THE NEW AUSTRIAN SCHOOL OF ECONOMICS

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The Hungarian Connection

The Austrian School of Economics dates its beginnings back to the publication in 1871 of a slender volume: *The Principles of Economics* (*Grundsätze der Volkwirtschaftslehre*) by Carl Menger. The adjective "Austrian" was meant to be derogatory, introduced by economists of German school of historicism to ridicule Menger's idea of basing economic science on axiomatic foundations, on the pattern of logic and mathematics. The root of the word "Austrian" is "East", so the connotation of "Austrian economics" is "oriental economics" — a kind of voodoo economics.

German economists could just as well have said "Austrian-Hungarian economics", since Hungary lies even further East than Austria, plus the fact that in 1871 Austria-Hungary was a dual monarchy, the two countries sharing not only a monarch but also many important political, economic, scientific, cultural institutions and traditions.

The Hungarian connection is dramatically revived by an unfortunate split in the rank and file of Austrian economists that took place in the 21st century. I have run conferences at the Martineum Academy in Szombathely, Hungary in the Austrian tradition and in the spirit of Carl Menger. I published course outlines under the aegis of the now defunct Gold Standard University on my website www.professorfekete.com. For my efforts I have been roundly denounced by parochial "American Austrians" at the Ludwig von Mises Institute in Auburn, Alabama. I consider this split most unfortunate at the most critical time, when the international monetary system shows signs of advanced *senile dementia* as well as of physical disintegration. This could have been a most opportune time for students of the gold standard to close ranks, join forces, and demand a return to the only monetary system that makes for economic stability, for peace and prosperity. They should have put their quibbles aside and offer a common platform and blueprint showing the world how it could be done. It was not meant to be.

Because of the urgency of the moment I have decided to make a fresh start and to establish a new school, proudly naming it the *New Austrian School of Economics* in Budapest, Hungary, where I live. My first act in doing so is to extend a sincere offer of cooperation to the American Austrians as soon as they are ready to look at Adam Smith's Real Bills Doctrine as a valid theory which is very much in the spirit of Menger.

The Quantity Theory of Money

It is a great pity that as a young man Ludwig von Mises embraced the Quantity Theory of Money, and has never during his long life been able to extricate himself from its clutches. For this reason he was alienated from Adam Smith's Real Bills Doctrine, the latter being an implicit refutation of the former. In spite of this flaw I still consider him the greatest economist of the 20th century. But the *mortmain* of Mises cannot be allowed to guide us in the 21st century when the Quantity Theory of Money is so spectacularly self-destructing, as witnessed by the Second Great Depression that started 80 years after the first, in 2009.

Cleansing of the Temple

The Real Bills Doctrine of Adam Smith states, in essence, that short-maturity bills of exchange drawn on goods *in most urgent demand* and moving fast enough to the ultimate gold-paying consumer, are capable of spontaneous monetary circulation, without any impetus or props from the governments or the banks. Indeed, bill circulation is possible in the absence of any banks at all. Such a system of financing production and trade *sans banques* could rise from the ashes of the regime of irredeemable currency before our very eyes. In the first decade of our century the governments and the banks have totally discredited themselves in the public's view as they have run the ship of the world's monetary system onto the rocks. Should the bankers have the temerity to show up after the shipwreck in order to set up shop, people will rise and chase them out — just as Jesus chased out the money changers in the famous scene "Cleansing of the Temple" (Mark 11:15-19; Matthew 21:12-17; Luke 19:45-48; John 2:12-25).

The scriptural teaching, confirmed by all four evangelists, is clear. *Social cooperation is still possible in the absence of banks.* It was a fatal mistake to ban the spontaneous circulation of bills maturing into gold from financing world trade — thereby promoting the bankers' dishonored promises to pay, and their never maturing but ever burgeoning debt, to the status of money.

Victors disallowing real bill circulation in 1918

The international gold standard did not collapse during the 1930's because of its inner contradictions — as schools inculcate the idea into all students. The truth is that the victorious powers inadvertently caused the collapse of the gold standard (with a 13-year lag) by disallowing its clearing system, the international bill market, to reopen for business after the cessation of hostilities in 1918.

The victors did not want to abolish the gold standard *per se*. After all, Britain returned to a gold bullion standard at the original parity of the pound sterling in 1925. The victorious allies acted vindictively. They just wanted to punish Germany over and above the provisions of the peace treaty. They forced the world into the straitjacket of bilateral trade, essentially a barter system that had evolved during the war. They refused to entertain Germany's post-war revival, given the benefits of multilateral world trade, epitomized by the international bill market as it operated before 1914. In effect, the victors wanted to perpetuate the wartime blockade of Germany in peacetime. Never mind that this also punished their own people. In their opinion it was a small price to pay for security. Little did the victorious powers realize that they were sounding the death knell for the gold standard. In a complex trading world such as that of the twentieth century the gold standard could hardly survive if it is castrated by cutting off its clearing system, bill circulation. The idea that the world could be coerced to embrace a system barring multilateral trade is akin to the idea that people could be forced back to barter by abolishing money.

History has borne out the truth of this observation. During a period of five years, from September 1, 1931, when Britain, to September 27, 1936, when Switzerland reneged on their domestic and international gold obligations, all other governments have similarly defaulted on their solemn promises to pay their creditors in the form of a fixed quantity and quality of gold. In some countries, so in the United States, draconian regulations were put into effect making the possession of gold a criminal offence in 1933. Such extreme measures had only one explanation: vindictiveness — even to the extent of hurting your own citizens and violating your own Constitution in the execution of an insane monetary policy. Government economists, university professors, financial writers and journalists have "forgotten" to raise the question whether such extreme and vindictive interference with the world's production and distribution of goods and services would ultimately have some untoward effects, even war, as a repercussion. Not one of them thought of suggesting that the legal tender status of bank notes should be declared unconstitutional through an international treaty — as the paramount measure to secure the preservation of world peace.

A Century of Legal Tender

The "forgotten questions" are belatedly being asked now. The present great financial crisis is not the outcome of some recent errors of commission or omission. Its ultimate cause goes back 100 years, to 1909. That was the year when France and Germany, in short succession after one another, enacted legal tender legislation making the note issue of the Bank of France and the Reichsbank legal tender in their respective jurisdictions. Without legal tender bank notes an all-out war could scarcely be fought. Members of the officer corps and procurers of munitions would demand remuneration in the gold coin of the realm. That could have put a speedy end to the war that started in 1914.

The real cause of the great financial crisis that started in 2009 is the inadvertent destruction of the gold standard a hundred years ago through the introduction of legal tender bank notes before World War I, and the vengeful decision to bar the international bill market after. It was these measures that have given rise to the corrosive regime of irredeemable currency, floating exchange rates, gyrating interest rates, and forever growing perpetual debt — a monetary arrangement never before globally embraced.

100 percent Gold Standard (so called)

I am an old man, two years shy of four score. I was looking forward to enjoying the quiet pleasures of retirement. However, the present world crisis calls me out of retirement. I feel it is my duty to do what I can to prevent a disaster, to wit, the establishment of the 100 percent gold standard (so called) and letting it run as the fall guy in a mission that is condemned to fail, as Britain's return to the gold standard was in 1925.

Britain's gold standard of 1925 failed because it did not have a clearing system and so it utterly lacked elasticity that only self-liquidating credit, embodied by real bill circulation could impart to the monetary system. It was doomed to failure from start. The 100 percent gold standard (so called) would repeat the mistake the British made in 1925. Another failure of the gold standard would set the world back another hundred years. In the meantime there would be trade wars, most likely leading to another world war. Our civilization would be put in harm's way.

The Theory of Discount

The 100 percent gold standard (so called) would also deprive the world of the benefits of the discount rate, this sophisticated and versatile instrument to regulate the economy. The economic triumph of the one hundred-year period from 1815 through 1914 is the triumph not only of the gold standard, but also of self-liquidating credit, the bill market, and the discount rate (as distinct from the rate of interest). During that triumphant period such economic maladies as chronic trade imbalance, structural unemployment, foreign exchange crises, unbridled increases in public and private debt were quite unknown. The world economy was on an even keel, delicately balanced by self-correction through the mechanism of the discount rate.

In the 19th century no sharp distinction could be made between "surplus" and "deficit" countries due to the self-correcting mechanism of the discount rate. It would have been unthinkable that balances of pound sterling would keep piling up in one country (as dollar balances do now in China), causing great disruptions in world trade, and leading to the dismantling of whole industries in the deficit countries.

Instead, surplus countries would experience an automatic fall, deficit countries an automatic rise in the discount rate. This would *immediately* induce a flow of short-term capital from the surplus countries to the deficit countries *in the form of consumer goods in the most urgent demand*. There is no better way, known to man, to satisfy the world's multifarious and fast-changing needs using the world's scarce resources most economically and efficiently, to the best advantage of all. This great mechanism of economic adjustment, capable of preventing structural unemployment and chronic imbalances in the world economy, the discount rate, was thoughtlessly thrown away by the victorious allies when they decided not to allow the reorganization of the international bill market for reasons of vindictiveness in 1918.

Open the Mint to Gold!

The secret of solution to the great financial crisis of our day is that governments should open the Mint to gold. This means restoring the individuals' right to convert their gold at the Mint, without limit, into the gold coin of the realm free of seigniorage charges. They should also have the right to melt down, hoard or export the gold coin of the realm as they see fit.

The significance of the opening of the Mint to gold is that it would convert idled gold into "gold on the go". Circulating gold coins would revive world trade as nothing else could. Gold locked up in government and private vaults is a curse putting the world economy in a bind (in addition to being a stupid economic waste of a unique scarce resource that has no substitute).

The Most Misunderstood of Metals

Gold is the most misunderstood metal in human history, because of the economists' failure to distinguish between its dynamic and static aspects in representing values. Economists have blithely assumed all along that the value of gold is the same whether it flows freely from one hand to the next, or whether the movement of gold is obstructed, in the worst case arrested, by the government (soon to be aped by banks and individuals). Yet the truth of the matter is that "gold on the go" is far more valuable than "gold locked up". Golden Ages of history were periods characterized by "gold on the go". Man trusted man, and men trusted their governments. Promises to pay gold were routinely made and kept. Gold was paid out without hesitation because men and governments were confident that they can get it back on the same terms any time of their own choosing. Above all, during the Golden Ages of history there was peace because goods and services could be more readily obtained through trade than through theft or conquest.

By contrast, under our present system wherein gold is concentrated in government and private hoards, there prevails a great distrust and widespread misery. Above all, there is perpetual war as goods and services could be more readily obtained through theft and conquest than through voluntary trade.

In rejecting gold our statesmen have rejected reason. Their guilty conscience is shown by their neurotic fear of an open debate on the gold question, and by the fact that they deny academic appointments to solid gold standard men, treating them as if they were cranks. Politicians are wont to erase the very thought of gold from the public consciousness.

The Best Unemployment Insurance Known to Man

The combination of a gold standard with bill trading would produce an economic miracle in the world far greater than the economic miracle of Ludwig Erhardt's Germany in 1949. The curse of trade deficits would disappear. Even if a country suffered a great natural disaster, say, the total loss of its annual crop, trade deficit would not necessarily follow. The discount rate would immediately shoot up in the stricken country. That country would be the best place in the world on which to draw bills. This would instantaneously generate a flow of short-term capital in the form of consumer goods in most urgent demand. No country would ever need to go to other governments begging for charity. Surplus countries would be prompted to expel gold in response to greater demand as demonstrated by the higher discount rate abroad.

Structural unemployment would disappear as it would be prevented before it became chronic by the higher discount rate in areas of falling employment. The higher local discount rate would generate an influx of finished and semi-finished goods from the surrounding areas. The processing and the distribution of these goods would create as many new jobs as necessary. The best "unemployment insurance" known to man is "gold standard *plus* bill trading". This is how the world economy worked before 1914; this is how it would have worked after 1918 had the victorious powers had the intelligence to allow multilateral trade and real bill circulation to make a comeback.

Hands-off Treasury bills

All the government needs to do is to open the Mint to gold and to protect real bill trading against fraud. Funds raised through the bill market are public funds that must be protected against misuse just as other forms of public funds must. Let me mention just three types of misuse: (1) drawing more than one bill on the same consignment of merchandise; (2) drawing a new bill upon the expiry of the old on the same unsold merchandise; (3) financing stores of goods in the expectation of a rise in price by drawing bills.

Bills of exchange drawn on goods in most urgent demand and moving fast enough to the ultimate gold-paying consumer are capable of monetary circulation on their own wings and under their own steam, regardless whether or not banks are standing by, ready to monetize them. But if they are, legislation should prohibit banks from borrowing short in order to lend long. In practice this means that the banks would be prohibited from rolling over short term commercial credit at maturity. Commercial banks must also be prohibited from conspiring with the drawer of the bill. Withholding stocks from trade in expectation of a rise in price must be financed by an investment bank, never by a commercial bank. The two types of banks should be strictly separated by law. Commercial banks must also be prohibited from investing in brick and mortar. In practice this means that mortgages are "hands-off ".

Treasury bills are also "hands-off", except on capital account. We know that people will want to eat and to keep themselves clad and shod tomorrow. That's what makes bills the safest earning asset. We also know that people will pay their taxes *only after* they have eaten, clad and shod themselves. That's why real bills as an earning asset are superior to Treasury bills.

The Curse of Senescence

The demand for gold has a component that is unknown to our generation, although it was ubiquitous a hundred years ago: the demand for yield on gold in gold. Gold used to wear two hats: if you wanted, gold was wealth; but if you wanted, gold was income. Moreover, the switch between the two was as simple as one-two-three, through the agency of the bill market. The possibility of making gold yield an income in gold is missing from the world today. The reason is the neurotic approach to gold promoted by the media and academia.

The discount earned by holding real bills to maturity is the safest way to generate an income in gold. Likewise, the safest way to convert that income back into gold is by selling real bills from portfolio.

But why is switching between gold as wealth and gold as income so important? Well, God created man and made him mortal. Also he made us subject to curse of senescence. Our capacity to generate an income is the lowest just when our need to rely on it is the greatest: when we grow old and frail. This seems unjust; but God has also given us a marvelous tool as a compensation: gold. The young man can hoard gold, maybe to adorn his wife with gold jewelry, thus converting income into wealth, so that they can turn this wealth back into income by dishoarding gold when he grows old and his surplus of income has turned into a deficit. Thus gold is man's tool to convert income into wealth and wealth into income safely. Gold is the catalyst in solving the problem of senescence. That indeed is gold's main excellence.

Exchanging income for wealth and wealth for income

The trouble is that hoarding and dishoarding gold is a laborious and time-consuming process, raising the problem of efficiency and safety. It is important for us to see that the efficiency of converting income into wealth and wealth into income can be greatly enhanced, and the time-consuming process can be telescoped into instant action, if we pass *from direct to indirect* conversion of income and wealth. That is to say, we pass from hoarding and dishoarding to the exchange of income for wealth and wealth for income.

The Theory of Interest

This leads us to the concept of interest. The interest rate is just the marginal efficiency of exchanging income and wealth (over the zero efficiency of direct conversion: hoarding and dishoarding). We can shape the theory of the origin of interest so as to describe the evolution of direct conversion of income into wealth or wealth into income through the agency of the *most hoardable* good, gold, resulting in the far more efficient indirect conversion: the exchange of wealth and income.

This closely follows Menger's familiar theory of the origin of money as the evolution of direct exchange (barter) resulting in the far more efficient indirect exchange through the agency of the *most marketable* good, gold.

Given the possibility of indirect conversion, that is, the exchange of income and wealth, the young man with a surplus of income but a deficit of wealth, who wants to go into business, no longer has to waste his best years to hoard gold in order to raise capital. He will seek out a congenial elderly man who has a surplus of wealth but a deficit of income. The two can go into partnership in exchanging the surplus income of the junior partner for the surplus wealth of the senior. But they can do it safely only if the God-ordained institution of the gold standard and the instrument of the gold bond have not been corrupted by do-gooder politicians, as they in fact have in inflicting the coercive regime of irredeemable currency upon the world.

Today no exchange of income and wealth is safe because we no longer have a reliable unit measuring value. This is a formidable obstruction in the way of forming new capital at a time when great capital destruction is taking place due to fluctuating interest rates. The problem of providing adequate capital for business cannot be solved satisfactorily while assuming the regime of irredeemable currency, under which the central bank can suppress the rate of interest all the way to zero — the main cause of capital destruction in the world today. It can be solved only under the regime of a gold standard, where the rate of interest is naturally stable, as shown by the stable price of the gold bond.

This is a new theory of interest that starts from the concept of the hoardability of gold and from the natural need of man to save for his old age. It enables us to see that old age security can be furnished far more efficiently through the voluntary efforts of individuals than through the coercive schemes of the government.

My Message to the Young

I have established the New Austrian School of Economics in order to spread these unorthodox ideas which are very much in the spirit of Carl Menger. Time has come to go beyond rehashing old truths: we must come up with new ideas on our own.

I hereby invite all young people who feel that regurgitating platitudes is not enough. Come to Budapest and enroll at the New School of Austrian Economics! Let's raise the torch and carry on the great work of enlightenment together! This is no time for cultism or for parochial quibblings. We must forge ahead past the stale criticism of the existing order. Armed with new ideas we are ready to act. I want to lead you and, then, I want you to lead the world!

There is no place anywhere else in the world where you can study the gold standard as it interacts with its clearing system, the bill market, and with the mechanism of the discount rate; where you can learn that legal tender legislation and the elimination of bill trading is invitation to war (first trade war, followed by shooting war); where you can learn that the starting point of the theory of interest must be gold, the most hordable commodity — except here, in Budapest, at the New School of Austrian Economics. The powers that be have expunged gold standard studies from the curriculum. As a consequence the charlatans of at our universities will never be able to come to grips with the theory of interest. There is no way to understand interest without understanding gold first. We shall recreate gold standard studies and advance it together.

See you in August when I shall deliver my first lecture series on the subject of *Disorder and Coordination in Economics — Has the world reached the ultimate economic and monetary disorder?*

May 12, 2010.

Calendar of Events

European Bankers Symposium, 9-10 June 2010, Hall, Tyrol, Austria.
Professor Fekete will be a keynote speaker on June 9, at 13:30. The title of his talk is: *(Gold) Architecture for a New World Finance System.* For more information, please see www.financetrainer.com .

ANNOUNCING THE ESTABLISHMENT OF THE AUSTRIAN SCHOOL OF ECONOMICS IN BUDAPEST. The first ten-day, 20-lecture course offered is entitled: Disorder and Coordination in Economics — *Has the world reached the ultimate economic and monetary disorder?* The lecturer is Professor Fekete, with the cooperation of Mr. Rudy Fritsch (Canada), Peter van

Coppenolle (Belgium), and Mr. Sandeep Jaitly (United Kingdom). It will be held in Budapest, Hungary, from August 9-20, 2010. Participation is limited, early registration is advisable. For more information and registration, contact Dr. Judith Szepesvari, the wife of Prof. Fekete at: szepesvari17@gmail.com. Inexpensive dorm-type accommodation is available for students (shared bathroom, shared kitchen); a three-star hotel is next door. Extra-curricular consulting with Professor Fekete can be arranged for an extra fee.

The school is meant for all students (including beginners) interested in the Austrian theory of money, credit, and banking. Its program plans to cover the whole spectrum of Austrian economics, with special emphasis on developments that took place after the death of the greatest 20th century economist, Ludwig von Mises, including the Real Bills doctrine and social circulating capital; the theory of money, credit and banking; and the theory of interest and discount.

Completion of this course will earn participants one credit towards a four-course, four-credit program that has been submitted for accreditation to the Adult Education Accreditation Board of Hungary. Participants will receive a certificate signed by Professor Fekete. The follow-up credit courses will cover these areas:

Adam Smith's Real Bills Doctrine and Social Circulating Capital.

The Austrian Theory of Interest and Discount.

The Austrian Theory of Money, Credit, and Banking.

Some of the follow-up courses may be offered at Martineum Academy in Szombathely, Hungary, where we have had four successful conferences already in the past. A special cordial invitation is extended to all Martineum alumni and their family members and friends!

It is not well-known that Budapest is one of the foremost spas in Central Europe with a dozen or so medicinal thermal springs. Participants of the course could stay on afterwards and savor the superb spa and cultural offerings in the city. Make it a family holiday! Bring the children! Eating and shopping facilities, as well as a swimming pool are nearby. Spectacular excursions can be arranged in the surrounding hills, and boat trips on the River Danube.