Blowing Up Modern Austrian Economics ... in a Good Way

Dr. Antal Fekete with Anthony Wile - January 11, 2015

Introduction: *Professor Antal E. Fekete is an author, mathematician, monetary scientist and educator. Born in Budapest, Hungary in 1932, he graduated from the Eötvös Loránd University of Budapest in mathematics in 1955. He immigrated to Canada in 1957 and was appointed Assistant Professor at the Memorial University of Newfoundland in 1958. In 1992, after 35 years of service, he retired with the rank of Full Professor. In 1983 he was resident scholar at the American Institute for Economic Research in Great Barrington, Massachusetts. In 1995 he was resident fellow at the Foundation for Economic Education in Irvington-on-Hudson, New York. In 1996 he was Visiting Professor at the Francisco Marroquín University in Guatemala. He is the founder and Chairman of the New Austrian School of Economics in Hungary. His website is www.professorfekete.com.*

Professor Fekete is a proponent of the gold standard and an outspoken critic of the current monetary system based on irredeemable currency. His work falls into the school of free-market economic thought inspired by Carl Menger. He claims that his theory of interest is an extension of Menger's work. Menger championed the theory of direct exchange morphing into indirect exchange; in the same way Professor Fekete is championing the theory of direct conversion of income into wealth and wealth into income (read: gold hoarding and dishoarding) morphing into indirect conversion (read: selling and buying gold bonds). Professor Fekete is an advocate of Adam Smith's Real Bills Doctrine that he calls the Gold Bills Doctrine.

Daily Bell: We're going to ask you some questions based in part on feedbacks we recently received regarding some of our inflation articles. Please feel free to comment for as long as you want, but please try to keep your answers simple and comprehensible from a layman's perspective so people can gain as much as possible from your insights. We appreciate your patience, as we know you've answered some of these questions before, but with such subject matter, repetition can be a good thing.

Antal Fekete: "*Repetitio est mater studiorum,*" says the Latin proverb – repetition is the mother of all learning.

Daily Bell: Please define deflation and disinflation from both a monetary and price standpoint.

Antal Fekete: Deflation is clearly not the same as a falling price level. Technological improvements in production cause a gently falling price level under sound money that is no deflation. Defining deflation as a contraction of the stock of money is plainly wrong. We have a vastly expanding money supply, yet a lot of economists (including myself) hold that we are in the midst of deflation. I prefer the definition of deflation as a pathological slowing in the velocity of money.

Daily Bell: We think monetary deflation over a long period of time is difficult to accomplish in a central bank, money-printing economy. Comments?

Antal Fekete: "Accomplish" is not the word. No one wants deflation any more than wanting a pathological condition in one's own body. "Occur" may be a better word. I disagree with your assumption that central banks' money printing is antithetical to deflation. I am in a minority of one in suggesting that just the opposite is the case: *expansion of the money supply through open market purchases of government bonds by the central bank is the direct cause of deflation*. I know this is counter-intuitive, yet true nevertheless. Please consider that bond speculators chime in and preempt the Fed. They buy the bonds first, only to dump them on the Fed at a hefty mark-up later. The current expression is "front-running the Fed." Speculators are in the driver's seat, not the Fed. It is amazing that smart speculators like John M. Keynes did not realize that there was a fly in their ointment for deflation, namely, risk free profits. The opportunity to reap them defeats the Quantity Theory of Money. "Propensity to consume" is eclipsed by the "propensity to pocket risk free profits."

Why is this deflationary? Well, because it slows down the velocity of money. No matter how fast the Fed is printing, its output is siphoned off by profit-hungry bond speculators even faster. So fast indeed that commodity speculators, who may otherwise be tempted to buy goods with the freshly printed money in anticipation of inflation, make a *volte-face* and march to the bond market where the fun is – unless they stay and short commodities like crude oil, to mention but one recent example.

Daily Bell: Along with Rothbard, as we understand it, asset inflation itself leads to what seems to be deflation and disinflation. Money volume must go up to go down. Truth to this?

Antal Fekete: I would modify language slightly: money velocity must go up first so that it could come down.

Daily Bell: If third-party credit facilities like American Express collapse, does this constitute monetary deflation?

Antal Fekete: The collapse of any firm is a symptom of deflation, with a vengeance. It activates the "domino effect". Deflation breeds more deflation. The velocity of money spirals down. Please note that the original push came from the open market purchases of bonds by the Fed. It caused to bleed white solid productive firms, whose profits were certainly not risk free.

Daily Bell: When central banks keep interest rates low, does this lead to disinflation and deflation? How so?

Antal Fekete: The word "disinflation," which suggests that the Fed can turn the spigot on and off, is not in my dictionary. In fact, the Fed has no such power. It can certainly turn the spigot on, but we have never seen the Fed turning it off. Worse still, it has absolutely no control over how people will be using the extra money spewed from spigots or dropped from helicopters. Well, the smart ones would buy bonds, not commodities as the Fed hoped. They knew they could always dump them on the Fed in the open market with a hefty markup. Risk free.

To answer your question, the central bank does not "keep" interest rates low. In fact, it "pushes" them low through open market purchases of government debt, which *increases* the bond price. The other side of the coin is the simultaneous *decrease* of the rate of interest. Of course, the purpose of the exercise, on a Quantity Theory argument, is the fomenting of inflation ? not deflation. The trouble is that the central bank does not know what it is doing. It sows inflation but reaps deflation. Its monetary policy is counterproductive, to put it politely. A more accurate way to describe it is that current monetary policy reflects a peculiar madness inflicted on a gang of impostors and usurpers of unlimited power who are trampling on the Constitution and causing unprecedented economic pain to society. When their system collapses, as John Law of Lauriston's has almost three hundred years ago, then they will have to escape from Washington in female garments, as John Law escaped from Paris, or in male garments with false beard, as would be more appropriate in the case of Janet, under the cover of the night.

Daily Bell: If central banks are keeping interest rates artificially low, how does this contribute to monetary deflation? What do the bond traders do that makes monetary INFLATION into a deflationary phenomenon?

Antal Fekete: It is not *low* interest rates that creates deflation but *falling* interest rates. The process is triggered by the central bank's open market purchases of bonds in an effort to pursue its inane policy of QE, eliciting the copycat action of bond speculators. A *chain reaction* is activated: bond purchases of the central bank alternating with bond purchases of the speculators. The central bank announces its time table for its bond buying program. Speculators pre-empt the central bank in buying first, dumping the bonds into the lap of the central bank while pocketing risk free profits afterwards. The expectation of the central bank, price inflation, does not materialize. It is frustrated by the bond speculators who hijack the freshly printed money on its way to the commodity market. Not to be deterred, the central bank prints more. To do that it has to go to the open market and buy more bonds, prompting speculators to pre-empt. The cycle now repeats and a vicious spiral is engaged. The upshot is a prolonged fall of interest rates that destroys capital across the board, causing a domino effect of falling firms ? as I mentioned a minute ago.

Daily Bell: Do you believe in the Misesian business cycle? Does it have validity, in your view?

Antal Fekete: Certainly, with some reservations. It does not assign a very high IQ to businessmen in the field. Why don't they learn from experience and factor into their calculations the distortion in the rate of interest due to monetary policy? I improve on the business cycle of Mises, pointing an accusing finger to bond speculation motivated by risk free profits. Businessmen are the brightest people we have. They are being victimized through the insane monetary policy of the Fed.

Daily Bell: Was the Great Depression a deflationary depression? We note that junior mining prices apparently went UP during the Great Depression.

Antal Fekete: Most certainly it was. It is axiomatic that gold mining shares go up during a depression. Depression is just another name for capital destruction, and gold is the only form of capital that is immune to destruction. If you consolidate all balance sheets in a country (including that of the national treasury), then all liquid assets will be wiped out, *with the sole exception of gold*. Gold is the only asset that is not duplicated as a liability in the balance sheet of someone else.

Daily Bell: Are we in a deflationary depression? Or are we in a kind of stagflation?

Antal Fekete: We are in a deflation that is metastasizing into a depression. The monster word "stagflation" does not appear in my dictionary.

Daily Bell: Has money volume increased in the US and Europe? Have prices increased in response?

Antal Fekete: As I hinted a while ago, increasing the volume of money does not necessarily cause an increase in the price level. The Quantity Theory of Money is a false theory. In spite of an eightfold increase in the stock of money in America the price of crude oil was cut in half and the price of iron, copper and a number of other metals showed steep declines ? thought impossible only a few months ago. If this is not deflation, then let me ask: How much farther do prices have to fall before we are allowed to use the D-word?

Daily Bell: Oil has apparently been manipulated down. Does this constitute price deflation nonetheless, or is it simply a kind of manipulation?

Antal Fekete: The manipulation theory was invented by those who are afraid to face the facts squarely. We should know better: no valorization scheme ever works for any significant length of time for any commodity. It is another matter that foreign policy makers in Washington may have stolen a ride on the back of spontaneously collapsing crude oil to punish Putin.

Daily Bell: Let's change the subject. Do you wish to have a larger debate on Adam Smith's Real Bills Doctrine and do you think this would be good for the field? Did anyone postulate real bills before Smith? Didn't he just comment on an observable phenomenon?

Antal Fekete: Yes, I do. The trouble is that my opponents don't feel they are sufficiently well versed in the subject to stand up in such a debate. You cannot have a debate with slogans, which is all I hear. Adam Smith did not postulate the Real Bills Doctrine; he was the first to codify it. Let's not belittle his contribution.

Daily Bell: For real bills to function properly do we need to get rid of monopoly central banking?

Antal Fekete: The existence of central banks is irrelevant to the proper functioning of real bills, as the experience of the 19th century convincingly demonstrates. Nor is the existence of a central bank a prerequisite for real bill circulation. By contrast, circulating gold coinage is.

Daily Bell: Is monopoly central banking tolerable and sustainable in the long run? Is it a good for society?

Antal Fekete: In the 19th century central banks operated on the profit principle and they did not have special privileges such as the monopoly of issuing legal tender bank notes. If anything, they had less elbow-room than other banks. For example, they were not supposed to take the initiative in putting out their credit. They did not foist their credit on society as latter-day central banks do. Customers were supposed to step forward and take the central bank's credit on the terms offered ? or leave it.

Daily Bell: Is government borrowing a "blessing," as Alexander Hamilton once held?

Antal Fekete: Hamilton was talking about government borrowing subject to a debt ceiling. He must have been turning in his grave for the past decade watching the annual ritual of Congress busily lifting the ceiling, eventually abolishing it altogether.

Having said that I may add that Hamilton is not my hero on the question of the debt of the federal government. Jefferson is.

Daily Bell: Can the government do good things with borrowed money?

Antal Fekete: It can provide for national defense, in case the country is threatened by a foreign enemy.

Daily Bell: Is government good for anything else than taking responsibility for defense?

Antal Fekete: That government is best whose debt is least. Government debt must be kept on a golden chain. It will break any other.

Daily Bell: Here's a quote from one of our feedbackers: "Real bills play a significant role in providing liquidity in gold redeemable currency which empowers the individual. Also, and perhaps more importantly, real bills keep the currency away from the grip of financial oligarchs." True? False? Why?

Antal Fekete: Absolutely true. There was no "structural unemployment" in the heyday of real bills in the 19th century. Structural unemployment appeared in the 20th century when the victorious Entente powers blocked the bill market in their neurotic fear of German competition, after the cessation of hostilities in 1918.

Daily Bell: Why doesn't someone involved with the Mises Institute find merit in the Real Bills Doctrine?

Antal Fekete: I am told that they do but are browbeaten by the doctrinaire and cultist leadership. After all, the name over the entrance is that of Ludwig von Mises, arch-opponent of the Real Bills Doctrine.

Daily Bell: What is their argument against the Real Bills Doctrine? Is it that real bills are in some sense inflationary? How so?

Antal Fekete: You have to ask them. In no sense are real bills inflationary. They arise and expire *pari passu* with the emergence of new merchandise and their removal from the market by the ultimate gold-paying consumer.

Daily Bell: Changing the subject, is charging interest on debt a form of usury? Should people be thrown in jail if they do it?

Antal Fekete: The whole complex problem of usury disappears at once if you change the perspective and look at the transaction not as lending and borrowing, but as exchanging income for wealth and wealth for income, which is a biological necessity for mortals like us. The borrower, typically a young man, exchanges income of which he has a surplus for wealth of which he has a deficit. By contrast the lender, typically an old man, exchanges wealth of which he has a surplus for income of which he has a deficit. Why in the name of the blindfolded Lady Justice should either man be thrown in jail for making the the exchange?

Daily Bell: Do real bills provide an alternative to charging interest? How so?

Antal Fekete: No. The rate of interest is not involved at all with credit conveyed through bill trading. What is involved here is the discount rate. The rate of interest is conveyed through bond trading. The two are entirely different, both in origin and effect. This is a large subject of its own. I am just posting a major paper entitled *Credit*, the subject of my Privatseminar in Madrid, in a few days' time, on my website: www.professorfekete.com, in which I carefully elaborate on this difference.

Daily Bell: Did Ludwig von Mises ignore some of the work of Menger? How so?

Antal Fekete: Not only did he ignore whole chunks of it, Mises took positions directly opposed to those of Menger. Menger did not subscribe to the Quantity Theory of Money; Mises did. Menger did not castigate commercial banks by calling them by the derogatory name "fractional reserve banks" for covering part of their note and deposit liability by real bills maturing in gold coin in 91 days or less; Mises did. Menger fully accepted Adam Smith's Real Bills Doctrine; Mises rejected it. Menger did not believe that fiat currency was a "present good"; Mises did. The list goes on.

Daily Bell: A feedbacker comments: "Carl Menger's is pure Austrian economics, in that he postulated a philosophy of free exchange and economic prosperity which rests on honest money and the liquidity that arises from real bills." Comment, please.

Antal Fekete: I wish to congratulate your feedbacker for his clear insight.

Daily Bell: Was Menger a proponent of real bills?

Antal Fekete: He didn't have to be. He didn't have to endorse the air he was breathing in either. Menger was immersed in a world financing its foreign and domestic trade in merchandise by drawing real bills on the retail merchant selling to the ultimate consumer before World War I. Menger fully accepted the practice of "fractional reserve" banking as legitimate. See his encyclopedic article *Geld*, 1909 edition.

Daily Bell: How far into the past do real bills go? Hundreds of years? Thousands of years?

Antal Fekete: Cicero mentions letters of credit, a precursor of bills of exchange, in one of his epistles to a friend who lived in Athens. His son was about to sail there. He wanted to know whether the son could take letters of credit rather than gold coins with him on this trip, drawn on an importer in Rome owing to an exporter in Athens. Apparently such letters of credits had a wide circulation based on the extensive trade between the two cities.

Real bills proper as Adam Smith understood the term originated in the 1200s in the Italian city states such as Venice, Florence and Genoa, for example. They had a vast trade with the Far East and the Levant, all of which was financed by drawing bills of exchange on local retailers, such as Antonio in Shakespeare's *Merchant of Venice*.

Daily Bell: Was there free-market private money before real bills? Would you characterize those systems before real bills as primitive?

Antal Fekete: Not during the Dark Ages. Lights went out and trade came to a standstill. Autarky was the rule after the collapse of the Western half of the Roman Empire. But before that event trading bills was the most sophisticated way of financing trade. It would never occur to me to characterize it as "primitive."

Daily Bell: The modern Austrian School, as one of our feedbackers put it, "subverted the classical Austrian school by denying society much needed liquidity, thus condemning it to deflation and depression, through denigrating real bills." Comments, if you please.

Antal Fekete: I wish to congratulate your feedbacker for his clear insight.

Daily Bell: Why do real bills provide extra liquidity? Is it because they make borrowing easier? Can't people borrow without a real bills facility? Does it have to be that formal?

Antal Fekete: It is a major misconception to think that real bills involve lending and borrowing. They don't. What they involve is clearing. When a wholesale merchant draws a bill on a retail merchant, he does not lend and the retail merchant does not borrow. Hardly ever would the latter pay gold coin upon delivery of supplies, and the former would *never* demand payments in gold coin.

Circulation of real bills started entirely spontaneously. Suppliers of the wholesale merchant were delighted to accept the bill drawn on the retail merchant in payment upon endorsing. The bill was an earning asset in their hands, thanks to the discount. They could liquidate the bill on short notice if the need arose.

Daily Bell: How did real bills pass out of favor in the 20th century? Are they still illegal?

Antal Fekete: They did not pass out; they were sabotaged by the victorious Entente powers in blocking the bill market in London, as I have already mentioned. They were guided by their neurotic fear of German efficiency. In doing so they inadvertently destroyed the wage fund out of which the wages of workers producing merchandise could be advanced ahead of the sale of merchandise to the ultimate gold-paying consumer. The destruction of the wage fund was the true cause of the Great Depression of the 1930s, and the horrendous unemployment it engendered. There was no way of advancing wage payments other than bill trading. Once suspended, no one was there to pay the wages of workers producing consumer goods. They had to be laid off.

Real bills were never made illegal. There was no need. The withdrawal of gold coins from circulation did the trick. The idea of a real bill maturing in irredeemable currency is preposterous. The real bill must mature in something *more* liquid, and irredeemable currency is *less* liquid than the real bill. It is a promise to pay *nothing*.

Daily Bell: What is necessary to allow real bill circulation – letting them return to prominence?

Antal Fekete: Three things: gold coins, gold coins and gold coins.

Daily Bell: Any other points you want to make?

Antal Fekete: Yes. Gold coins are the most marketable instruments known to man. Its holder can trade on the best terms possible. Gold bills are the second most marketable instruments. Demand for them is virtually unlimited. Banks overflowing with gold coins scramble to expel them in exchange for real bills, the best earning asset a commercial bank can have.

If you bought a house in the 19th century, you would not accumulate gold coins in anticipation of paying the purchase price on closing day. You accumulated real bills with the same maturity. Likewise, if you issued bonds, you did not accumulate gold coins in anticipation of paying the face value of your bonded debt upon maturity. You accumulated real bills with the same maturity date.

Only ignoramuses believe that gold coins financed the economy directly in the 19th century and real bills were just a reactionary aberration.

Daily Bell: Thanks for your time!