirit of Menger) as the harbinger of a cataclysmic event comparable only to the collapse of the Western Roman Empire in 476 A.D. This cataclysmic event that is looming large on our horizon is the advent of *permanent gold backwardation*. That is the event of the gold basis going negative never again to return to positive territory, its natural habitat. In practice it means that all deliverable gold (including the entire mine output) disappears in hoards. All offers of gold for sale are simultaneously withdrawn regardless how high the bid price may be. Gold, if available at all, can only be obtained through barter.

Most people fail to see why this is a threat to our well-being. After all, you can't eat gold, can you? What these people don't realize is that permanent backwardation of gold triggers a peculiar contagion: the condition will gradually spread to all other markets for highly marketable goods including food and fuel. The consequences of the return to barter will be appalling. They include the domino-effect causing serial collapses of firms, unprecedented

unemployment, famine, pestilence, to say nothing of the breakdown of law and order. Governments are helpless in the face of gold going into hiding. The American government will in particular be unable to sequester the better part of the riches of the world in exchange for irredeemable promises to pay, as it has been doing since 1971. As long as gold futures markets are open, *some* gold can be obtained for U.S. dollars. But once permanent gold backwardation shuts down gold futures trading, no gold can be obtained for U.S. dollars ever again – an irreversible condition. People may ignore this threat at their own peril.

Post-Mises Austrian economists fail to see the threat of the fatal transition from multilateral trade to barter, nor do they view transition to barter as the ultimate in deflation. They are noisily predicting that the denouement of the present global experiment with irredeemable currency will take the form of *hyperinflation* (when the velocity of money is rising and gets larger than any positive number, however large). But there is also another pathology of money: that of *hyperdeflation* (when the velocity of money is falling and becomes smaller than any positive number, however small). Permanent gold backwardation will trigger it ‘with the certainty of scientific law’.

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NASOE pledges to remain faithful to the philosophy and methodology of Menger. Its scientific program consists in correcting all errors originating in the palpably weakening commitment to Menger’s principles. This Manifesto is just the latest in a series of challenges NASOE has issued since the turn of the century – all of which has fallen on deaf ears. But those who bear the future of our civilization at heart, like Menger and Mises did, would put petty jealousy aside and stop the name-calling and the mud-slinging. They would let the grand debate take place. Let truth win the day. Let the sound money movement rally under the banner of Menger. United, it can win the coming battle with the forces of social destruction whose chief strength, fiat money, is so obviously withering on the vine.

* Cf. the three editions of *Handwörterbuch der Staatswissenschaften*:

1st : 1892, vol. 3, pp 730-757;

2nd : 1900, vol 4, pp 60-106;

3rd: 1909, an English translation in Michael Latzer and Stefan Schmitz (editors),

Carl Menger and the Evolution of Payments Systems: from barter to electronic money, Cheltenham: Edward Elgar, 2002.