Lecture 10:

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GOLD STANDARD UNIVERSITY

Summer Semester

Monetary Economics 101: The Real Bills Doctrine of Adam Smith

Lecture 10

THE REVOLT OF QUALITY

- Deliberate Dollar Debasement -

- The Congenital Disease of All Paper Currencies -

- Omnipotent Government -

- Demonetizing Gold -

The Portuguese Bank Note Case

At the end of the previous Lecture I ran out of time and couldn’t include the story of the Portuguese bank notes as I had intended. It is such an amusing and instructive story that I would not let you miss it, so I start with it this time.

Mises’ dictum that the bank note is a present good naturally leads to the tantalizing question whether an undetected counterfeit bank note is a present good as well. Exactly the same argument that made the genuine bank note a present good would make a counterfeit bank note a present good, too. Pity, this puts the bankers and counterfeiters into the same class: they are both in the business to create present goods out of practically nothing. I would be happy to rest my case there, however, it raises more questions than it answers. Should the practice of producing present goods out of nothing be outlawed along with quackery and witchcraft regardless whether this dangerous prestidigitation is practiced by honorable gentlemen, the bankers, or by disreputable crooks, the counterfeiters? Both the banker and counterfeiter are illusionists, mesmerizing the public into believing that their product, the bank note, is a present good and not merely a promise to deliver present good on demand. Both the banker and the counterfeiter are determined to escape any and all responsibility concerning the bank note after they have succeeded in putting it into circulation. The activities of the two are hardly different from an economic point of view. The difference is exclusively in our legal arrangements, aiding and abetting the former, while criminalizing the latter. It should criminalize both.

The following example, known as the Portuguese bank note case, is quite instructive and you will be pleased to hear it. In the late 1920's an astonishing and ingenious crime led to a fascinating civil suit that was not without its ironic side. A gang of international swindlers succeeded in convincing the well-respected London firm Waterlow & Sons, engravers of postage stamps and bank notes, that they were the representatives of the Bank of Portugal placing an order for the printing of a large quantity of fresh Portuguese bank notes. The order was duly filled and the bank notes were delivered to the swindlers. When the fraud was finally discovered, the Bank of Portugal was forced to call in all its extant notes, replacing them with a new issue. The criminals were never apprehended, but the Bank of Portugal sued Waterlow & Sons in British courts, demanding compensation for losses resulting from the issue of fraudulent notes. In listening to expert testimony the Court discovered that the case involved issues of unusual subtlety and complexity. The Court admitted evidence of negligence, but the question of damages was another matter. If it had been postage stamps instead of irredeemable bank notes in which the swindlers had trafficked, it would have been clear that the loss incurred by Portugal was equal to the face value of the fraudulent issue. With respect to bank notes, however, no such simple assertion could be made. Among the questions that troubled the experts the following stood out as particularly relevant to our study: would the Bank of Portugal have issued the same amount of bank notes even if the swindlers had not done so? If not, was the increase in the supply of paper currency resulting from the fraudulent notes beneficial or detrimental to the Portuguese economy? Some experts even testified that the swindlers may have done an unintentional favor to Portugal in helping fend off an imminent deflation. At any rate, why should the face value, rather than replacement value of a counterfeit bank note, govern considerations for damages, if the bank note is irredeemable anyway? These and other considerations led the high court to award only a

small fraction of the damages claimed. See: C.H. Kisch, *The Portuguese Bank Note Case*, London, 1932, and Wilhelm Röpke, *The Economics of Free Society*, Chicago, 1963.

The Yellowback Saga

My next example will, more than any other, demonstrate the difference between a present good and a promise to deliver a present good to bearer on demand. A U.S. $20 gold certificate (nicknamed the "yellowback" in order to distinguish it from the "greenback") and a U.S. $20 gold coin were both present goods, in the sense of Mises, on Saturday, March 4, 1933, the day of the inauguration of F. D. Roosevelt as the 31st president of the United States. The new president was elected to office in 1932 on a platform which contained the following preamble:

Believing that a party platform is a Covenant with the people to be faithfully kept by the party when entrusted with power, and that the people are entitled to know in plain words the terms of contract to which they are asked to subscribe, we hereby declare this to be the platform of the Democratic Party . . .

and this declaration:

A sound currency is to be preserved at all hazards.

During the election campaign of 1932 Mr. Roosevelt chastised president Hoover for endangering the integrity of the dollar by uttering irresponsible remarks about the possibility of going off the gold standard. There appears to be no evidence that Mr. Roosevelt favored the debasement of the dollar prior to his election. But debasement began very soon after inauguration. By the Emergency Banking Act, passed by Congress and signed into law on March 9, 1933, the president was empowered to prevent the hoarding and exportation of gold. Next day the Administration took the first step by refusing license to exporters of gold. With that refusal the dollar and the yellowbacks with it declined sharply in terms of gold and foreign exchange abroad. *For all intents and purposes the yellowback ceased to be a present good*. Lest there remain any doubt about the matter, on April 5, 1933, an Executive Order was issued requiring the owners of gold coins, gold bullion, and gold certificates (yellowbacks) to deliver these items to a Federal Reserve bank against replacement in the form of Federal Reserve notes (greenbacks) on or before May 1, 1933. The Executive Order specified heavy penalties for non-compliance.

Deliberate Dollar-Debasement

Actual debasement of the dollar was authorized under Section 43 of the Agricultural Adjustment Act of May 12, 1933, the "Thomas Amendment", empowering the president to reduce the gold content of the dollar. On June 5, 1933, Congress passed a "Joint Resolution to assure uniform value to the coins and currencies of the United States". This recited that holding and dealing in gold affected public interest and were therefore the object of regulation; that the provisions of obligations which purport to give the obligee the right to require payment in gold coin obstructed the power of Congress to regulate the value of money and are inconsistent with the policy to maintain equal value of every dollar coined or issued. It then declared that "every provision in any obligation purporting to give the obligee a right to require payment in gold is against public policy, and directed that every obligation, heretofore and hereafter incurred, whether or not any such provision is contained therein or made with respect thereto, shall be discharged upon payment, dollar for dollar, in any coin or currency which at the time of payment is legal tender for public and private debts".

The final status of the yellowbacks remained unclear until 1935, when the U.S. Supreme Court decided against the creditors of the U.S. government (Nortz v. the United States). In this landmark decision the high court ruled that the government of the U.S. did not act unconstitutionally in breaking its promise, stated on the face of the gold certificate:

This certifies that there have been deposited in the Treasury of the United States of America twenty dollars in gold coin of present weight and fineness, payable to bearer on demand.

In the opinion of the Court:

These gold certificates were currency . . . Being currency and constituting legal tender, it is entirely inadmissible to regard the gold certificates as warehouse receipts. They were not contracts for a certain amount of gold as a commodity. They called for dollars, not bullion.

However, in the words of Justice McReynolds who formulated the minority opinion of the four dissenting justices,

These were contracts to return gold left on deposit; otherwise to pay its value in currency.

The majority of the Court argued that the Constitution granted monetary powers to the government, including the power "to coin money and regulate the value thereof". Therefore, the breaking of this promise fell within the power to regulate the value of coin. The Court side-stepped the issue whether another provision of the Constitution, denying the power to the government to deprive citizens of property without due process of the law, was violated or not. Incredibly, the high court even argued that no loss accrued to the citizens in consequence of the arbitrary action of the government, because the domestic purchasing power of the Federal Reserve notes remained identical to that of the

yellowback which it replaced. In saying this, the high court ignored the immediate and sizeable losses of individuals under the jurisdiction of the United States who had obligations payable in foreign currency, as well as losses of citizens living in or visiting foreign countries.

Appalling Legal and Moral Chaos

Justices McReynolds, Van Devanter, Sutherland, and Butler disagreed with the majority of the court. The dissenting opinion was delivered by Justice McReynolds. It should be taught in American schools along with the *Emancipation Proclamation.*

We conclude that, if given effect, the enactments here challenged will bring about confiscation of property rights and repudiation of national obligations. Acquiescence in the decisions just announced is impossible; the circumstances demand a statement of our views. To let oneself slide down the easy slope offered by the course of events and to dull one's mind against the extent of danger . . . that is precisely to fail in one's obligations of responsibility.
Just men regard repudiation and spoilation of citizens by their sovereign with abhorrence; but we are asked to affirm that the Constitution has granted power to accomplish both. No definite delegation of such power exists; and we cannot believe the far-seeing framers, who labored with hope of establishing justice and securing the blessings of liberty, intended that the expected government should have authority to annihilate its own obligations and destroy the very rights which they were endeavoring to protect. Not only is there no permission for such actions; they are inhibited. And no plentitude of words can conform them to our charter.
The federal government is one of delegated and limited powers which derive from the Constitution. It can exercise only the powers granted to it. Powers claimed must be denied unless granted . . . The fundamental problem now presented is whether recent statutes passed by Congress in respect of money and credits, were designed to attain a legitimate end. Or whether, under the guise of pursuing monetary policy, Congress really has inaugurated a plan primarily designed to destroy private obligations, repudiate national debts, and drive into the Treasury all the gold within the country, in exchange for inconvertible promises to pay of much less value. Considering all circumstances, we must conclude they show that the plan disclosed is of the latter description and its enforcement would deprive the parties before us of their rights under the Constitution. Consequently the Court should do what it can to afford relief . . .

The end or objective of the Joint Resolution [of June 5, 1933] was not 'legitimate'. The real purpose was not 'to assure uniform value to the coins and currencies of the United States', but to destroy certain valuable contractual rights . . .

These words of Alexander Hamilton ought not to be forgotten: "When a government enters into contract with an individual, it deposes, as to the matter of its Constitutional authority, and exchanges the character of legislator for that of a moral agent, with the same rights and obligations as an individual. Its promises may be justly considered as excepted out of its power to legislate, unless in aid of them. It is in theory impossible to reconcile the idea of a promise which obliges, with a power to make a law which can vary the effect of it . . ."

It was not intended to give Congress the power under the law to repudiate the obligations in question . . . No such power was ever granted by the framers of the Constitution. It was not there then. It was not there yesterday. It is not there today. We are confronted with a condition in which the dollar may be reduced to 50 cents today, to 30 cents tomorrow, to 10 cents the next day, and to 1 cent the day after . . .

Under the challenged statutes it is said that the United States has realized profits amounting to $2,800,000,000. But this assumes that gain may be generated by legislative fiat. To such counterfeit profits there would be no limit; with each new debasement of the dollar they would expand. Two billions might be ballooned indefinitely to twenty, thirty, or what you will.

Losses of reputation for honorable dealing will bring us unending humiliation. The impending legal and moral chaos is appalling.

Congenital Disease of All Paper Currencies

Thus did the yellowback cease to be a 'present good' at the stroke of a pen in 1935. At any rate, the market had long recognized the true state of affairs: it treated the yellowback as a dishonored paper. By contrast, the $20 gold piece was still a present good after the Supreme Court decision as it is still today. So is the gold Napoleon. They continue to be a present good on the same terms indefinitely, whatever fate awaited the issuer. Paper money issued under the authority of Napoleon III, of course, no longer enjoys present-good status. They and the yellowback have suffered from the same congenital disease of all paper currencies: their status is tied up with the fortunes and integrity of the issuing authority. The gold coin is free from this congenital disease precisely because, unlike the paper currency, it is a present good, not a promise.

I treated the saga of the yellowback at length because it shows, I think, that Mises' concept of a present good is untenable. The yellowback lost its status as a present good, as the term is understood by Mises, for no cause more substantial than a stroke of the pen. This not only violates one's intuitive idea of a present good, but also obscures the real state of affairs. It appears to condone the mischief involved in the prestidigitation. There is no need to stretch the meaning of the term 'present good'. A perfectly satisfactory term

to cover bank notes and other varieties of paper currency redeemable in gold already exists: they are promises to pay bearer a definite quantity of gold on demand. The value of a present good can be protected against physical deterioration by its owner in taking precautions to prevent it. The value of a promise cannot be so protected: it depends on the integrity of the other party and that of the prevailing legal system. A promise can be broken, no matter how carefully one protects the paper on which it is written. Nor does it matter who the promisor is and what what resources are at his disposal. As our example shows, even if the promise has been issued by the government of the richest and 'most democratic' country on the face of the earth, with vast economic and military resources at its command, and even if the promise is backed up by Constitutional guarantees, a promise is still just a promise, and not a present good. Greater economic and military power won't make a country less likely to stoop so low as to have recourse to fraudulent bankruptcy, in order to destroy the contractual rights of weaker countries or individuals.

Gold needs no endorsement. It can be tested with scales and acids. The recipient of gold does not have to trust the government stamp on it if he doesn't trust the government that had stamped it. No act of faith is called for when gold is used in payments, and no compulsion is required. Gold is gold, and paper is paper. A present good is a present good, and a promise is a promise. Finally, whether the highest of high courts admits it or denies it, a broken promise is just that: a broken promise.

Omnipotent Government

Apparently, Mises maintains that even an irredeemable bank note is a present good. However, to call an irredeemable bank note a present good is to admit that the banks and the government can indeed create wealth out of little scraps of paper by sprinkling some ink on them. It is an admission that governments are omnipotent. But if we are to admit this, then we are forced to acknowledge that the regime of irredeemable currency, based on broken promises and on the prerogative of the government to declare bankruptcy fraudulently or, in most general terms, on contemptuous disregard for the rules of civilized dealings between individuals and the government, can endure indefinitely.

Apologists for the regime of irredeemable currency have no patience with this analysis of the historical origins of their regime. They refuse to face the fact that the viability of their regime is based on a deliberate confusion between present and future goods, that is, ultimately, on human gullibility. They try to assume a pragmatic stance. "Let bygones be bygones", they plead. "What alone matters is that the system works and will endure, because all that remains to clear up is this trifling matter of finding the 'optimal' rate at which the money supply is to be increased in order to stabilize the value of the monetary unit." I can dispose of the pragmatic argument that, indeed, there is a unique formula defining the optimal rate of increase in the quantity of irredeemable currency, in one sentence. The declining value of irredeemable currency is not a result of having the

‘wrong’ rate of increase in its quantity, but it is a result of surreptitiously smuggling an item from the liability column to the asset column of the balance sheet of the government.

The proposition that the regime of irredeemable currency can endure indefinitely flies in the face of historical evidence. No irredeemable currency has ever survived the test of times. If it was not made redeemable in specie in good time, then it ignominiously lost all its value in due course. Nor was the destruction of value caused by ‘overissuing’: it was caused by the original default. When the norms of honorable dealings between the people and the government are turned upside down, and the dishonored paper is being promoted as money, (that is, elevated from the bottom of the garbage heap to the position of the highest-powered monetary asset of the credit pyramid), then the progressive depreciation of the value of the currency is the natural course of events. First, the dishonored paper goes to a discount in gold. Then, for a time, the discount may move up and down, according to the expectation that reason might prevail and redemption might be resumed. When all hope fades, the inevitable happens. The dishonored paper loses all its remaining value.

The Revolt of Quality

The idea that the monetary regime based on irredeemable currency can endure indefinitely is the stuff of which the dreams of dictators are made. The list of attempts to translate that dream into reality is very long. Yet every one of those attempts in history failed, and did so miserably. There is no shred of scientific evidence that the substance of the present attempt is any different from that of the previous ones. It is true that this experiment has so far survived longer than previous ones. This proves nothing, nor is it necessarily an improvement, for it only prolongs the agony, and makes the end-game even more painful. The paramount fact is that the depreciation of currencies is continuing year in and year out, in good times and in bad, albeit at a varying rate. The linguistic innovation of introducing the euphemism ‘price inflation’ and the official pretense that monetary depreciation is a ‘natural’ phenomenon rather than the direct result of dishonorable dealings, will not make the outlook for the present experiment any brighter. Nor is there any reasonable hope that some significant scientific discovery, or a break-through in data processing and information technology, will change the pessimistic long-term outlook for the regime. It cannot be emphasized too strongly that longevity of a monetary regime is a matter decided not on the basis of the *quantity* of money or the rate at which it is increased, but by the *quality* of assets in the balance sheet of the monetary authority. It is futile to pretend, as the Friedmanites do, that *restricting quantity makes for quality*. Restricting the quantity of a dishonored promise cannot make it more valuable. If the regime of irredeemable currency could be perpetuated, it would be tantamount to the overthrow of the fundamental principle of double-entry book-keeping. This principle demands that an item must appear either in the liability column, or in the asset column of the balance sheet, and it cannot be shifted from one to the other at pleasure. It is not

possible to create a liability in the balance sheet of the government and pretend that, by increasing this liability at the ‘optimal rate’ one can, somehow, increase the assets in the same balance sheet, as the Friedmanites do.

If the revenues of the government consist exclusively of its own liabilities, as is the case today, then the implication is that the citizens are mere slaves of government authority with no power over their own affairs. It means that the citizens, their children, their chattels, their produce, all belong to the government. In order for them to buy food, shelter, medicine, etc., they have to get permission, in the form of a piece of government debt (itself subject to unilateral cancellation) to do so. Elections are meaningless. They are about deciding which party will collect the tithes, not about the question whether tithes should be abolished altogether. The pretense is maintained that the government is in debt to its citizens, and it is the destiny of the debt to be retired. This has no basis in fact. The government debt will never be retired: it is to keep growing indefinitely. It is the citizens who are in fact in debt to the government. It is no longer true that the government belongs to the people: rather, the people belong to the government. In the words of the currency expert, the late Dr. Franz Pick, government bonds are "certificates of guaranteed confiscation". Tax revenues can, in theory, reduce the rate of increase in government debt. However, to the extent that the government wants to translate tax revenues into tangible goods and services, the debt reduction is immediately canceled. In order to have command over real goods and services the government has to borrow, and borrow it must at an accelerating pace. The burden of debt can only be lightened through ongoing currency depreciation. This depreciation must occur in fits and starts. Otherwise people would see clearly what is going on, and would refuse to hold the currency, causing it to lose its value, as it were, overnight.

The unstated premise underlying the regime of irredeemable currency is the proposition that it is possible to keep borrowing with the right hand while destroying the value of the resulting obligations with the left. Governments trying to perpetuate the regime of irredeemable currency will ultimately find that they are destroying their own credit and their ability to borrow in the process. They will, sooner or later, reach the point where they can no longer borrow because they are no longer trusted. This is the *revolt of quality*. Even with the most drastic quantity controls of money-creation, the destruction of the regime of irredeemable currency is inevitable.

Gold Demonetization

In the late 1960's quantity theorists widely predicted that the de-monetization of gold would seriously undermine the exchange value of gold. Ludwig von Mises was among them: "The important thing to be remembered is that with every sort of money, de-monetization, i.e., the abandonment of its use as a medium of exchange must result in a serious fall of its exchange value." (*Human Action*, p. 428, third edition, Chicago, 1963.)

To a quantity theorist, the disappearance of the lion's share of the demand, the monetary demand, couldn't help but make gold cheaper. It is a source of endless amazement for me that a quantity theorist could be so blinded to the other side of the de-monetization coin, namely the effect it has on the irredeemable bank note in which gold is quoted.

It is not known whether these views of the quantity theorists had any influence on the thinking of the decision-makers who demonetized gold on August 15, 1971. Be that as it may, the idea that dishonouring promises to pay gold on demand would, somehow, cause the dishonored paper to go to a premium in terms of gold is preposterous. It is true that insolvent bankers have in the past tried to promote their discredited paper (sometimes using extreme measures such as the death penalty to punish the owners of contraband gold, as proposed by John Law of Lariston and, later, by the issuers of the assignats and mandats), to no avail. *Logic and history prove that dishonored promises to pay gold always and everywhere go to a discount, never to a premium*. Indeed, this is exactly what happened after gold was demonetized world-wide in 1971. In less than a decade the U.S. dollar went to a 90 percent discount in terms of gold. Moreover, the discount was commensurate with the 90 percent loss in purchasing power that the dollar suffered during the same period. There is no use to blame that loss on the conspiracy of Arab sheiks and the gnomes of Zurich. The huge loss in the value of the dollar during the decade of the 1970's was due to one cause only: the de-monetization of gold. The hope that the discount on the dollar would ever disappear is a forlorn one. Domestically and internationally, a deflation of that magnitude is unthinkable. Furthermore, the disarray in America's budgetary and trade accounts suggests that the currency depreciation is likely to continue, if not accelerate. The only way to stop the rot would be the adoption of a reasonable plan to resume gold redeemability of the dollar. Neither party has so far come up with a platform embracing the idea.

The use of the word 'demonetization' in connection with gold is inappropriate. It is but a euphemism for debt-abatement (partial debt-repudiation) inflicted upon the foreign creditors of the United States of America. These foreign creditors were deprived of a valuable property right: the right to a fixed amount of gold per dollar. This unilateral and capricious act has done nothing to benefit the citizens or the government of the U.S. On the contrary, the debt abatement had one predictable consequence: harsher terms on future borrowing, as measured by the higher and unpredictable rates of interest which the government and the people of the United States had to pay on new borrowings abroad. It is true that the burden of debtors who had contracted debt prior to the abatement was lightened but, insofar as they were the same borrowers on whom the harsher terms on further borrowing fell for the indefinite future, there were no beneficiaries, only losers. In particular, the big losers were the taxpayers. The international credit of the U.S. government was grievously damaged as manifested by the unprecedented interest rates (e.g., 16 percent per annum on the 30-year bonds) the Treasury was forced to pay on its obligations.

From Greatest Creditor to Greatest Debtor

The stubborn denial that the credit standing of the U.S. has been damaged in any way by the de-monetization of gold of 1971 is the centerpiece of mainstream economics. We must realize, however, that gold de-monetization is just a euphemism for the crime of pauperizing the laboring classes here and abroad, who are the main holders of the irredeemable dollar. Ironically, the 'moneyed classes' have the habit of holding irredeemable currency for as short a period of time as necessary. Then they get rid of it by investing their funds in something more reasonable.

This is a world of crime and punishment. No one, not even the government of the mightiest nation on earth can exempt itself from the consequences, which are numerous. One of them is the fact that, in an incredibly short period of time, America turned itself from the world's greatest creditor into its greatest debtor country. Another is that that part of the American industry which is not in the process of dismantling itself, is losing international competitiveness, just at the time the country would need a strong export industry to help pay for its burgeoning foreign debt. Due to volatile interest rates in the 1980's, a large part of America's park of capital goods has become submarginal. Producers were either unwilling or unable to maintain capital by replacing worn and obsolete equipment with new ones. As capital was becoming submarginal under a rising interest-rate structure, so were the producers. They were forced to sell their business at a loss, and invest the proceeds in high-yield Treasury bonds. This was a textbook-case how the government can despoil its own taxpayers. In printing high coupon-rates on Treasury bonds, instead of collecting taxes from the productive members of society, the government is now obliged to pay them for holding its debt. A large segment of the producers found themselves unable to compete with the high coupon rates the government so cavalierly printed on its bonds and, from producers of new wealth they became coupon-clippers. The consequences of wholesale destruction of capital are camouflaged by the burgeoning import of consumer goods. Foreigners accept the dollar for the time being, as in their judgment the dollar was depreciating more slowly than their domestic currency. Such a situation cannot continue indefinitely. The most visible sign of the progressive deterioration is the ever-growing trade deficit, the flip-side of the accumulation of U.S. Treasury paper in foreign hands. At one point, the world market will get saturated with the U.S. dollar. When that happens, another convulsion in the world's commodity and financial markets will follow.

It is not widely understood that the dollar was given a stay of execution by the fortuitous demise of the Soviet Union and its Evil Empire in 1990. This unforeseen historic event turned the dollar-glut into a fresh dollar shortage. All of a sudden a new market, counting some 400 million souls, was thrown wide open to dollar-penetration a market that had earlier been hermetically sealed off by the threat of the firing-squad. Huge though this market for dollars may appear, it is not unlimited. At one point it would also become saturated as had markets in Western Europe done in the late 1960's. It is no use predicting that the present dollar-shortage would never turn into a dollar glut. Similar predictions were also made during the dollar-shortage of the 1950's at a time when America's trade advantage over the rest of the world appeared unassailable. When the dollar-glut of the

late 1960's hit the unsuspecting world, those predictions were totally discredited. Today America's trade position is incomparably weaker, and getting weaker still. And, remember, America is no longer the world's greatest creditor. Now, it is the world's greatest debtor. Accordingly, the effects of the dollar glut, when it comes, will be that much worse.

The Swing of the Wrecker's Ball

Another great danger has unexpectedly appeared on the horizon, the blackhole of zero interest. It turned out that the volatility of interest rates, that was unleashed through the demonetization of gold, also has a long cycle measured in decades. At first, the pendulum was swinging towards infinite interest, threatening the dollar with hyperinflation. Right now the pendulum is swinging to the other extreme, to zero interest, spelling hyper-deflation. This is just as damaging to the producers as the swing towards infinite interest was in the early 1980's. It is impossible to predict whether one or the other extreme in the swinging of the wrecker's ball will make the world economy to collapse. Hyperinflation and hyper-deflation are just two different forms of the same phenomenon: credit collapse. Arguing which of the two forms will dominate is futile: it blurs the focus of inquiry and frustrates efforts to avoid disaster. In the meantime, the wrecker's ball keeps swinging, with ever wider amplitude, and ever greater force.

The credit of the U.S. government suffered its greatest setback in history, as a result of the 1971 devaluation of the dollar, even though it was only by a relatively insignificant amount (the official price of gold was increased from $35 only to $38). The deterioration of the credit of the U.S. still continues, with unforeseeable consequences. This is not generally acknowledged by financial writers at home and abroad. The gross mismanagement of credit in the U.S. and in the rest of the world has created intractable problems for which there are no painless solutions.

Such are the consequences of the confusion between present and future goods, between capital and credit, between assets and liabilities deliberately fostered in the minds of the people by the proponents of mainstream economics.

* * *

The Transition from Direct to Indirect Exchange

Don Lloyd of Peabody, Massachusetts, writes that I got the meaning of Mises wrong when I referred to the individual rearranging his scale of values in response to direct

exchange being abandoned and replaced by indirect exchange (Lecture 8, Mises by North). Suppose that he preferred apples to oranges under direct exchange but, with the advent of indirect exchange, he finds that he reverses his preferences. The price of an apple being $6 and that of an orange $4 apiece, Don says that the difference in price, $2, affords him enough extra market power to make the change worth his while. In contrast to my suggestion, that the individual would rearrange his scale of values to *conform* to the prevailing constellation of prices, he has rearranged his to *oppose* it.

Don, I appreciate your comment. Here is my answer. Apart from the fact that the changeover from direct to indirect exchange took hundreds if not thousands of years (so that no individual could observe the entire process), under indirect exchange you are no longer comparing apples and oranges. You compare one apple to one orange *plus* something you can buy for $2, say a plum. In other words, you haven't changed your preference for apples at all. One apple still ranks higher in your scale of values than one orange. The new element is that you can now *measure* the difference in values; you can actually *subtract* one value from another.

Your example does not weaken my position, it confirms it. Not only does the advent of money and prices give you everything you have had before (namely the possibility of ranking), it gives you more (the possibility of *measuring*). You can now answer the question by *how much*you prefer one apple to one orange. You always rank the more expensive item higher in your scale. You don't always buy what you value higher, but if buy the cheaper instead, then it is because of your preference for saving the difference. It is a very common human experience to have to make do with the cheaper item, in spite of our preferences.

It is not enough to *say* that you oppose the valuation of the market. To give substance to your valuation, you have to *do* something about it. This is what the entrepreneur does, in going into production to bring down the price that, in his opinion, the market values too highly. Indeed, I am not saying that *all* individuals *always* conform their scale of values to the constellation of prices. On the contrary: the exceptions are enormously important, or should be, to an Austrian economist. These exceptions explain the origin and nature of entrepreneurship to us. The entrepreneur *dares* oppose conventional wisdom as he posits his own valuation against that of the market. If he values *A* less than *B* but finds that in the markets $a > b$ (*A* is more expensive than *B*) then he will resort to arbitrage. This may take different forms, but the one that is important for our purposes is the entrepreneur's. He goes into the production of A using new materials, new production technologies, or even opening up new markets for A, so that he can bring a down and earn entrepreneurial profits. Please note that it is not only his entrepreneurial insight that serves as the source of those profits, but also the monetary economy which has helped him to spot an anomaly. Entrepreneurship has become easier under indirect exchange precisely because the entrepreneur can *measure, add, subtract, multiply and divide* values, none of which were impossible under indirect exchange.

Subjective economists, of course, have realized the great significance of the revolution represented by the transition from direct to indirect exchange. Nevertheless, they have

failed to deal adequately with the aspect how this transition affected the subjective valuation of individuals. Ludwig von Mises devotes three sentences to this in *The Theory of Money and Credit:*

"Nowadays exchange is usually carried on by means of money, and since every commodity has therefore a price expressible in money, the exchange value of every commodity can be expressed in terms of money. This possibility enabled money to become a medium for expressing values when the growing elaboration of the scale of values which resulted from the development of exchange necessitated a revision of the technique of valuation. That is to say, opportunities for exchanging induce the individual to rearrange his scale of values." (Op.cit., p 61.)

I submit that this "rearranging of values" was, in fact, a revolution in the subjective valuation of goods by individuals. The market *harmonized* subjective individual values, by codifying them in the price structure. As a result, values were lent the appearance of being ‘objective’. It may appear that subjective individual values were made to conform to 'objective’ values as manifested by prices. Of course, we know that subjective values had been first, and they were synthesized into prices, so we still talk about ‘subjective theory of value’. The harmonization of scattered individual values into the constellation of prices was a revolution of the utmost significance. Among others, it was responsible for the change that entrepreneurs started using *market calculation*. They could not have done it without being able to measure the value of goods and services.

Thank you, Don, for your stimulating observations. I hope you will eventually agree with me that this is a point where Austrian economists could carry science further.

Antal E. Fekete
Professor
Memorial University of Newfoundland
St.John's, CANADA A1C5S7
e-mail: aefekete@hotmail.com

GOLD STANDARD UNIVERSITY

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Monetary Economics 101: The Real Bills Doctrine of Adam Smith

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Lecture 2: Don't Fix the Dollar Price of Gold
Lecture 3: Credit Unions
Lecture 4: The Two Sources of Credit
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