NEW AUSTRIAN ECONOMICS MANIFESTO

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In a recent pamphlet Llewellyn H. Rockwell, President of the Mises Institute writes that we are all ceaselessly being bombarded by the media and college educators with propaganda to the effect

> "that capitalism causes depressions and exploits the poor. That government is our salvation, and the bureaucrat a hero. That America owes its wealth to the Federal Reserve. That without massive regulation we'd be sunk…That cutting government even a smidgen and permitting free markets would be a disaster… John Maynard Keynes died more than 60 years ago, but his ideas still rule us from the grave: give government more power, and print more money…"

It is a pleasure to acknowledge that Mises University, the Mises Institute's week-long summer program for students has done an outstanding service to society in flouting the conventional wisdom about government, and explaining the logic behind free enterprise.

Why then does the New Austrian School of Economics (NASOE) take issue with the Mises Institute? As this Manifesto explains it does because post-Mises Austrian economics has ceased to be open to new ideas. It is trying to ossify Austrian economics at the level where Mises left it. It is inimical to the appearance of new knowledge as it flows directly from the founding principles of our school, unless stamped with its own *nihil obstat*. Discussion and criticism are discouraged. Many a topic is outright tabooed. There is a tendency to turn science into cult. As a result, post-Mises Austrian economics never came up with a really potent theory that could offer an alternative to the mainstream. Nor did it draw up a comprehensive blueprint for the new economic order that would follow the collapse of the current experiment with global irredeemable currency. It claims a monopoly of ideas how the gold standard of the future ought to look like. It must be 'one hundred percent' or nothing. The last thing it would consider doing is to sponsor a conference that would entertain ideas other than its own.

The reason for these failings is that post-Mises Austrian economics has deviated from, if not completely abandoned the philosophy and methodology of the founder of the movement, Carl Menger (1840-1921). To substantiate this charge here is a list of six errors, the first three of which are errors of commission; the last three are errors of omission.

(1) Post-Mises Austrian economics dismissed Adam Smith's Gold Bills Doctrine (GBD) on the argument that it is 'inflationary' and has led to 'the source of all evil', fractional reserve banking. This was an act of denying Menger who, in his encyclopaedic article *Geld* (3rd edition, 1909) devotes an argument to justifying the practice [2].

Indeed, commercial banks do create credit upon deposits in excess of cash (gold) reserves. The asset backing this liability is "their usually extensive discounting of bills of exchange". The central bank issues "document money" in fulfillment of its mission to rediscount bills of exchange offered to it by commercial banks in need of cash.

Thus Menger, "in order to develop a realistic theory of an economy's cash requirements", far from condemning what post-Mises Austrian economists disingenuously call 'fractional reserve banking', endorses it. Apparently he does that because he accepts Adam Smith's GBD without reservations.

The term 'fractional reserve banking' used in the context of discounting real bills is a malicious misnomer. Reserves of commercial banks discounting real bills are *not* fractional. They are *full* in the sense that the non-gold part of it consists of real bills 'maturing into gold' in less than 13 weeks. They are the most marketable instruments second only to gold. Real bills can fly on their own wings and under their own power (read: they can circulate as money without duress, something the reserves for irredeemable currency certainly cannot do). They represent *self-liquidating credit*. Accordingly, gold bills are the best earning assets a commercial bank can have. Demand for them is exceedingly keen. Not only do commercial banks scramble to get them; financial institutions and other economic agents with large maturing liabilities do as well. Bonds won't do for the purpose of accumulating cash in anticipation of payments falling due. They lack the necessary marketability. Loose talk about the inflationary effect of discounting only betrays ignorance about basic banking theory as it was developed by German experts in the 19th century, and as it was understood by Menger.

The payments system incorporating discount facilities for gold bills payable in gold coin any time during the gestation period (not exceeding 13 weeks) of the maturing consumer goods made possible a spectacular and unprecedented expansion of production, employment and world trade in the nineteenth century − all promoting prosperity. It would do so again in the twenty-first.

The victorious Entente powers in their wisdom did not allow the bill market and the practice of discounting gold bills to make a comeback at the end of World War I in 1918. To that extent they can justly be blamed for the ensuing Great Depression of the 1930's. The bill market is the clearing house of the gold standard, as it were. It facilitates wages to be paid *before* the finished goods are sold to the ultimate consumer for cash. It was not the gold standard *per se* that caused the Great Contraction, rather, it was the *castration* of the gold standard in removing its most potent part, its clearing house, that is, the bill market. Without discounting facilities for bills the *wage fund* of society is strangled. Horrendous unemployment follows the destruction of the wage fund. Workers cannot be paid as no one can advance wage payments in the absence of the bill market.

The only way to replenish the wage fund is to resurrect the bill market and the trading of gold bills. It has never happened. 'Structural unemployment' of today is due to the suppression of the bill market without which wages cannot be paid in advance of the sale of merchandise. The government would rather pay workers for not working and farmers for not farming than restoring gold bills.

The dismissal of GBD by post-Mises Austrian economics led to the fatal confusion between the rate of interest and the discount rate. It also confused the two inevitable sources of credit: savings and consumption. Post-Mises Austrian economics is quite unable to see how propensity to consume can be a source of credit. Well, just as the rate of interest gages the *propensity to save* (namely, the greater the propensity to save the lower does the rate of interest go), so the rate of discount gages the *propensity to consume* (namely, the greater the propensity to consume the lower does the discount rate go). Unlike the rate of interest, the discount rate *can* go to zero (as it did when people expected doomsday to occur on January 1, 1000). The propensity to consume and the propensity to save are *not* complementary because of the presence of a third, *the propensity to hoard*, especially as it becomes prominent during the terminal stage of the regime of irredeemable currency. Hoarding must be distinguished from saving. Despite formal similarities, the rate of interest and the discount rate are fundamentally different both with regard to their sources and their effects.

(2) Post-Mises Austrian economics embraced the Equilibrium Theory of Price and the concept of evenly rotating economy in spite of Menger who was the first economist defying Aristotle in pointing out that the price-phenomenon rests on disequilibrium rather than equilibrium. Far from being static, it is dynamic. As a result, price is not monolithic. It varies between two extremes, the higher asked and the lower bid price. These two extremes never coincide in the very nature of the case. Two separate analyses are required to see how asked and bid prices are formed, each on its own. Supply-demand equilibrium is a spurious concept for a second reason, too. It leaves speculation out of consideration. The presence of speculative bid and offer (that are often made intuitively on the spur of the moment) renders supply and demand indefinable insofar as science is concerned.

(3) Post-Mises Austrian economics failed to develop a theory of interest in the spirit of Menger. In particular, it has nothing to say on the *origin of interest*, even though the *origin of money*, treated by Menger, could serve as a pattern. Paraphrasing George A. Selgin and Lawrence H. White [3], we may describe the origin of interest as follows. It is a logical evolutionary account or 'rational reconstruction' of the development of interest as it arose out of the economic need of man to hoard. It explains how interest had emerged incrementally and spontaneously from individuals' efforts to economize on their costs of hoarding and dishoarding.

Just as Menger's rational reconstruction of the transition from direct to indirect exchange, one also has the rational reconstruction of the transition from *direct conversion* of income into wealth (through hoarding) or of wealth into income (through dishoarding) to *indirect conversion*, namely, the *exchange* of income for wealth and wealth for income (through buying and selling bonds in the bond market).

The rise of money is the result of the evolution of marketability. But since we have two separate transitions involved, we need to refine the evolution of marketability into two distinct processes: the evolution of *marketability in the* *large* (also known as *saleability*), and the evolution of *marketability in the small* (also known as *hoardability*). Each promotes a monetary metal, the former gold, the latter silver, as money to be used for large and small payments, respectively. Silver, at least initially, was more suitable for hoarding purposes. Gold's specific value is so much higher as to make it unsuitable for coinage in molar quantities. The important thing to observe is how the evolution of interest was facilitated by marketability in the small.

Historically, the latter evolution was completed much later, after the scholastic fathers and protestantism have made interest taking and paying morally acceptable (they had previously been proscribed by canonical and secular law, making the quotation of the rate of interest perilous if not impossible). For the first time, legal protection was extended to gold bonds under contract law. Bond-trading was legalized. In consequence, the bond market was able to supersede hoarding and dishoarding monetary metals as a means of converting income into wealth and wealth into income. Following the indulgence of interest taking and paying, vast quantities of monetary metals were freed for other purposes such as capital formation and refinement of division of labor. It also allowed the interest rate to be quoted openly *sine ira et studio* as the rate at which the (fixed) face value of the bond is amortized by the (ever-changing) bond price as quoted in the bond market. Incidentally, this remark also confirms that the rate of interest *is* a market phenomenon − contrary to the position taken by post-Mises Austrian economics.

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Furthermore, post-Mises Austrian economics failed to develop all the implications of Menger's *Principle of Marginality*. In particular, time preference was curiously left out in spite of Böhm Bawerk's vision that variations in time preference bring about variations in the floor; while variations in the marginal productivity of capital bring about variations in the ceiling for interest rates. In particular, post-Mises Austrian economics never clarified that time preference makes sense only if *marginal time preference* is meant. It simply ignored the fact that the Prodigal Son's time preference differs from that of Scrooge.

Marginal time preference is defined as the time preference of the *marginal saver*. He is the first to sell his gold bond in protest against low interest rates as they are being pushed below the rate of marginal time preference by the government and its lackeys, the banks. The marginal saver holds the gold coin until the banks relent and allow the rate of interest to return to the rate of marginal time preference. Relent they most assuredly will in consequence of the arbitrage between the gold market and the gold bond market. It is this very arbitrage that lends time preference teeth as nothing else will: it counters the artificial lowering the rate of interest with the draining of reserves from the banking system. Banks are forced to call in their shakiest loans. As soon as the rate of interest is allowed to return to the rate of marginal time preference, the marginal saver will release the gold coin in buying back his gold bond *at a profit.* Regrettably, post-Mises Austrian economics failed to reveal the essential nexus between gold and interest.

Incidentally, this also shows that promises to pay gold coin whose maturity and security is recognized (such as for example the 'yellowbacks', gold certificates issued by the U.S. Treasury were before 1933) *cannot* deputize for the gold coin – refuting the position of Mises. In selling his gold bond the marginal saver will refuse to take the yellowback in payment. He will insist on getting the gold coin. (If he took the yellowback, he would be exchanging an interest-bearing instrument for one that is not bearing interest. In doing so he would be acting contrary to purpose.)

Thus time preference manifests itself through the demand for *present gold* as distinct from *future gold*. It *does not* manifest itself through the demand for one present apple in exchange for one half of one apple in ten years' time. Such a demand, to put it politely, is most implausible. So much for the concept of 'originary interest' of Mises that fails to refer to gold. A theory of interest without reference to gold is 'like a production of *Hamlet* in which the prince fails to appear'.

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Just as marginal time preference serves as the *floor*, marginal productivity serves as the *ceiling* to limit the range within which the rate of interest may vary. *Marginal productivity* is defined as the productivity of the *marginal entrepreneur.* He is the first to sell his business as interest rates rise. He invests the proceeds in the bonds of his more productive colleagues and will hold them until the rate of interest falls back to the rate of marginal productivity. Fall back it must, in response to the arbitrage between the bond market and the market for capital goods. (To be sure, such an arbitrage *does* take place and it *does* have an effect on the rate of interest, protestations of post-Mises Austrian economists notwithstanding). As soon as the rate of interest returns to the rate of marginal productivity, the marginal entrepreneur will sell his bonds *at a profit*, will buy back his business with the proceeds, thus re-entering the rank of producers. Regrettably, post-Mises Austrian economics, in denial of Böhm-Bawerk, intentionally ignored the inevitable nexus between productivity and interest.

(4) Post-Mises Austrian economics failed to come up with a positive theory of the gold standard. The monetary metal out of which the monetary unit is made ought to have marketability exceeding that of all other goods – as postulated by Menger [4]. This is tantamount to saying that the marginal utility of the monetary metal declines more slowly than that of any other good; so slowly indeed that it is practically constant. Following Mises, latter day Austrian economists hold that the marginal utility of gold (or, for that matter, that of any other good) *cannot* be constant since it would imply infinite demand – a contradictory notion. Be that as it may, the objection is frivolous. Menger's postulate re-stated in terms of marginal utility says that gold had become the most marketable good within the observation of man because its marginal utility declines at a rate slower than that of any other good. There is no need to refer to constant marginal utility. The mistake Mises made was that he ignored interest as the obstruction to infinite demand.

Post-Mises Austrian economics has, due to its rejection of Menger's postulate, missed gold's role as the only prophylactic against bad debt. The reason for the gold standard's longevity is that, under its *aegis*, no Babelian Tower of bad debt can breed nor can one be bred.

(5) Finally, post-Mises Austrian economics neglected to study speculation in depth, especially as it has evolved after the American embargo of gold imposed in 1971, followed by the opening of the gold futures markets shortly thereafter. It has failed to recognize the gold basis (*basis* in general is defined as the spread between the price for delivery in the nearby future and that for delivery on the spot – a concept very much in the spirit of Menger) as an important economic indicator.

For agricultural goods the basis exhibits a clear cyclical pattern as it goes from pre-harvest negative to post-harvest positive and, thereafter, it gravitates to negative values again as surpluses give way to deficit during the crop-year. For gold, the cyclical pattern is turned into a vanishing pattern. The gravitation of the gold basis towards negative territory is unmistakable. From the positive, reflecting a robust full-carrying charge (the maximum possible) it has been gradually and unobtrusively eroding to zero for the past forty years. At present it is nibbling at negative values, threatening to plunge into the black hole, from where there is no return.

The gold basis is the harbinger of a cataclysmic event comparable to the collapse of the Western Roman Empire in 476 A.D., marking a major setback in the history of civilization. The cataclysmic event that is looming large on our horizon is the advent of *permanent gold backwardation*, namely, the event of the gold basis going negative never again to return to positive territory − its natural habitat. In practice it means that all deliverable gold disappears in hoards. All offers of gold for sale are simultaneously withdrawn regardless how high the bid price may go. Annual gold mining output is no longer sold for cash. It is bartered away.

Recall that during the fifth century, the last time gold went into hiding globally, production, employment and trade shrank drastically and, with it, the prosperity of the Western Roman Empire vanished. By contrast, in the Eastern Roman Empire gold continued to flow to the Mint of Constantinople uninterrupted, while production, employment and trade prospered. The mindset of mainstream economics is too dull to grasp the difference between the Dark Age of gold vanishing in hoards, and the Golden Age of gold on the go.

Most people fail to see why permanent backwardation of gold (the modern equivalent of gold going into hiding) is a threat to our well-being. After all, you can't eat gold, can you? What these people don't realize is that permanent backwardation of gold is *highly contagious*. Barter replacing multilateral trade will gradually spread to all other markets for marketable goods, including food, fodder, and fuel.

Consequences of the return to barter will be appalling. They include the domino-effect causing the serial collapse of firms, unemployment exceeding any that has so far been experienced, famine, pestilence, to say nothing of the breakdown of law and order. Hordes of hungry people will roam the country, pilfer and plunder in search of food. Governments are helpless in the face of gold going into hiding. The American government will in particular be unable to sequester the better part of the riches of the world in exchange for irredeemable promises to pay, as it has been doing since 1971.

As long as gold futures markets are open, *some* gold can still be obtained in exchange for dollars. To that extent the dollar can be said to represent monetary value. The situation changes radically once permanent gold backwardation shuts down gold futures trading. Soon thereafter gold ceases to be routinely available in exchange for dollars. Arbitrage of gold for gold futures, animating futures trading with the carrot of risk-free profits, has all of a sudden become irreversible, replacing the carrot of gold with the stick of worthless paper. People who succumbed to the siren sound and fell for the bait of risk-free arbitrage sold their gold against promises to replace it at a lower price. People who have been tricked out of their position through artificially induced price declines were denuded of their gold as well. They are now holding the (paper) bag. *Caveat vendor!* People ignore the threat of permanent backwardation of gold at their own peril.

Post-Mises Austrian economists fail to see the threat of the fatal transition from multilateral trade to barter. Nor do they view the relapse from multilateral trade back to barter with alarm as the ultimate in deflation. On the contrary, they are shouting from their roof-top that the denouement of the present global experiment with irredeemable currency will take the form of *hyperinflation.* This is the condition that obtains when the velocity of money is rising and gets greater than any positive number, however large.

But money has another pathology as well, if occurring less frequently. As a matter of fact, it may have never occurred in all history − just as *global* experimentation with irredeemable currency hasn't: the pathology of what we may call, in want of a better term, *hyperdeflation*. It is the condition that obtains when the velocity of money is falling and becomes lower than any positive number, however small.

Permanent gold backwardation will trigger hyperdeflation 'with the certainty of scientific law'.

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NASOE pledges to remain faithful to the philosophy and methodology of Menger. Its scientific program consists in correcting all errors originating in the palpably weakening commitment to Menger's principles. This Manifesto is just the latest in a series of challenges NASOE has issued since the turn of the century – all of which have fallen on deaf ears.

But those who bear the future of our civilization at heart, like Menger and Mises did, would put petty jealousy behind them. They would stop the name-calling and the mud-slinging. They would let the grand debate take place. Let truth win the day. Let the sound money movement rally under the banner of Menger. United, it can win the coming battle with the forces of social destruction whose chief strength, fiat money, is so obviously withering on the vine.

References

[1] Michael Latzer and Stefan Schmitz (editors), *Carl Menger and the Evolution of Payments Systems: from barter to electronic money*, Cheltenham: Edward Elgar, 2002, p 19-20.

[2] Menger, *Geld*, 3rd edition (1909), Chapter XIV: The Demand for Money, (B) The demand for money of the national economy; *op.cit.,* p 84-88.

[3] *op.cit.,* p 133.

[4] Menger, *Geld*, 3rd edition (1909), Chapter III: The Emergence of Precious-Metal Money, *op.cit.,* p 39.

Note

This Manifesto was drafted by an *ad hoc* committee of the New Austrian School of Economics. Subsequently it was offered for public debate. After amendments it was submitted to the meeting held at the British Museum in London in October, 2013, where it was formally adopted on October 6, 2013.