TWO VIEWS ON THE SELF-IMMOLATION OF PAPER MONEY

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Letter to a reader commenting on my criticism of Mises

Dear Mr. West:

Thank you for your interest in my work. Also thank you for giving me this opportunity to rethink my criticism of the monetary theories of Ludwig von Mises. Believe me, I did not take the task of criticizing Mises lightly. I, too, hold that he was a giant among the great thinkers of mankind. So was also Aristotle. Yet neither is above criticism.

I have criticized Mises on two points in my piece “The Gold-Demonetization Hoax”. One concerns the question whether constant marginal utility exists as a limiting case; the other whether subjective value can be measured objectively. The two are closely related and cannot be separated. I quote from your letter.

> “You state Professor Mises denies the constant marginal utility of gold because it implies infinite demand that is contradictory. I believe what Professor Mises is saying is that those who argue against a limited demand for money based on their belief in constant marginal utility are erroneously confusing cash holdings (the subject he is addressing) with wealth. He goes on to make a distinction between the two and argues only that the demand for wealth, as denominated in money, is indeed unlimited. But cash holdings are limited to their usefulness in acquiring wealth. Cash will be spent as quickly as possible, leaving only a sufficient reserve. Mises does not argue against constant marginal utility.”
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> “The second item is your statement that Professor Mises denies that there is a unit of value. The section you quote is a lead-in to his argument that monetary calculation in a socialist society is impossible. His argument is that without free trade you cannot establish value because there is no scientific way to construct a unit of value. That money by definition is both a unit and a store of value is not argued; only that value cannot be determined unless two parties agree on it. There is no “extrinsic” unit that can be placed on an item.”

I don’t think it can be disputed that Mises in fact rejected the idea of gold or any other substance having constant marginal utility whether absolutely or, as a limiting case, relatively. For him a yardstick measuring value simply could not exist. Value was subjective and as such could only be compared but not measured. As a consequence, the material itself of which the yardstick was to be made would be subject to declining marginal utility so that two different specimens would have different values, even to the same individual.

Consider, if you will, an imaginary world we shall call Rubberland where no substances of solid state exist. The nearest thing is elastic state, the state of rubber-like substances of which Rubberland consists. In such a world there is no possibility to measure length or distance, as an elastic yardstick is an oxymoron. Physics would be a “subjective” discipline. Length and distance would still exist, subject to consensus and comparison but not to measurement. Anyone in Rubberland who believed that measuring distance was possible would commit a grave scientific error. Upon substituting “value” for “length” subjective economics is akin to the physics of Rubberland.

Mises’ views on gold are based strictly on supply/demand considerations. Gold has been promoted by the market to the status of money because of its supply/demand characteristics, not because of its unique marginal utility. By the same token, governments could deprive gold of this status by denying it monetary demand, the lion’s share of total demand. Mises thought that if gold was ever demonetized by the governments, then its exchange value would fall. He cited the example of demonetizing silver in the 1870's, followed by a sixty-year decline of silver’s value by more than 80 percent. To suggest that a causal relation exists between the two events is a fallacy that in logic goes by the name *post hoc, ergo propter hoc* (after it, therefore because of it).

In any event, Mises was proved wrong. A hundred years after silver-demonetization governments, brow-beaten by the US, declared that they were demonetizing gold, too. Yet, lo and behold, gold’s exchange value, far from collapsing, rose greatly in the wake of the announcement. By more than by 2000 percent, in less than ten years’ time. It is clear that Mises misjudged gold, as a result of his dogmatic insistence that all values, without exception, were subjective. To say that the value of gold was an exception would be considered heresy by him. Yet the truth is that gold has a property that makes its value objective. Gold is the only substance that has constant marginal utility.

In Rubberland the analogous development would be if explorers and prospectors had discovered a (for them) unique inelastic substance we shall call “solid”. Now it has become possible to construct a yardstick and start measuring lengths and distances, something that could not be done before. The subjective discipline of physics has now acquired an objective character. Needless to say, the discovery of solid has not changed the nature of other substances in Rubberland. Those of elastic state were still elastic after the introduction of the yardstick. What was different was that measurement has been made possible scientifically for the first time.

Due to its constant marginal utility gold has become the “most hoardable” good. This means that the opportunity cost of hoarding gold is lower than that of any other. As a consequence the stocks-to-flows ratio (existing stocks divided by annual flows of new production) for gold is a high multiple, while for all other goods it is but a small fraction. This is what makes gold’s value objective. The individual’s trust in gold’s value is not simply subjective as it would be in the case of other commodities. In the case of gold it is reinforced greatly by an objective fact, namely the stock of monetary gold in the world, the accumulation of millennia, reflecting the superb confidence in gold's value by generations that have gone before us. This also shows that governments are helpless in their effort to demonetize gold. To do so they would have to dissipate existing stocks of monetary gold in order to bring its stocks-to-flows ratio in line with that of other goods, a job that would take centuries to accomplish.

I myself treat every supply/demand argument, including the quantity theory of money (QTM), with the greatest suspicion. The notion of supply and demand does not stand up to scientific scrutiny. It is anecdotal, and has only metaphorical merit. Any argument using it is necessarily *ad hominem*. Conclusions are valid only in so far as the existence of speculation in the commodity under consideration can be ignored. Speculators never have a firm commitment either to the long or the short side of the market. They could, and often would, change sides at the drop of the hat, sometimes rationally, at other times not so rationally. Furthermore, they could sell short. That is, they could sell something forward that they haven't got, nor do they know how they will liquidate their commitment. Their motto is: "Sell now, worry later." Speculators on the short side of the market can be squeezed and, in the worst-case scenario, cornered by the longs (although not the other way round). Supply and demand, if they are to have any meaning, must include speculative supply and demand, as they also participate in the price-forming process. But this inclusion makes supply and demand bereft of any scientific merit, on account of the capricious nature of speculation.

The QTM is demonstrably wrong. In every historic hyperinflationary episode that ultimately reduced the value of irredeemable currency to naught the demand for money, far from vanishing, actually outstripped supply. When the rate of depreciation of paper money reaches a certain threshold, the government printing office can no longer produce, and the banking system can no longer deliver, the bank notes fast enough to the consumer who needs them if only for the purpose of buying food. Yet the short supply of, and the desperate demand for, paper money could not protect its value against further losses, nor could it avert its ultimate demise. Where does this leave the QTM? Well, it is not a scientific theory by a long shot. At best it is a mechanical metaphor that may work as long as fair weather lasts. But it is mercilessly swept away by the first storm. It is certainly not an adequate scientific tool with which to investigate the one hundred percent mortality rate afflicting irredeemable currencies through the sudden death syndrome. The QTM is a linear model that is entirely inapplicable in a non-linear world such as ours. If you really want to understand why an irredeemable currency is bound to lose all its value in due course, then you need a non-linear model.

I don't disagree with Mises that there is a confusion about "money" and "wealth", and that people limit their cash-holding to their actual needs for it. But I don't think this has any relevance to the problem of gold's marginal utility. Consider the proverbial man "who has everything". What can you give him on his birthday that would not make him even more bored? There is only one possible answer to that question: give him a gold coin. No matter how many he may already have, he would accept the additional coin on exactly the same terms as he has accepted the previously acquired ones, including the first. His cash-holding has nothing to do with it. Also irrelevant is whether he would keep it or spend it. What solely matters is the fact that if you gave him anything else, he would value your gift less than he would the previously acquired unit of the same.

I am sorry to say, Mises' stand on the unit of value is a case of one wanting to have his cake and eat it. On the one hand, according to Mises, it is not admissible to assume the existence of an objective unit of value as it would contradict the fundamental principle of subjective economics whereby all values are subjective. On the other hand, Mises wants to endow businessmen with the power to be able to calculate the probability of future prices and profits which is not possible without an objective unit of value. Free trade has nothing to do with it, unless we assume that under a regime of tariffs and quotas economic calculation was no longer possible as a subjective unit of value would only have validity between consenting adults, and as such would be useless in economic calculation.

I submit that a more consistent solution to the problem is to admit the existence of an objective unit of value, by virtue of the constant marginal utility of the monetary metal as it has spontaneously evolved through the well-known process described by Carl Menger. This admission does not contradict the subjective nature of value. The monetary commodity is the only exception. The value of everything else is subjective. Exchange takes place when the seller of a certain item values it less than the buyer who values it more, as measured by the unit of value. The fact that in the monetary economy this leads to the formation of a market price (or, more correctly, *two* prices: the lower bid and the higher asked price) will of course not invalidate the principle of subjective value.

The mathematician has no difficulty with the dichotomy of comparison *versus* measurement. He has always distinguished between two kinds of numbers. *Ordinal numbers* (subject to such axioms as reflexivity, symmetry, and transitivity) are only used for comparison. *Cardinal numbers* (subject to axioms such as commutativity, associativity of addition and multiplication, as well as distributivity of the latter over the former) are used for counting. In the barter economy values were expressed in terms of ordinal numbers. Measuring values was not possible, nor was their addition or multiplication. Only their comparison was. However, with the evolution of the monetary economy it has become possible to measure, add and multiply values according to the rules of cardinal arithmetic, while retaining the facility of comparing them as before.

I consider the contribution of Mises, that economic calculation in a socialist society without private ownership of the means of production is not possible, as one of the greatest, if not the greatest, result of twentieth-century economics. Values do exist in a socialist economy also, since individuals can exchange chattels just as they would in a barter economy. But values cannot be measured for lack of an objective unit of value. (Illegal ownership of gold may carry the death penalty.) Still less can values be added or multiplied. As a result the socialist economy is ultimately doomed for lack of possibility to do economic calculation.

Mises did not live to see the collapse of the Evil Empire coming, as it did, hard on the heels of the collapse of the Soviet economy which he predicted, after three score of years of Bolshevik officials doing their level best to refute his theory through propping it up by hook of crook.

Mises also predicted another event, no less momentous, namely the demise of the regime of irredeemable currencies. However, he argued the case on the strength of the QTM, a *non sequitur*. Mises missed the fact that *exactly the same argument* applies here as well. No less than in the case of a socialist economy, under the regime of an irredeemable currency businessmen ultimately lose their ability to calculate for lack of an objective unit of value. Gold is prevented from fulfilling its foreordained function because of coercive legal tender laws domestically, bribe and blackmail internationally. For thirty-five years now central bankers have been burning the midnight oil to find ways to fend off the impending catastrophe threatening the world, as a result of the impossibility of economic calculation under a US-imposed regime of irredeemable currency. Their efforts are in vain. This Evil Empire, too, is doomed, and for the very same reason. The world economy, as the Soviet economy before it, will also succumb to the sudden death syndrome, because it has lost the faculty of economic calculation.

It is amazing that the latter-day adherents of the Austrian School have all missed this point. They are preparing to witness the hyperinflationary self-immolation of the dollar, an event that may or may not take place. It may be well-worth noting here that hyperinflations so far, at any rate those which culminated in the total destruction of the value of irredeemable currency, have all occurred in the wake of wars (or civil wars) destroying supplies and production facilities. We have yet to witness a hyperinflation in peacetime with supplies and production facilities intact.

The Austrians and other hard money advocates are totally unprepared for the self-immolation of the dollar through economic paralysis due to the inability of businessmen to calculate. This would mean deflation in the form of business failures, imploding debt, domino-effect of bankruptcies, unemployment, destruction of wealth and values, a scenario more likely than inflation.

Self-immolation of the dollar? Certainly. Through inflation? Possibly but not inevitably. Then through deflation, perhaps? Yes indeed, if the dollar turns out to be a tough cooky, and refuses to roll over in a way prescribed by sycophants and cultists.

Yours, etc.