A TALE OF TWO SCHOOLS

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The New Austrian School of Economics (NASE) will celebrate its tenth anniversary this year. Under different names in different locations it has attracted many a student from all parts of the world. Its next session will take place from March 24 to April 2, 2012. It looks like NASE has found its permanent home in Munich, the capital of Bavaria where it will offer two ten-day (twenty-lecture) sessions twice a year, in the Spring and in late Summer. The first Ph.D. degree will be awarded at the coming Spring Session.

Why two Austrian Schools?

I have never addressed this question in public before. NASE goes back to the fountainhead of Carl Menger. This fountain is still gushing forth in its original purity and splendor while our tragedy, the most devastating credit collapse in world history that Menger foresaw a hundred years beforehand, is unfolding. Although I am admiring Ludwig von Mises as the greatest economist of the 20th century, it has not been possible for me to analyze some of the notions of Mises deviating from Menger's original vision in the cultist atmosphere of the American Austrian establishment for reasons of its intolerance. These deviations have mostly to do with the theory of interest. In my view the dogmatic approach of Mises is not in the spirit of Menger. Unlike his teacher, Mises embraced the Quantity Theory of Money without carefully delineating the extremely narrow limits of its validity. Moreover, Mises categorically rejected the idea of interest as a market phenomenon. Not only is his intransigence contradicted by empirical facts, but it also represents a break with Menger's own methodology.

The evolution of interest

Interest is not a matter for postulating apodictic truths. Rather interest, as money itself is the result of a long evolution. In the case of money we are looking at the evolution of direct exchange, culminating in the indirect exchange of goods. In the case of interest we are looking at the evolution of direct conversion of income into wealth and wealth into income through hoarding and dishoarding, culminating in the indirect conversion through exchanging rent-charges, bonds, and other similar instruments.

But beyond the taboo on reading Mises critically I have found that the approach of the American Austrians is far too superficial. Take for example the burning problem of the impending collapse of the international monetary system staring us in the face. It should be obvious that the problem cannot be solved without Adam Smith's Real Bills Doctrine (RBD). Love them or hate them, real bills will start circulating spontaneously in want of other media of exchange. Gold will be unavailable as it will have gone into hiding, and it will be a painfully slow process to coax it out.

The Real Bills Doctrine

American Austrians refuse to accept the wisdom of Adam Smith's RBD. They believe that there is plenty of monetary gold to go around to finance the myriad of transactions of our complex, many-faceted world economy. Even if there was, gold would be a fetter upon technological progress as it would hamper the further refinement of division of labor. To avoid this deflationary bias, it will be necessary in the future, as it has been in the past to augment the stock of monetary gold by granting limited and ephemeral monetary privileges to the *next best thing* to gold, namely real bills – relying, as they do on *self-liquidating credit*. Real bills mature into gold coins in 91 days or less (91 days being the length of the seasons at the end of which demand for consumer goods changes). They are paid out of the proceeds of the sale of consumer goods in most urgent demand using the gold coins released by the consumer. They are *not inflationary* because real bills arise simultaneously with and in consequence of the production of new goods most urgently demanded by the consumers. Moreover, real bills expire as these goods are removed from the market by them.

A most recent restatement of the position of the American Austrians on RBD can be found in *The Daily Bell* interview with Dr. Joseph Salerno of Pace University (July 3, 2011). Salerno vigorously rejects the "age-old fallacy" (mark the fact that he shies away from mentioning Adam Smith by name) according to which regardless whether a bank provides mortgage finance or whether it discounts a real bill, it must increase its demand deposit liabilities. In doing so it increases the money supply and puts upward pressure on prices. Yet, in spite of Salerno's sweeping equalization of these two banking activities, there is still a difference. Money provided for mortgage finance has been sunk into bricks and mortar which are among the most illiquid assets of all. By contrast, money from the proceeds of discounting real bills is financing the movement of goods in most urgent demand from the producers to the ultimate gold-paying consumers. The liquidity of these bills is second only to that of gold itself and, better still, they are an *earning asset* in virtually unlimited demand by banks and others in need of quick assets. Note that the concept of liquidity (marketability by another name) is quintessential Menger. This has apparently escaped the attention of Salerno, as before him it had escaped the attention of Mises himself. NASE puts marketability at the very heart of its inquiry. It has refined the concept further by distinguishing between *marketability in the small* (a.k.a. hoardability), and *marketability in the large* (a.k.a. salability). As it turns out, silver is the most hoardable and gold is the most salable good of all. This explains the duality of the monetary systems before 1873, when silver was foolishly demonetized by the governments of Western countries.

According to an aphorism on Lombard Street of old, long since forgotten, there is no easier profession in the world than that of the banker, *as long as he can tell a real bill and a mortgage apart.* Detractors of RBD may do well to brush up their knowledge of the principles governing pre-1936 banking theory, especially the part on self-liquidating credit (a phrase Mises never used except to ridicule it, in calling it *Deus ex machina*).

Interest rate *versus* discount rate

Salerno also believes with Mises that there is no substantial difference between the rate of interest and the discount rate. He says that if banks persisted in maintaining the rate at which they discounted real bills below the natural rate of interest, then they would generate a torrent of real bills for discounting, that would cause an inflationary spiral of money-creation and price increases.

The difference of the discount rate from the rate of interest is fundamental, all declarations to the contrary notwithstanding. Mises considered the former to be a short-term interest rate with interest payment collected at the beginning of the loan period rather than at the end. However, the fundamental difference is far more important than this technicality. The concept, the sources and the formation of the two rates are very different.

Interest is paid by the debtor to the creditor on loans. Discount is paid by the lower to the higher-order producer of the maturing consumer good. *No loan is involved* in discounting. Neither one of the two producers is subordinate to the other. They are like the two blades of a scissor. Take away either one -- no cutting is possible. At any rate, it is ridiculous to suggest that the lower-order producer is in debt to the higher-order producer. The former handles merchandise that is one step closer to the consumer. For this reason alone the former controls a good commanding higher marketability. The dependence of the latter on the former is obvious.

The confusion of the two rates gives rise to a long string of serious errors. The rate of interest takes its origin in the *propensity to save*; the discount rate takes its in the *propensity to consume*. The propensity in either case varies inversely with the rate itself. Consumer demand is satiated through the very act of consumption. This means that consumption causes the discount rate to rise, rather than to fall -- as Salerno would have us believe. The banks have no mythical power over the discount rate; they must follow the wishes of the sovereign consumer. Thus, by definition, there can be no torrent of real bills triggering an inflationary spiral and price increases. Salerno's analysis is shallow without any redeeming features.

The mission of NASE is to go back to the unpolluted sources: to Carl Menger's theory of the origin of money; to his all-important concept of marketability; and to his consistent application of marginalism. For example we at NASE talk about the principle of *marginal* time preference. It asserts that, when the rate of interest falls below his marginal rate, the marginal bondholder will sell his bonds (a future good) and with the proceeds will buy gold (a present good). This gold/bond arbitrage of the savers is anathema to Mises-worshippers because they think that Scrooge, the Prodigal Son, and everybody else have exactly the same time preference. The truth, however, is that there is a whole spectrum of different rates of time preferences from that of Scrooge to that of the Prodigal Son. The critical one, the rate of marginal time preference marking the point where the marginal bondholder will sell his bonds, is decisive. It has a crucial role to play in preventing the rate of interest from falling through the floor. The mechanism through which it does that is the bond market. After all is said and done, interest *is* a market phenomenon.

Furthermore, according to Mises paper promises to pay gold to bearer, nay, even fiat money promising to pay nothing, is a present good. He explicitly stated that *a gold certificate, if its security cannot be doubted, is just as much a present good as the gold coin itself.* Heck no, it isn't, and the marginal bondholder knows it. If he accepted such a promise, however secure, in exchange for his bond, then he would be jumping from the frying pan right into the fire. He would be worse off than if he held on to his bond. The bond at least pays interest at a positive rate, however low it may be. By contrast, paper promises of gold such as a gold certificate pay interest exactly at zero percent. The bondholder's avowed protest against low interest rates would be counter-productive. The conclusion is that the principle of time preference as formulated by Mises is utterly inadequate. It is a paper tiger having no effect whatsoever on the condition it is supposed to rectify. It leaves all the victims of Bernanke's ZRP helpless.

But as those who have eyes to see can see, even in the fast-degrading monetary system of ours *marginal* time preference -- as opposed to the time preference of Mises which is hardly more than a pious wish -- is alive and kicking. Savers from individuals to pension funds to central banks are selling their bonds in a panic and rush to buy gold with the proceeds in response to zero interest rates. This is marginal time preference in action.

We may conclude that the American Austrian establishment is badly in need of a critic. NASE has volunteeed to serve as one, but the offer was rejected. It is regrettable that American Austrians are deaf to criticism of any kind. Mises was a modest man. He never thought that *his* had to be the last word. He severely castigated those who would settle arguments by calling names. I sincerely hope that we can have a conference where arguments on both sides can be presented without fear and favor, and let the best argument win. So far, any suggestion of this kind was refused out of hand. I would be personally very happy to participate in a public debate with Dr. Salerno.

This is no time for fratricidal bickering. The survival of our civilization is at stake.

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ANNOUNCEMENT

New Austrian School of Economics

Course Four Munich, Germany

from **March 24 - April 2, 2012**

Title of the course:

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For further information or in order to register for the course you can get in contact with the organizers Ludwig Karl and Wilhelm Rabenstein via mail (nasoe@kt-solutions.de) or phone (+49 – 170 – 380 39 48 , before calling please consider a possible time lag).
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