WHERE MISES WENT WRONG

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Ludwig von Mises erred when he dismissed what is known as the Fullarton Effect. In 1844 John Fullarton of the Banking School described how low interest rates were resisted by savers in selling their gold bonds and hoarding gold instead. Mises ridiculed the idea, calling gold hoards a *deus ex machina* in Human Action (3rd revised edition, p 440). My theory of interest corrects this mistake in giving due recognition to the Fullarton Effect. I can well understand the frustrations of Robert Blumen, Sean Corrigan, and other detractors of mine reluctant to read the voluminous outpourings of this "inflationist monetary crank". Rather than finding a weak point in my argument they call me names, stonewall Adam Smith, conjure up the bogyman of John Law, set up straw men only to knock them down again, and quarrel bitterly with my *ad hoc* examples while ignoring my comprehensive theory of interest. For the benefit of discriminating students of Carl Menger and Eugene Böhm-Bawerk I restate this novel theory in a concise form.

The rate of interest is a market phenomenon. It is defined as the rate at which the coupons of the gold bond amortize its price as quoted in the secondary bond market. The mathematician has shown us formulas expressing the rate of interest in terms of the price of the gold bond. They confirm that the two are inversely related: the higher the bond price, the lower is the rate of interest and *vice versa*. As a consequence, the lower bid price of the gold bond corresponds to the ceiling and the higher asked price to the floor of the range to which the rate of interest is confined. The question is what economic factors determine these constraints and how.

The floor is determined by the time preference of the marginal bondholder. If the rate of interest falls below it, then he takes profit in selling the overpriced gold bond and will keep the proceeds in gold coin. When the rate of interest bounces in response to bondholder resistance, he will buy back the gold bond at a lower price. The gold hoards are no *deus ex machina*: they are the very tool of human action in setting a limit to falling interest rates.

The ceiling is determined by the marginal productivity of capital, that is, the rate of productivity of the capital of the marginal producer. If the rate of interest rises above it, then he sells his plant and equipment and invests the proceeds in the underpriced gold bond. When the rate of interest falls back in response to producer resistance, he will sell the gold bond at a profit and use the proceeds to deploy his capital in production once more.

There is no valid reason to denigrate the productivity theory of interest following Mises. The theory of time preference and the productivity theory are not mutually exclusive. On the contrary, they are complementary. The fratricidal wars between the two schools have been in vain: they did not serve the advancement of science. They merely contributed to its retardation. Only a synthesis of the two theories can adequately explain the formation of the rate of interest

I submit that my theory of interest brings about such a synthesis. It is in the spirit of Menger and is in harmony with the insights of Böhm-Bawerk. It represents a breakthrough that provides solid foundation for further development of the theory. In Mises, time preference is no more than a pious wish. It is the gold hoards that lend teeth to those wishes. Nothing else can. Mises was not alive to the arbitrage of the marginal bondholder between bonds and gold, the most potent form of arbitrage between present and future goods. Likewise, Mises failed to explain how changes in the rate of interest guide production, to wit, through arbitrage of the marginal producer between bonds and capital goods.

Mises also criticized the Banking School on the subject of reflux (op.cit., p 444). He charged that banks regularly short-circuit reflux by putting retired bank notes back into circulation: “The regular course of affairs is that the bank replaces bills expired and paid by discounting new bills of exchange. Then to the amount of bank notes withdrawn from the market through the repayment of the earlier loan there corresponds an amount of newly issued bank notes.” This ignores the fact that the credit to which each and every non-fraudulent bill gives rise is self-liquidating. Moreover, if the Reichsbank of Germany, for example, had discounted new bills on the same old merchandise, then it would have violated the law. At any rate, the argument of the Banking School refers to the transparent case of bill circulation. Slow or fraudulent bills can take no refuge in the portfolio of conspiring banks. The bill market is fully capable of ferreting out delinquent bills and will refuse to discount them.

The nexus between drawer and drawee of the bill of exchange is not the same as that between lender and borrower. The drawer is no lender, discounting is no lending, and the discount rate is not the same as the rate of interest. The drawee is the active protagonist in the drama of supplying the consumer with urgently needed goods; the drawer is passive. It is the drawee who promptly reacts to changes in the height of the discount rate. These changes are governed by the consumers. The discount rate is not regulated by the savers, still less is it set by the banks. The drawee, typically a retail merchant, has the unconditional privilege of prepaying his bills. The discount serves as an incentive. If demand is brisk, it will take a lower discount rate to induce him to prepay; if sluggish, a higher one. Moreover, in the latter case, the marginal retail merchant will not re-order his usual quota of consumer goods from his suppliers. Instead, he will carry part of his circulating capital in the form of bills drawn on more productive merchants until demand picks up again. Evidently Mises misconstrued the problem of discounting. Insisting that retail inventory was financed through loans at the bank, Mises failed to notice that the marginal retail merchant was doing arbitrage between bills and consumer goods. He would thin out merchandise on his shelves while beefing up his portfolio of bills in response to the consumer’s reining back spending, while he would sell bills from his portfolio and use the proceeds to replace the missing merchandise on his shelves upon renewed interest of the consumer in buying. Wrongly, Mises blotted out the important distinction between the discount rate and the rate of interest which are governed by entirely different economic factors and move quite independently of one another.

Not until these three most important forms of human action, the arbitrage of the marginal bondholder, the arbitrage of the marginal producer, and the arbitrage of the marginal retail merchant are more widely recognized can further significant progress in the theory of interest be made.

References

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Note

The foregoing piece was written as a rejoinder to Sean Corrigan's series of papers criticizing me by name, posted on the website LewRockwell.com. I sent it to Lew whom I have known for over twenty years and with whom I thought I have had a cordial relation. I asked him to post my rejoinder so that his readership could see both sides of the argument. Lew refused.

The late Percy Greaves, the author of the pamphlet "Mises Made Easier", used to be upset whenever economic research was mentioned in his presence: "Research? What research? All the research has already been done by Mises. All that is left is to explain Mises to the public.

I am also an admirer of Mises. I have acknowledged my intellectual indebtedness to him many times. I have made a conscious effort to use his terminology in preference to others. I have approached the criticism of Mises carefully and modestly. I have not rushed into print with it. I even withheld the publication of my own theory of interest for several years because it was in conflict with that of Mises on several points.

Bettina Bien, the widow of Percy Greaves, is a good friend of mine. She used to invite me to her home in Irvington-on-Hudson for dinner. We discussed Mises and economics a great deal. She had attended the Mises seminar at New York University for 18 years. She is a serious, devoted, and honorable student of Mises. She painstakingly put together the most complete bibliography of Mises. Years ago I asked her if she could explain some inconsistencies that I thought I have discovered in Mises' work. While she agreed that they appeared to be inconsistencies, she couldn't offer an explanation.

I welcomed Lew's founding of the Mises Institute because I believed that it was dedicated to the search for and the dissemination of scientific truth, as was Mises himself. I am sadly disappointed to see that Lew is outdoing Percy. Not only does he think that all the research has been done and all we need to do is to regurgitate it again and again; he also thinks that Mises needs an "intellectual bodyguard".

Science has nothing to fear from an open debate. Feeling of insecurity is characteristic of a cult. Mises would have abhorred the idea that his scientific heritage has fallen to the care of a self-appointed "thought police" that would censor and suppress all dissent.

The style and approach of Corrigan and Blumen fall short of the high ideals of Mises. These gentlemen cannot for a moment assume that their selected targets may write and act in good faith. They do not want to dispute. They want to discredit. In refusing to publish my rejoinder Rockwell has stooped to their level. I am sorry for him. He prefers sycophants to thinkers.

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