

HUMAN ACTION

by Ludwig von Mises, 4th edition (1996)

PART SIX

THE HAMPERED MARKET ECONOMY

XXXI. CURRENCY AND CREDIT MANIPULATION

1. The Government and the Currency

Media of exchange and money are market phenomena. What makes a thing a medium of exchange or money is the conduct of parties to market transactions. An occasion for dealing with monetary problems appears to the authorities in the same way in which they concern themselves with all other objects exchanged, namely, when they are called upon to decide whether or not the failure of one of the parties to an act of exchange to comply with his contractual obligations justifies compulsion on the part of the government apparatus of violent oppression. If both parties discharge their mutual obligations instantly and synchronously, as a rule no conflicts arise which would induce one of the parties to apply to the judiciary. But if one or both parties' obligations are temporally deferred, it may happen that the courts are called to decide how the terms of the contract are to be complied with. If payment of a sum of money is involved, this implies the task of determining what meaning is to be attached to the monetary terms used in the contract.

Thus it devolves upon the laws of the country and upon the courts to define what the parties to the contract had in mind when speaking of a sum of money and to establish how the obligation to pay such a sum is to be settled in accordance with the terms agreed upon. They have to determine what is and what is not legal tender. In attending to this task the laws and the courts do not *create* money. A thing becomes money only by virtue of the fact that those exchanging commodities and services commonly use it as a medium of exchange. In the unhampered market economy the laws and the judges in attributing legal tender quality to a certain thing merely establish what, according to the usages of trade, was intended by the parties when they referred in their deal to a definite kind of money. They interpret the customs of the trade in the same way in which they proceed when called to determine what is the meaning of any other terms used in contracts.

Mintage has long been a prerogative of the rulers of the country. However, this government activity had originally no objective other than the stamping and certifying of weights and measures. The authority's stamp placed upon a piece of metal was supposed to certify its weight and fineness. When later princes resorted to substituting baser and cheaper metals for a part of the precious metals while retaining the customary face and name of the coins, they did it furtively and in full awareness of the fact that they were engaged in a fraudulent attempt to cheat the public. As soon as people found out these artifices, the debased coins were dealt with at a discount as against the old better ones. The governments reacted by resorting to compulsion and coercion. They make it illegal to discriminate in trade and in the settlement of deferred payments between "good" money and "bad" money and decreed maximum prices in terms of "bad" money. However, the result obtained was not that which the governments aimed at. Their decrees failed to stop the process which adjusted commodity prices (in terms of the debased currency) to the actual state of the money relation. Moreover, the effects appeared which Gresham's Law describes.

The history of government interference with currency is, however, not merely a record of debasement practices and of abortive attempts to avoid their inescapable catallactic consequences. There were governments that did not look upon their mintage prerogative as a means of cheating that part of the public who placed confidence in their rulers' integrity and who, out of ignorance, were ready to accept the debased coins at their face value. These governments considered the manufacturing of coins not as a source of surreptitious fiscal lucre but as a public service designed to safeguard a smooth functioning of the market. But even these governments--out of ignorance and dilettantism--often resorted to measures which were tantamount to interference with the price structure, although they were not deliberately planned as such. As two precious metals were used side by side as money, authorities naively believed that it was their task to unify the currency system by decreeing a rigid exchange ratio between gold and silver. The bimetallic system proved a complete failure. It did not bring about bimetallism, but an alternating standard. That metal which, compared with the instantaneous state of the fluctuating market exchange rate between gold and silver, was overvalued in the legally fixed ratio, predominated in domestic circulation, while the other metal disappeared. Finally the governments abandoned their vain attempts and acquiesced in monometallism. The silver purchase policy that the United States practiced for many decades was virtually no longer a device of monetary policy. It was merely a scheme for raising the price of silver for the benefit of the owners of silver mines, their employees, and the states within the boundaries of which the mines were located. It was a poorly disguised subsidy. Its monetary significance consisted merely in the fact

that it was financed by issuing additional dollar bills whose legal tender quality does not differ essentially from that of the Federal Reserve notes, although they bear the practically meaningless imprint "Silver Certificate."

Yet economic history also provides instances of well-designed and successful monetary policies on the part of governments whose only intention was to equip their countries with a smoothly working currency system. Laissez-faire liberalism did not abolish the traditional government prerogative of mintage. But in the hands of liberal governments the character of this state monopoly was completely altered. The ideas which considered it an instrument of interventionist policies were discarded. No longer was it used for fiscal purposes or for favoring some groups of the people at the expense of other groups. The government's monetary activities aimed at one objective only: to facilitate and to simplify the use of the medium of exchange which the conduct of the people had made money. A nation's currency system, it was agreed, should be sound. The principle of soundness meant that the standard coins--i.e., those to which unlimited legal tender power was assigned by the laws--should be properly assayed and stamped bars of bullion coined in such a way as to make the detection of clipping, abrasion, and counterfeiting easy. To the government's stamp no function was attributed other than to certify the weight and the fineness of the metal contained. Pieces worn by usage or in any other way reduced in weight beyond the very narrow limits of tolerated allowance lost their legal tender quality; the authorities themselves withdrew such pieces from circulation and reminted them. For the receiver of an undefaced coin there was no need to resort to the scales and to the acid test in order to know its weight and content. On the other hand, individuals were entitled to bring bullion to the mint and to have it transformed into standard coins either free of charge or against payments of a seigniorage generally not surpassing the actual expenses of the process. Thus the various national currencies became genuine gold currencies. Stability in the exchange ratio between the domestic legal tender and that of all other countries which had adopted the same principles of sound money was brought about. The international gold standard came into being without intergovernmental treaties and institutions.

In many countries the emergence of the gold standard was effected by the operation of Gresham's Law. The role that government policies played in this process in Great Britain consisted merely in ratifying the results brought about by the operation of Gresham's Law; it transformed a de facto state of affairs into a legal state. In other countries governments deliberately abandoned bimetallism just at the moment when the change in the market ratio between gold and silver would have brought about a substitution of a de facto silver currency for the then prevailing de

facto gold currency. With all these nations the formal adoption of the gold standard required no other contribution on the part of the administration and the legislature than the enactment of laws.

It was different in those countries which wanted to substitute the gold standard for a --de facto or de jure--silver or paper currency. When the German Reich in the 'seventies of the nineteenth century wanted to adopt the gold standard, the nation's currency was silver. It could not realize its plan by simply imitating the procedure of those countries in which the enactment of the gold standard was merely a ratification of the actual state of affairs. It had to replace the standard silver coins in the hands of the public with gold coins. This was a time-absorbing and complicated financial operation involving vast government purchases of gold and sales of silver. Conditions were similar in those countries which aimed at the substitution of gold for credit money or fiat money.

It is important to realize these facts because they illustrate the difference between conditions as they prevailed in the liberal age and those prevailing today in the age and those prevailing today in the age of interventionism.

2. The Interventionist Aspect of Legal Tender Legislation

The simplest and oldest variety of monetary interventionism is debasement of coins or diminution of their weight or size for the sake of debt abatement. The authority assigns to the cheaper currency units the full legal tender power previously granted to the better units. All deferred payments can be legally discharged by payment of the amount due in the meaner coins according to their face value. Debtors are favored at the expense of creditors. But at the same time future credit transactions are made more onerous for debtors. A tendency for gross market rates of interest to rise ensues as the parties take into account the chances for a repetition of such measures of debt abatement. While debt abatement improves the conditions of those who were already indebted at the moment, it impairs the position of those eager or obliged to contract new debts.

The antitype of debt abatement--debt aggravation through monetary measures--has also been practiced, though rarely. However, it has never deliberately been planned as a device to favor the creditors at the expense of the debtors. Whenever it came to pass, it was the unintentional effect of monetary changes considered as peremptory from other points of view. In resorting to such monetary changes governments put up with their effects upon deferred payments either because they considered the measures unavoidable or because they assumed that creditors and debtors, in

determining the terms of the contract, had already foreseen these changes and duly taken them into account. The best examples are provided by British events after the Napoleonic wars and again after the first World War. In both instances Great Britain some time after the end of hostilities returned, by means of a deflationary policy, to the prewar gold parity of the pound sterling. The idea of engineering the substitution of the gold standard for the war-time credit-money standard by acquiescing in the change in the market exchange ratio between the pound and gold, which had already taken place, and of adopting this ratio as the new legal parity, was rejected. This second alternative was scorned as a kind of national bankruptcy, as a partial repudiation of the public debt, and as a malicious infringement upon the rights of all those whose claims had originated in the period preceding the suspension of the unconditional convertibility of the banknotes of the Bank of England. People labored under the delusion that the evils caused by inflation could be cured by a subsequent deflation. Yet the return to the prewar gold parity could not indemnify the creditors for the damage they had suffered as far as the debtors had repaid their old debts during the period of money depreciation. Moreover, it was a boon to all those who had lent during this period and a blow to all those who had borrowed. But the statesmen who were responsible for the deflationary policy were not aware of the import of their action. They failed to see consequences which were, even in their eyes, undesirable, and if they had recognized them in time, they would not have known how to avoid them. Their conduct of affairs really favored the creditors at the expense of the debtors, especially the holders of the government bonds at the expense of the taxpayers. In the 'twenties of the nineteenth century it aggravated seriously the distress of British agriculture and a hundred years later the plight of British export trade. Nonetheless, it would be a mistake to call these two British monetary reforms the consummation of an interventionism intentionally aiming at debt aggravation. Debt aggravation was merely the unintentional outcome of a policy aiming at other ends.

Whenever debt abatement is resorted to, its authors protest that the measure will never be repeated. They emphasize that extraordinary conditions which will never again present themselves have created an emergency which makes indispensable recourse to noxious devices absolutely reprehensible under any other circumstances. Once and never again, they declare. It is easy to conceive why the authors and supporters of debt abatement are compelled to make such promises. If total or partial nullification of the creditors' claims becomes a regular policy, lending of money will stop altogether. The stipulation of deferred payments depends on the expectation that no such nullification will be decreed.

It is therefore not permissible to look upon debt abatement as a device of a system of economic policies which could be considered as an alternative to any other system of society's permanent

economic organization. It is by no means a tool of constructive action. It is a bomb that destroys and can do nothing but destroy. If it is applied only once, a reconstruction of the shattered credit system is still possible. But if the blows are repeated, total destruction results.

It is not correct to look upon inflation and deflation exclusively from the point of view of their effects upon deferred payments. It has been shown that cash-induced changes in purchasing power do not affect the prices of the various commodities and services at the same time and to the same extent, and what role this unevenness plays in the market.¹ But if one regards inflation and deflation as means of rearranging the relations between creditors and debtors, one cannot fail to realize that the ends sought by the government resorting to them are attained only in a very imperfect degree and that, besides, consequences appear which, from the government's point of view, are highly unsatisfactory. As is the case with every other variety of government interference with the price structure, the results obtained not only are contrary to the intentions of the government but produce a state of affairs which, in the opinion of the government, is more undesirable than conditions on the unhampered market.

As far as a government resorts to inflation in order to favor the debtors at the expense of the creditors, it succeeds only with regard to those deferred payments which were stipulated before. Inflation does not make it cheaper to contract new loans; it makes it, on the contrary, more expensive by the appearance of a positive price premium. If inflation is pushed to its ultimate consequences, it makes any stipulation of deferred payments in terms of the inflated currency cease altogether.

3. The Evolution of Modern Methods of Currency Manipulation

A metallic currency is not subject to government manipulation. Of course, the government has the power to enact legal tender laws. But then the operation of Gresham's Law brings about results which may frustrate the aims sought by the government. Seen from this point of view, a metallic standard appears as an obstacle to all attempts to interfere with the market phenomena by monetary policies.

In examining the evolution which gave governments the power to manipulate their national currency systems, we must begin by mentioning one of the most serious shortcomings of the classical economists. Both Adam Smith and David Ricardo looked upon the costs involved in the preservation of a metallic currency as a waste. As they saw it, the substitution of paper money for

¹ See above, pp. 411-413.

metallic money would make it possible to employ capital and labor, required for the production of the quantity of gold and silver needed for monetary purposes, for the production of goods which could directly satisfy human wants. Starting from this assumption, Ricardo elaborated his famous *Proposals for an Economical and Secure Currency*, first published in 1816. Ricardo's plan fell into oblivion. It was not until many decades after his death that several countries adopted its basic principles under the label *gold exchange standard* in order to reduce the alleged waste involved in the operation of the gold standard nowadays decried as "classical" or "orthodox."

Under the classical gold standard a part of the cash holdings of individuals consists in gold coins. Under the gold exchange standard the cash holdings of individuals consist entirely in money-substitutes. These money-substitutes are redeemable at the legal par in gold or foreign exchange of countries under the gold standard or the gold exchange standard. But the arrangement of monetary and banking institutions aims at preventing the public from withdrawing gold from the Central Bank for domestic cash holdings. The first objective of redemption is to secure the stability of foreign exchange rates.

In dealing with problems of the gold exchange standard all economists--including the author of this book--failed to realize the fact that it places in the hands of governments the power to manipulate their nations' currency easily. Economists blithely assumed that no government of a civilized nation would use the gold exchange standard intentionally as an instrument of inflationary policy. Of course, one must not exaggerate the role that the gold exchange standard played in the inflationary ventures of the last decades. The main factor was the proinflationary ideology. The gold exchange standard was merely a convenient vehicle for the realization of the inflationary plans. Its absence did not hinder the adoption of inflationary measures. The United States was in 1933 by and large still under the classical gold standard. This fact did not stop the New Deal's inflationism. The United States at one stroke--by confiscating its citizens' gold holdings--abolished the classical gold standard and devalued the dollar against gold.

The new variety of the gold exchange standard as it developed in the years between the first and the second World Wars may be called the flexible gold exchange standard or, for the sake of simplicity, the *flexible standard*. Under this system the Central Bank or the Foreign Exchange Equalization Account (or whatever the name of the equivalent governmental institution may be) freely exchanges the money-substitutes which are the country's national legal tender either against gold or against foreign exchange, and vice versa. The ratio at which these exchange deals are transacted is not invariably fixed, but subject to changes. The parity is flexible, as people say. This flexibility, however, is almost always a downward flexibility. The authorities used their

power to lower the equivalence of the national currency in terms of gold and of those foreign currencies whose equivalence against gold did not drop; they never ventured to raise it. If the parity against another nation's currency was raised, the change was only the consummation of a drop that had occurred in that other currency's equivalence (in terms of gold or of other nations' currencies which had remained unchanged). Its aim was to bring the appraisal of this definite foreign currency into agreement with the appraisal of gold and the currencies of other foreign nations.

If the downward jump of the parity is very conspicuous, it is called a devaluation. If the alteration of the parity is not so great, editors of financial reports describe it as a weakening in the international appraisal of the currency concerned.² In both cases it is usual to refer to the event by declaring that the country concerned has raised the price of gold.

The characterization of the flexible standard from the catallactic point of view must not be confused with its description from the legal point of view. The catallactic aspects of the issue are not affected by the constitutional problems involved. It is immaterial whether the power to alter the parity is vested in the legislative or in the administrative branch of the government. It is immaterial whether the authorization given to the administration is unlimited or, as was the case in the United States under New Deal legislation, limited by a terminal point beyond which the officers are not free to devalue further. What counts alone for the economic treatment of the matter is that the principle of flexible parities has been substituted for the principle of the rigid parity. Whatever the constitutional state of affairs may be, no government could embark upon "raising the price of gold" if public opinion were opposed to such a manipulation. If, on the other hand, public opinion favors such a step, no legal technicalities could check it altogether or even delay it for a short time. What happened in Great Britain in 1931, in the United States in 1933, and in France and Switzerland in 1936 clearly shows that the apparatus of representative government is able to work with the utmost speed if public opinion endorses the so-called experts' opinion concerning the expediency and necessity of a currency's devaluation.

One of the main objectives of currency devaluation--whether large-scale or small-scale--is, as will be shown in the next section, to rearrange foreign trade conditions. These effects upon foreign trade make it impossible for a small nation to take its own course in currency manipulation irrespective of what those countries are doing with whom its trade relations are closest. Such nations are forced to follow in the wake of a foreign country's monetary policies. As

² See above, p. 461.

far as monetary policy is concerned they voluntarily become satellites of a foreign power. By keeping their own country's currency rigidly at par against the currency of a monetary "suzerain-country," they follow all the alterations which the "suzerain" brings about in its own currency's parity against gold and the other nations' currencies. They join a monetary *bloc* and integrate their country into a monetary *area*. The most talked about bloc or area is the sterling bloc or area.

The flexible standard must not be confused with conditions in those countries in which the government has merely proclaimed an official parity of its domestic currency against gold and foreign exchange without making this parity effective. The characteristic feature of the flexible standard is that any amount of domestic money-substitutes can in fact be exchanged at the parity chosen against gold or foreign exchange, and vice versa. At this parity the Central Bank (or whatever the name of the government agency entrusted with the task may be) buys and sells any amount of domestic currency and of foreign currency of at least one of these countries which themselves are either under the gold standard or under the flexible standard. The domestic banknotes are really redeemable.

In the absence of this essential feature of the flexible standard, decrees proclaiming a definite parity have a quite different meaning and bring about quite different effects.³

4. The Objectives of Currency Devaluation

The flexible standard is an instrument for the engineering of inflation. The only reason for its acceptance was to make reiterated inflationary moves technically as simple as possible for the authorities.

In the boom period that ended in 1929 labor unions had succeeded in almost all countries in enforcing wage rates higher than those which the market, if manipulated only by migration barriers, would have determined. These wage rates already produced in many countries institutional unemployment of a considerable amount while credit expansion was still going on at an accelerated pace. When finally the inescapable depression came and commodity prices began to drop, the labor unions, firmly supported by the governments, even by those disparaged as anti-labor, clung stubbornly to their high-wages policy. They either flatly denied permission for any cut in nominal wage rates or conceded only insufficient cuts. The result was a tremendous increase in institutional unemployment. (On the other hand, those workers who retained their jobs improved their standard of living as their hourly real wages went up.) The burden of

³ See below, section 6 of this chapter.

unemployment doles became unbearable. The millions of unemployed were a serious menace to domestic peace. The industrial countries were haunted by the specter of revolution. But union leaders were intractable, and no statesman had the courage to challenge them openly.

In this plight the frightened rulers bethought themselves of a makeshift long since recommended by inflationist doctrinaires. As unions objected to an adjustment of wages to the state of the money relations and commodity prices, they chose to adjust the money relation and commodity prices to the height of wage rates. As they saw it, it was not wage rates that were too high; their own nation's monetary unit was overvalued in terms of gold and foreign exchange and had to be readjusted. Devaluation was the panacea.

The objectives of devaluation were:

1. To preserve the height of nominal wage rates or even to create the conditions required for their further increase, while real wage rates should rather sink.
2. To make commodity prices, especially the prices of farm products, rise in terms of domestic money or, at least, to check their further drop.
3. To favor the debtors at the expense of the creditors.
4. To encourage exports and to reduce imports.
5. To attract more foreign tourists and to make it more expensive (in terms of domestic money) for the country's own citizens to visit foreign countries.

However, neither the governments nor the literary champions of their policy were frank enough to admit openly that one of the main purposes of devaluation was a reduction in the height of real wage rates. They preferred for the most part to describe the objective of devaluation as the removal of an alleged "fundamental disequilibrium" between the domestic and the international "level" of prices. They spoke of the necessity of lowering domestic costs of production. But they were anxious not to mention that one of the two cost items they expected to lower by devaluation was real wage rates, the other being interest stipulated on long-term business debts and the principal of such debts.

It is impossible to take seriously the arguments advanced in favor of devaluation. They were utterly confused and contradictory. For devaluation was not a policy that originated from a cool

weighing of the pros and cons. It was a capitulation of governments to union leaders who did not want to lose face by admitting that their wage policy had failed and had produced institutional unemployment on an unprecedented scale. It was a desperate makeshift of weak and inept statesmen who were motivated by their wish to prolong their tenure of office. In justifying their policy, these demagogues did not bother about contradictions. They promised the processing industries and the farmers that devaluation would make prices rise. But at the same time they promised the consumers that rigid price control would prevent any increase in the cost of living.

After all, the governments could still excuse their conduct by referring to the fact that under the given state of public opinion, entirely under the sway of the doctrinal fallacies of labor unionism, no other policy could be resorted to. No such excuse can be advanced for those authors who hailed the flexibility of foreign exchange rates as the perfect and most desirable monetary system. While governments were still anxious to emphasize that devaluation was an emergency measure not to be repeated again, these authors proclaimed the flexible standard as the most appropriate monetary system and were eager to demonstrate the alleged evils inherent in stability of foreign exchange rates. In their blind zeal to please the governments and the powerful pressure groups of unionized labor and farming, they overstated tremendously the case of flexible parities. But the drawbacks of standard flexibility became manifest very soon. The enthusiasm for devaluation vanished quickly. In the years of the second World War, hardly more than a decade after the day when Great Britain had set the pattern for the flexible standard, even Lord Keynes and his adepts discovered that stability of foreign exchange rates has its merits. One of the avowed objectives of the International Monetary Fund is to stabilize foreign exchange rates.

If one looks at devaluation not with the eyes of an apologist of government and union policies, but with the eyes of an economist, one must first of all stress the point that all its alleged blessings are temporary only. Moreover, they depend on the condition that only one country devalues while the other countries abstain from devaluing their own currencies. If the other countries devalue in the same proportion, no changes in foreign trade appear. If they devalue to a greater extent, all these transitory blessings, whatever they may be, favor them exclusively. A general acceptance of the principles of the flexible standard must therefore result in a race between the nations to outbid one another. At the end of this competition is the complete destruction of all nations' monetary systems.

The much talked about advantages which devaluation secures in foreign trade and tourism, are entirely due to the fact that the adjustment of domestic prices and wage rates to the state of affairs created by devaluation requires some time. As long as this adjustment process is not yet

completed, exporting is encouraged and importing is discouraged. However, this merely means that in this interval the citizens of the devaluating country are getting less for what they are selling abroad and paying more for what they are buying abroad; concomitantly they must restrict their consumption. This effect may appear as a boon in the opinion of those for whom the balance of trade is the yardstick of a nation's welfare. In plain language it is to be described in this way: The British citizen must export more British goods in order to buy that quantity of tea which he received before the devaluation for a smaller quantity of exported British goods.

The devaluation, say its champions, reduces the burden of debts. This is certainly true. It favors debtors at the expense of creditors. In the eyes of those who still have not learned that under modern conditions the creditors must not be identified with the rich not the debtors with the poor, this is beneficial. The actual effect is that the indebted owners of real estate and farm land and the shareholders of indebted corporations reap gains at the expense of the majority of people whose savings are invested in bonds, debentures, savings-bank deposits, and insurance policies.

There are also foreign loans to be considered. When Great Britain, the United States, France, Switzerland and some other European creditor countries devalued their currencies, they made a gift to their foreign debtors.

One of the main arguments advanced in favor of the flexible standard is that it lowers the rate of interest on the domestic money market. Under the classical gold standard and the rigid gold exchange standard, it is said, a country must adjust the domestic rate of interest to conditions on the international money market. Under the flexible standard it is free to follow in the determination of interest rates a policy exclusively guided by considerations of its own domestic welfare.

The argument is obviously untenable with regard to those countries in which the total amount of debts to foreign countries exceeds the total amount of loans granted to foreign countries. When in the course of the nineteenth century some of these debtor nations adopted a sound money policy, their firms and citizens could contract foreign debts in terms of their national currency. This opportunity disappeared altogether with the change in these countries' monetary policies. No foreign banker would contract a loan in Italian lire or try to float an issue of lire bonds. As far as foreign credits are concerned, no change in a debtor country's domestic currency conditions can be of any avail. As far as domestic credits are concerned, devaluation abates only the already previously contracted debts. It enhances the gross market rate of interest of new debts as it makes a positive price premium appear.

This is valid also with regard to interest rate conditions in the creditor nations. There is no need to add anything to the demonstration that interest is not a monetary phenomenon and cannot in the long run be affected by monetary measures.

It is true that the devaluations which were resorted to by various governments between 1931 and 1938 made real wage rates drop in some countries and thus reduced the amount of institutional unemployment. The historian in dealing with these devaluations may therefore say that they were a success as they prevented a revolutionary upheaval of the daily increasing masses of unemployed and as, under the prevailing ideological conditions, no other means could be resorted to in this critical situation. But the historian will no less have to add that the remedy did not affect the root causes of institutional unemployment, the faulty tenets of labor unionism. Devaluation was a cunning device to elude the sway of the union doctrine. It worked because it did not impair the prestige of unionism. but precisely because it left the popularity of unionism untouched, it could work only for a short time. Union leaders learned to distinguish between nominal wage rates and real wage rates. Today their policy aims at raising real wage rates. They can no longer be cheated by a drop in the monetary unit's purchasing power. Devaluation has worn out its usefulness as a device for reducing institutional unemployment.

Cognizance of these facts provides a key for a correct appraisal of the role which Lord Keynes's doctrines played in the years between the first and second World Wars. Keynes did not add any new idea to the body of inflationist fallacies, a thousand times refuted by economists. His teachings were even more contradictory and inconsistent than those of his predecessors who, like Silvio Gesell, were dismissed as monetary cranks. He merely knew how to cloak the plea for inflation and credit expansion in the sophisticated terminology of mathematical economics. The interventionist writers were at a loss to advance plausible arguments in favor of the policy of reckless spending; they simply could not find a case against the economic theorem concerning institutional unemployment. In this juncture they greeted the "Keynesian Revolution" with the verses of Wordsworth: "Bliss was it in that dawn to be alive, but to be young was very heaven."⁴ It was, however, a short-run heaven only. We may admit that for the British and American governments in the 'thirties no way was left other than that of currency devaluation, inflation and credit expansion, unbalanced budgets, and deficit spending. Governments cannot free themselves

⁴ Cf. P.A. Samuelson, "Lord Keynes and the *General Theory*," in *Econometrica*, 14, (1946), 187; reprinted in *The New Economics*, ed. S.E. Harris (New York, 1947), p. 145.

from the pressure of public opinion. They cannot rebel against the preponderance of generally accepted ideologies, however fallacious. But this does not excuse the officeholders who could resign rather than carry out policies disastrous for the country. Still less does it excuse authors who tried to provide a would-be scientific justification for the crudest of all popular fallacies, viz., inflationism.

5. Credit Expansion

It has been pointed out that it would be an error to look upon credit expansion exclusively as a mode of government interference with the market. The fiduciary media did not come into existence as instruments of government policies deliberately aiming at high prices and high nominal wage rates, at lowering the market rate of interest and at debt abatement. They evolved out of the regular business of banking. When the bankers, whose receipts for call money deposited were dealt with by the public as money-substitutes, began to lend a part of the funds deposited with them, they had nothing else in view than their own business. They considered it harmless not to keep the whole equivalent of the receipts issued as a cash reserve in their vaults. They were confident that they would always be in a position to comply with their obligations and, without delay, redeem the notes issued even if they were to lend a part of the deposits. Banknotes became fiduciary media within the operation of the unhampered market economy. The begetter of credit expansion was the banker, not the authority.

But today credit expansion is exclusively a government practice. As far as private banks and bankers are instrumental in issuing fiduciary media, their role is merely ancillary and concerns only technicalities. The governments alone direct the course of affairs. They have attained full supremacy in all matters concerning the size of circulation credit. While the size of the credit expansion that private banks and bankers are able to engineer on an unhampered market is strictly limited, the governments aim at the greatest possible amount of credit expansion. Credit expansion is the governments' foremost tool in their struggle against the market economy. In their hands it is the magic wand designed to conjure away the scarcity of capital goods, to lower the rate of interest or to abolish it altogether, to finance lavish government spending, to expropriate the capitalists, to contrive everlasting booms, and to make everybody prosperous.

The inescapable consequences of credit expansion are shown by the theory of the trade cycle. Even those economists who still refuse to acknowledge the correctness of the monetary or circulation credit theory of the cyclical fluctuations of business have never dared to question the conclusiveness and irrefutability of what this theory asserts with regard to the necessary effects of

credit expansion. These economists too must admit and do admit that the upswing is invariably conditioned by credit expansion, that it could not come into being and continue without credit expansion, and that it turns into depression when the further progress of credit expansion stops. Their explanation of the trade cycle in fact boils down to the assertion that what first generates the upswing is not credit expansion, but other factors. The credit expansion which even in their opinion is an indispensable requisite of the general boom, is, they say, not the outcome of a policy deliberately aiming at low interest rates and at encouraging additional investment for which the capital goods needed are lacking. It is something which, without active interference on the part of the authorities, in a miraculous way always appears whenever these factors begin their operation.

It is obvious that these economists contradict themselves in opposing plans to eliminate the fluctuations of business by abstention from credit expansion. The supporters of the naive inflationist vies of history are consistent when they infer from their--of course, utterly fallacious and contradictory--tenets that credit expansion is the economic panacea. But those who do not deny that credit expansion brings about the boom that is the indispensable condition of the depression disagree with their own doctrine in fighting the proposals to curb credit expansion. Both the spokesmen of the governments and the powerful pressure groups and the champions of the dogmatic "unorthodoxy" that dominates the university departments of economics agree that one should try to avert the recurrence of depressions and that the realization of this end requires the prevention of booms. They cannot advance tenable arguments against the proposals to abstain from policies encouraging credit expansion. But they stubbornly refuse to listen to any such idea. They passionately disparage the plans to prevent credit expansion as devices which would perpetuate depressions. Their attitude clearly demonstrates the correctness of the statement that the trade cycle is the product of policies intentionally aimed at lowering the rate of interest and engendering artificial booms.

It is a fact that today measures aimed at lowering the rate of interest are generally considered highly desirable and that credit expansion is viewed as the efficacious means for the attainment of this end. It is this prepossession that impels all governments to fight the gold standard. All political parties and all pressure groups are firmly committed to an easy money policy.⁵

⁵ If a bank does not expand circulation credit by issuing additional fiduciary media (either in the form of banknotes or in the form of deposit currency), it cannot generate a boom even if it lowers the amount of interest charged below the rate of the unhampered market. It merely makes a gift to debtors. The inference to be drawn from the monetary cycle theory by those who want to prevent the recurrence of booms and of the subsequent depressions is not that the banks should not lower the rate of interest, but that they should abstain from credit expansion. Of

The objective of credit expansion is to favor the interests of some groups of the population at the expense of others. This is, of course, the best that interventionism can attain when it does not hurt the interests of all groups. But while making the whole community poorer, it may still enrich some strata. Which groups belong to the latter class depends on the special data of each case.

The idea which generated what is called *qualitative credit control* is to channel the additional credit in such a way as to concentrate the alleged blessings of credit expansion upon certain groups and to withhold them from other groups. The credits should not go to the stock exchange, it is argued, and should not make stock prices soar. They should rather benefit the "legitimate productive activity" of the processing industries, of mining, of "legitimate commerce," and, first of all, of farming. Other advocates of qualitative credit control want to prevent the additional credits from being used for investment in fixed capital and thus immobilized. They are to be used, instead, for the production of liquid goods. According to these plans the authorities give the banks concrete directions concerning the types of loans they should grant or are forbidden to grant.

However, all such schemes are vain. Discrimination in lending is no substitute for checks placed on credit expansion, the only means that could really prevent a rise in stock exchange quotations and an expansion of investment in fixed capital. The mode in which the additional amount of credit finds its way into the loan market is only of secondary importance. What matters is that there is an inflow of newly created credit. If the banks grant more credits to the farmers, the farmers are in a position to repay loans received from other sources and to pay cash for their purchases. If they grant more credits to business as circulating capital, they free funds which were previously tied up for this use. In any case they create an abundance of disposable money for which its owners try to find the most profitable investment. Very promptly these funds find outlets in the stock exchange or in fixed investment. The notion that it is possible to pursue a credit expansion without making stock prices rise and fixed investment expand is absurd.⁶

The typical course of events under credit expansion was until a few decades ago determined by two facts: that it was credit expansion under the gold standard, and that it was not the outcome of concerted action on the part of the various national governments and the central banks whose conduct these governments directed. The first of these facts meant that governments were not

course, credit expansion necessarily entails a temporary downward movement of market interest rates. Professor Haberler (*Prosperity and Depression*, pp. 65-66) has completely failed to grasp this primary point, and thus his critical remarks are vain.

⁶ Cf. Machlup, *The Stock Market, Credit and Capital Formation*, pp. 256-261

prepared to abandon the convertibility of their country's banknotes according to the rigidly fixed parity. The second fact resulted in a lack of quantitative uniformity in the size of credit expansion. Some countries got ahead of other countries and their banks were faced with the danger of a serious external drain upon their reserves in gold and foreign exchange. In order to preserve their own solvency, these banks were forced to take recourse to drastic credit restriction. Thus they created the panic and inaugurated the depression on the domestic market. The panic very soon spread to other countries. Businessmen in these other countries became frightened and increased their borrowing in order to strengthen their liquid funds for all possible contingencies. It was precisely this increased demand for new credits which impelled the monetary authorities of their own countries, already alarmed by the crisis in the first country, also to resort to contraction. Thus within a few days or weeks the depression became an international phenomenon.

The policy of devaluation has to some extent altered this typical sequence of events. Menaced by an external drain, the monetary authorities do not always resort to credit restriction and to raising the rate of interest charged by the central banking system. They devalue. Yet devaluation does not solve the problem. If the government does not care how far foreign exchange rates may rise, it can for some time continue to cling to credit expansion. But one day the crack-up boom will annihilate its monetary system. On the other hand, if the authority wants to avoid the necessity of devaluing again and again at an accelerated pace, it must arrange its domestic credit policy in such a way as not to outrun in credit expansion the other countries against which it wants to keep its domestic currency at par.

Many economists take it for granted that the attempts of the authorities to expand credit will always bring about the same almost regular alternation between periods of booming trade and of subsequent depression. They assume that the effects of credit expansion will in the future not differ from those that have been observed since the end of the eighteenth century in Great Britain and since the middle of the nineteenth century in Western and Central Europe and in North America. But we may wonder whether conditions have not changed. The teachings of the monetary theory of the trade cycle are today so well known even outside of the circle of economists, that the naive optimism which inspired the entrepreneurs in the boom periods of the past has given way to a certain skepticism. It may be that businessmen will in the future react to credit expansion in a manner other than they have in the past. It may be that they will avoid using for an expansion of their operations the easy money available because they will keep in mind the inevitable end of the boom. Some signs forebode such a change. But it is too early to make a definite statement.

In another direction the monetary theory of the trade cycle has certainly affected the course of events. Although no official--whether he works in the bureaus of a government's financial services or of a central bank, or whether he teaches at a neo-orthodox university--is prepared to admit it, public opinion by and large no longer denies the two main theses of the circulation credit theory: viz., that the cause of the depression is the preceding boom and that this boom is engendered by credit expansion. The awareness of these facts alarms the financial press as soon as the first signs of the boom appear. Then even the authorities begin to talk about the necessity of preventing a further rise in prices and profits, and they really begin to restrict credit. The boom comes to an early end; a recession starts. The result has been that in the last decade the length of the cycle was considerably cut down. There was still an alternation of boom and slump, but the phases lasted a shorter time and succeeded one another more frequently. This is a far cry from the "classical" period of the ten and a half years of William Stanley Jevon's crop cycle. And, most important, as the boom comes to an earlier end, the amount of malinvestment is smaller and in consequence the following depression is milder too.

The Chimera of Contracyclical Policies

An essential element of the "unorthodox" doctrines, advanced both by all socialists and by all interventionists, is that the recurrence of depressions is a phenomenon inherent in the very operation of the market economy. But while the socialists contend that only the substitution of socialism for capitalism can eradicate the evil, the interventionists ascribe to the government the power to correct the operation of the market economy in such a way as to bring about what they call "economic stability." These interventionists would be right if their antidepression plans were to aim at a radical abandonment of credit expansion policies. However, they reject this idea in advance. What they want is to expand credit more and more and to prevent depressions by the adoption of special "contracyclical" measures.

In the contest of these plans the government appears as a deity that stands and works outside the orbit of human affairs, that is independent of the actions of its subjects, and has the power to interfere with these actions from without. It has at its disposal means and funds that are not provided by the people and can be freely used for whatever purposes the rulers are prepared to employ them for. What is needed to make the most beneficent use of this power is merely to follow the advice given by the experts.

The most advertised among these suggested remedies is contracyclical timing of public works and expenditure on public enterprises. The idea is not so new as its champions would have us

believe. When depression came in the past, public opinion always asked the government to embark upon public works in order to create jobs and to stop the drop in prices. But the problem is how to finance these public works. If the government taxes the citizens or borrows from them, it does not add anything to what the Keynesians call the aggregate amount of spending. It restricts the private citizen's power to consume or to invest to the same extent that it increases its own. If, however, the government resorts to the cherished inflationary methods of financing, it makes things worse, not better. It may thus delay for a short time the outbreak of the slump. But when the unavoidable payoff does come, the crisis is the heavier the longer the government has postponed it.

The interventionist experts are at a loss to grasp the real problems involved. As they see it, the main thing is "to plan public capital expenditure well in advance and to accumulate a shelf of fully worked out capital projects which can be put into operation at short notice." This, they say, "is the right policy and one which we recommend all countries should adopt."⁷ However, the problem is not to elaborate projects, but to provide the material means for their execution. The interventionists believe that this could be easily achieved by holding back government expenditure in the boom and increasing it when the depression comes.

Now, restriction of government expenditure may be certainly be a good thing. But it does not provide the funds a government needs for a later expansion of its expenditure. An individual may conduct his affairs in this way. He may accumulate savings when his income is high and spend them later when his income drops. But it is different with a nation or all nations together. The treasury may hoard a considerable part of the lavish revenue from taxes which flows into the public exchequer as a result of the boom. As far and as long as it withholds these funds from circulation, its policy is really deflationary and contracyclical and may to this extent weaken the boom created by credit expansion. But when these funds are spent again, they alter the money relation and create a cash-induced tendency toward a drop in the monetary unit's purchasing power. By no means can these funds provide the capital goods required for the execution of the shelved public works.

The fundamental error of these projects consists in the fact that they ignore the shortage of capital goods. In their eyes the depression is merely caused by a mysterious lack of the people's propensity both to consume and to invest. While the only real problem is to produce more and to consume less in order to increase the stock of capital goods available, the interventionists want to

⁷ Cf. League of Nations, *Economic Stability in the Post-War World*, Report of the Delegation on Economic Depressions, Pt. II. (Geneva, 1945), p. 173.

increase both consumption and investment. They want the government to embark upon projects which are unprofitable precisely because the factors of production needed for their execution must be withdrawn from other lines of employment in which they would fulfill wants the satisfaction of which the consumers consider more urgent. They do not realize that such public works must considerably intensify the real evil, the shortage of capital goods.

One could, of course, think of another mode for the employment of the savings the government makes in the boom period. The treasury could invest its surplus in buying large stocks of all those materials which it will later, when the depression comes, need for the execution of the public works planned and of the consumers' goods which those occupied in these public works will ask for. But if the authorities were to act in this way, they would considerably intensify the boom, accelerate the outbreak of the crisis, and make its consequences more serious.⁸

All this talk about contracyclical government activities aims at one goal only, namely, to divert the public's attention from cognizance of the real cause of the cyclical fluctuations of business. All governments are firmly committed to the policy of low interest rates, credit expansion, and inflation. When the unavoidable aftermath of these short-term policies appears, they know only of one remedy--to go on in inflationary ventures.

6. Foreign Exchange Control and Bilateral Exchange Agreements

If a government fixes the parity of its domestic credit or fiat money against gold or foreign exchange at a higher point than the market--that is, if it fixes maximum prices for gold and foreign exchange below the potential market price--the effects appear which Gresham's Law describes. A state of affairs results which--very inadequately--is called a scarcity of foreign exchange.

It is the characteristic mark of an economic good that the supply available is not so plentiful as to make any intended utilization of it possible. An object that is not in short supply is not an

⁸ In dealing with the contracyclical policies the interventionists always refer to the alleged success of these policies in Sweden. It is true that public capital expenditure in Sweden was actually doubled between 1932 and 1939. But this was not the cause, but an effect, of Sweden's prosperity in the 'thirties. This prosperity was entirely due to the rearmament of Germany. This Nazi policy increased the German demand for Swedish products on the one hand and restricted, on the other hand, German competition on the world market for those products which Sweden could supply. Thus Swedish exports increased from 1932 to 1938 (in thousands of tons): iron ore from 2,219 to 12,485; pig iron from 31,047 to 92,980; ferro-alloys from 15,453 to 28,605; other kinds of iron and steel from 134,237 to 256,146; machinery from 46,230 to 70,605. The number of unemployed applying for relief was 114,000 in 1932 and 165,000 in 1933. It dropped, as soon as German rearmament came into full swing, to 115,000 in 1934, to 62,000 in 1935, and was 16,000 in 1938. The author of this "miracle" was not Keynes, but Hitler.

economic good; no prices are asked or paid for it. As money must necessarily be an economic good, the notion of a money that would not be scarce is absurd. What those governments who complain about a scarcity of foreign exchange have in mind is however, something different. It is the unavoidable outcome of their policy of price fixing. It means that at the price arbitrarily fixed by the government demand exceeds supply. If the government, having by means of inflation reduced the purchasing power of the domestic monetary unit against gold, foreign exchange, and commodities and services, abstains from any attempt at controlling foreign exchange rates, there cannot be any question of a scarcity in the sense in which the government uses this term. He who is ready to pay the market price would be in a position to buy as much foreign exchange as he wants.

But the government is resolved not to tolerate any rise in foreign exchange rates (in terms of the inflated domestic currency). Relying upon its magistrates and constables, it prohibits any dealings in foreign exchange on terms different from the ordained maximum price.

As the government and its satellites see it, the rise in foreign exchange rates was caused by an unfavorable balance of payments and by the purchases of speculators. In order to remove the evil, the government resorts to measures restricting the demand for foreign exchange. Only those people should henceforth have the right to buy foreign exchange who need it for transactions of which the government approves. Commodities the importation of which is superfluous in the opinion of the government should no longer be imported. Payment of interest and principal on debts due to foreigners is prohibited. Citizens must no longer travel abroad. The government does not realize that such measures can never "improve" the balance of payments. If imports drop, exports drop concomitantly. The citizens who are prevented from buying foreign goods, from paying back foreign debts, and from traveling abroad, will not keep the amount of domestic money thus left to them in their cash holdings. They will increase their buying either of consumers' or of producers' goods and thus bring about a further tendency for domestic prices to rise. But the more prices rise, the more will exports be checked.

Now the government goes a step further. It nationalizes foreign exchange transactions. Every citizen who acquires--through exporting, for example--an amount of foreign exchange, is bound to sell it at the official rate to the office of foreign exchange control. If this provision, which is tantamount to an export duty, were to be effectively enforced, export trade would shrink greatly or cease altogether. The government certainly does not like this result, but neither does it want to admit that its interference has utterly failed to achieve the ends sought and has produced a state of affairs which is, from the government's own point of view, much worse even than the previous

state of affairs. So the government resorts to a makeshift. It subsidizes the export trade to such an extent that the losses which its policy inflicts upon the exporters are compensated.

On the other hand, the government bureau of foreign exchange control, stubbornly clinging to the fiction that foreign exchange rates have not "really" risen and that the official rate is an effective rate, sells foreign exchange to importers at this official rate. If this policy were to be really followed, it would be equivalent to paying bonuses to the merchants concerned. They would reap windfall profits in selling the imported commodity on the domestic market. Thus the authority resorts to further makeshifts. It either raises import duties or levies special taxes on the importers or burdens their purchases of foreign exchange in some other way.

Then, of course, foreign exchange control works. But it works only because it virtually acknowledges the market rate of foreign exchange. The exporter gets for his proceeds in foreign exchange the official rate plus the subsidy, which together equal the market rate. The importer pays for foreign exchange the official rate plus a special premium, tax, or duty, which together equal the market rate. The only people who are too dull to grasp what is really going on and let themselves be fooled by the bureaucratic terminology, are the authors of books and articles on new methods of monetary management and on new monetary experience.

The monopolization of buying and selling of foreign exchange by the government vests the control of foreign trade in the authorities . It does not affect the determination of foreign exchange rates. It does not matter whether or not the government makes it illegal for the press to publish the real and effective rates of foreign exchange. As far as foreign trade is still carried on, only these real and effective rates are in force.

In **order** to conceal better the true state of affairs, governments are intent upon eliminating all reference to the real foreign exchange rate. Foreign trade, they think, should no longer be transacted by the intermediary of money. It should be barter. They enter into barter and clearing agreements with foreign governments. Each of the two contracting countries should sell to the other country a quantity of goods and services and receive in exchange a quantity of other goods and services. In the text of these treaties any reference to the real market rates of foreign **exchange** is carefully avoided. However, both parties calculate their sales and their purchases in terms of the world market prices expressed in gold. These clearing and barter agreements substitute bilateral trade between two countries for the triangular or multilateral trade of the

liberal age. But they in no way affect the fact that a country's national currency has lost a part of its purchasing power against gold, foreign exchange, and commodities.

As a policy of foreign trade nationalization, foreign exchange control is a step on the way toward a substitution of socialism for the market economy. From any other point of view it is abortive. It can certainly neither in the short run nor in the long run affect the determination of the rate of foreign exchange.