

# Study Guide to *Human Action* by Robert P. Murphy

## Chapter XXXI. Currency and Credit Manipulation

### Chapter Summary

#### 1. The Government and the Currency

Governments do not create money. However, in contractual disputes the courts must determine the meaning of certain phrases, and in this respect all governments must define what is "legal tender." In addition, historically governments have served to certify the weight and fineness of the coins circulating as media of exchange. Many governments eventually abused this privilege by debasing the content of the coins and then passing laws attempting to force their subjects to accept the debased coins at par with legitimate ones.

The international gold standard was the product not of international agreements but of classical liberalism. When governments did not attempt to use their influence on the money stock to achieve other goals, and instead sought merely to ensure the quality of coins circulating as money, the international gold standard and all of its advantages emerged as a happy byproduct.

#### 2. The Interventionist Aspect of Legal Tender Legislation

The simplest and oldest variety of monetary interventionism is debasement coupled with legal-tender laws aimed at relieving the plight of debtors. The government inflates the currency so that its purchasing power falls, and then declares that debts contracted before the debasement can be paid off at par with the weaker currency. (Governments sometimes engage in *deflation*, where the stock of money shrinks and its purchasing power increases, which aids creditors at the expense of debtors. But in these situations, the aim was not to help the creditors; this was simply a side effect of the policy.)

As with other forms of interventionism, monetary inflation does not help the debtors in the long run. At best, it provides relief to those with existing debt at the moment of the announced policy. Yet any new debtors will have to pay higher gross interest rates, and if the depreciations occur frequently enough, the credit system may break down altogether. If the goal of the inflationary episodes is to aid debtors, the tool is a failure.

#### 3. The Evolution of Modern Methods of Currency Manipulation

A metallic currency is not easily subject to government manipulation, because attempts at debasement will lead to the effects described by Gresham's law. In this respect, "hard money" presents an obstacle to government's inflationary aims. The classical economists overlooked this benefit of a hard-money system, when they praised the lower resource costs of using a paper-money system rather than a metallic one.

Under the orthodox or classical gold standard, governments announced the exchange rate between their currency and a specific weight of gold. Subjects carried not only bank notes but also pieces of gold (often in coins) and spent them as money. Anyone could redeem currency for

the appropriate quantity of physical gold. Governments were thus constrained in their creation of additional units of paper money because they could always be redeemed for gold and thus drain the gold reserves of the Treasury.

Under the gold-exchange standard, governments still pledge to redeem currency with specified quantities of gold. However, the public no longer carries gold in its cash holdings; it only holds money substitutes. Furthermore, the government takes steps to dissuade the public from redeeming these notes and thus draining the reserves. By weaning the public from its holding of actual gold in its cash balances, the gold-exchange standard gives the government much more flexibility in inflating the money supply. In fact, the gold-exchange standard as it developed between the world wars was dubbed the *flexible standard* because the pledged redemption ratios between currencies and gold could be adjusted to achieve the governments' aims.

#### **4. The Objectives of Currency Devaluation**

During the boom period that ended in 1929, labor unions of almost all countries had succeeded in raising wage rates above their market-clearing levels. When the Depression ensued and prices collapsed, the fixed nominal wage rates led to unbearable unemployment. Because they dared not challenge the unions openly, governments resorted to devaluation in order to lower real wage rates without requiring the unions to admit that their demands had been disastrous. (That is to say, with an inflated currency, prices of other goods and services could rise while wage rates remained the same or rose to a smaller extent. This brought them closer to what they would have been without union interference and so reduced the level of institutional unemployment.)

Besides reducing real wage rates, governments also hoped that currency devaluation would achieve the following objectives:

- Raise commodity prices (which would benefit farmers)
- Favor debtors at the expense of creditors
- Encourage exports and reduce imports
- Attract more foreign tourists while discouraging citizens from visiting other countries

Currency devaluation was a poor tool to achieve these ends. Unions learned soon enough to couch their demand in terms of real wages. Aiding farmers with rising prices only punished consumers. Nominal interest rates incorporated a price premium in light of inflation. Finally, the alleged benefits on the balance of trade could only work, even in the short run, if one country devalued its currency more than its trading partners did.

#### **5. Credit Expansion**

Credit expansion can occur even on an unhampered market. Historically, bankers realized that they could profit from maintaining less than 100% reserves in the vault, because, during normal operations most customers would not show up at the same time wishing to withdraw their funds

from the bank. However, in an unhampered market where contractual obligations are enforced, the scope of private credit expansion is quite limited.

Things are different in modern times. Governments have seized control of the monetary and banking system, and routinely use systematic credit expansion in the pursuit of various ends. Besides higher prices and wealth redistribution, credit expansion also leads to the boom-bust cycle that plagues modern economies. The gold standard provided a brake on any individual country's credit expansion; if it exceeded the pace of other countries, they would drain its gold reserves. But with the advent of flexible standards that permit frequent devaluations, governments can engage in discretionary credit expansion with much more freedom.

### ***The Chimera of Contracyclical Policies***

Socialists and interventionists alike blame recurring depressions on inherent failings of the market economy; they do not recognize the role played by government credit expansion during the boom. Those who advocate contracyclical policies recommend that the government raise interest rates and run budget surpluses during boom periods, and lower interest rates and run budget deficits during economic slumps. What these recommendations overlook is that the slump is caused by a lack of capital goods; during the boom, too many production processes were set in motion and some must be abandoned. The government cannot alter this physical fact through borrowing money or creating additional quantities of paper money.

## **6. Foreign Exchange Control and Bilateral Exchange Agreements**

Because of national prestige, and to deny the harmful effects of its inflationary policy, a government may decree a maximum price (quoted in the domestic currency) for units of a foreign currency, which is below the market exchange rate. As with any other price, this leads to a shortage of the foreign currency, because domestic citizens wish to purchase more units of it (with their domestic currency as payment) than foreign citizens wish to sell. This situation is blamed on speculators and an unfavorable trade balance, and is described by the nonsensical phrase "a scarcity of foreign exchange."

The government can resort to makeshifts to ease the problem. It can forbid purchases of the foreign currency except for approved purposes. This may reduce the amount of imports, but in the long run it cannot help the trade balance because the thwarted citizens spend their domestic currency on domestic items, driving up their prices and thus discouraging exports (matching the decline in imports). However "unfavorable" the trade balance was initially, it remains just as unfavorable after the new prohibitions.

The government can enforce the official, overvalued exchange rate, while still permitting the return of the de facto market exchange rate, by subsidizing exporters and taxing importers. Then the interventions on the foreign-exchange market do not alter the conditions of foreign trade, but they do bring the economy closer to full-blown socialism.

In order to conceal the decline in the currency's purchasing power against gold or other currencies, the government may resort to barter agreements with other nations.

***Remarks About the Nazi Barter Agreements***

The Nazi government of the Reich concluded barter and clearing agreements with various foreign countries. Though these arrangements were heralded as the dawn of a new age in monetary management, in reality they represented ways for the governments to achieve their own political ends at the expense of members of their populations who were out of favor with the government. For example, Germany might agree to trade manufactured goods for farm products with another country, but at prices such that the two collections would be valued at \$11 million, even though on the world market each bundle of goods would be worth only \$10 million. This would allow Germany's trading partner to bestow a gift on its farmers (who could sell at a higher price than they would have fetched on the world market), and to punish those forced to obtain their foreign manufactured goods through the barter arrangement.

**Why It Matters**

Here Mises explains why interventionism in the monetary and banking system cannot achieve the popular aims that people believe. As in the previous chapter, Mises supplements standard economic analysis of the issues with his historical understanding. He shows how an initial intervention (with foreign exchange, for example) led to further interventions as the unintended consequences accumulated.

**Technical Notes**

- (1) Mises writes that "[o]ne of the main arguments advanced in favor of the flexible standard is that it lowers the rate of interest on the domestic money market" (p. 786). What he means is that measures to lower the rate of interest through credit expansion will be quickly aborted under a classical gold standard if one country expands more quickly than its peers. However, if the country is allowed to devalue its currency with respect to other currencies and gold, then it can expand credit (and lower domestic interest rates) without fear of a gold outflow. We see this in modern times; when one central bank lowers its interest rate target, its currency generally falls against others in response.
- (2) In discussing the recurrence of trade cycles due to credit expansion, Mises writes, "It may be that [the businessmen] 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... But it is too early to make a positive statement" (791–792). This is an interesting observation, because the leading neoclassical critique of Misesian business-cycle theory is that he (allegedly) assumes that the business community is ignorant of the mechanism. Most modern Austrians deal with this "rational-expectations" objection by arguing that credit expansion is a prisoner's dilemma of sorts, where even if borrowers are fully aware of a credit bubble, the incentives are still rigged to ensure that someone will borrow the cheaper money issued by the central bank.

## Study Questions

### 1. The Government and the Currency

Comment: "A thing becomes money only by virtue of the fact that those exchanging commodities and services commonly use it as a medium of exchange."

- What were some typical government interventions with regard to currency?

### 2. The Interventionist Aspect of Legal Tender Legislation

- What is the simplest and oldest variety of monetary interventionism?
- What are the consequences of debt abatement?
- Do governments ever engage in debt aggravation? Do they aim to do so?

### 3. The Evolution of Modern Methods of Currency Manipulation

- Why did the classical gold standard act as a restraint on monetary interventionism?
- Why were economists—including Mises himself—naïve concerning the gold-exchange standard?
- What is the definition of devaluation?
- What is meant by the flexible standard?

### 4. The Objectives of Currency Devaluation

- What were the five objectives of devaluation?
- What are the negative consequences of devaluation? Are there positive ones too?
- Can devaluation provide a long-run solution to institutional unemployment?

### 5. Credit Expansion

- To what does Mises refer when he says, "The begetter of credit expansion was the banker, not the authority"? What is the situation currently?
- What is meant by "qualitative credit control"?
- What would be the consequences if the credit expansion were limited to special interest groups?
- Is it possible to pursue a credit expansion without affecting stock prices?

- Why is the only real problem to produce more and to consume less in order to increase the stock of capital goods available?
- Why do public-works projects actually intensify the crisis?

#### **6. Foreign Exchange Control and Bilateral Exchange Agreements**

- What is meant by the term "scarcity of foreign exchange"? Why doesn't Mises endorse this terminology?
- Can governments alleviate an unfavorable trade balance by restricting the imports their citizens can make?

Comment: "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."