

AUSTRIAN MONETARY THEORY: COMMENT ON PASCAL SALIN'S PAPER

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The paper by Professor Salin (2022) comparing the Austrian and Chicago schools in the field of monetary theory is very stimulating. One would expect nothing less from a leading monetary theorist sympathetic to both schools. Austrians can learn a lot from engaging with non-Austrian approaches to monetary theory and economics generally. After all, one can learn from the refutation of false doctrines as well as from true theories expounded outside one's own school of thought. In the case of the Chicago school, there is the opportunity to do both: although there are many similarities between Chicago and Austrian monetary theory, the differences are crucial and, as will be argued, generally suggest the superiority of the Austrian position. This superiority follows from the strict Austrian insistence on methodological individualism, as Joseph Salerno (2010c) argued when comparing Austrian and Chicago approaches to the balance of payments, and more generally from the insistence on praxeology as the correct economic method. On the other hand, monetarists are close to Austrians in insisting on the central role of money and monetary institutions, and they have produced a large literature examining empirical questions—for instance, Milton Friedman (1990) and Marc Flandreau (1996) on the question of bimetallism in

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the US and France, respectively—and have done yeoman’s work in the field of international monetary theory by advancing the monetary approach to the balance of payments (Mundell 1971; Johnson 1972).

This article will comment on a few of Professor Salin’s suggestions for fertile engagement.

NEUTRALITY OF MONEY AND THE QUANTITY THEORY

Salin’s description of Austrian monetary theory in the first part of the paper zeroes in on what, to the Austrians, are the key issues: the “structure” of the money supply and the processes of money creation. As regards the first point, there are only two caveats. First, Mises (1998, 395) always insists that money is the most commonly accepted medium of exchange, not “the good which is considered as the most liquid asset by money-users.” This is perhaps simply a semantic difference, but in an advanced monetary economy, there is a sharp distinction between money and very liquid assets, or secondary media of exchange. Liquid assets have some money-like qualities, and at least part of the demand for them arises from individuals’ desire for greater liquidity—indeed, this is the only reason why it makes sense to distinguish between secondary media of exchange and other goods, not the objective facts as to the turnover or liquidity of the market for a good. In an advanced market economy, individuals may keep their cash balances to a minimum by holding liquid assets (Mises 1998, 459–63), but this does not mean that these assets become money-like or that we can predicate their “moneyness”—there is no spectrum of moneyness on which different goods can be placed. “Liquidity” after all simply means that an asset is more certainly realizable at short notice without loss (Hicks 1962)—i.e., that one expects to be able to sell it for money at short notice at its expected market price. In other words, liquidity is a purely derivative concept and depends on the existence of a primary money, contra attempts to conceptualize money as simply the good highest in “moneyness,” as, for instance, by Horwitz (1990).

Second, Professor Salin goes too far when he says that to Mises, the definition of the quantity of money is arbitrary because it sums up components of a very different nature. The premise is true,

but the conclusion does not follow: after all, one of Mises's many contributions to monetary theory was to identify and explain the relationship between what he called money in the narrow sense and money in the broader sense (i.e., money substitutes). It is precisely because the quantity of money in the broader sense, made up of base money and claims to money, *can* be identified that the theory of banking has any connection to the theory of money at all. Theoretically, this identification is relatively straightforward: if a claim to money circulates at par, then it is a money substitute. Empirically, it may be harder to clearly identify borderline cases: Mises himself saw the great flaw of the Peel Banking Act in the refusal of the Currency school to accept that bank deposits form part of the money supply. The distinguishing mark of money substitutes, and a second important reason that banking must be considered in monetary theory, is that they are created in the process of extending new loans:

Circulation credit is credit granted out of funds especially created for this purpose by the banks. In order to grant a loan, the bank prints banknotes or credits the debtor on a deposit account. It is creation of credit out of nothing. It is tantamount to the creation of fiat money, to undisguised, manifest inflation. (Mises 2011, 191)

Austrian business cycle theory, which traces booms to credit expansion by money-creating banks, would be a nonstarter if the quantity of money could not be meaningfully defined and analyzed in terms of its components, which are distinguished based on how they originate and where they enter the economy.

Professor Salin suggests that Austrians can accept the neutrality of money and rejects Mises's insistence that any injection of money leads to redistribution and permanent changes in the positions of individuals in the economy. Milton Friedman (1969, 6) made this argument when discussing the optimum quantity of money (or rather the optimal growth rate of the money supply). In his initial model, Friedman argued that any distributional effects from a money injection are only temporary, that they will vanish as soon as the new equilibrium is reached. However, it is clear from Friedman's argument that this only follows from the restrictions he postulates: if money can only be exchanged for consumption goods and each person's endowment of capital goods is fixed, then the inflow of money has no consequences for the distribution of capital

and hence for long-term incomes. In other words, money is neutral because it is assumed to be neutral.¹ Mises, on the contrary, insists that the inflow of new money always leads to a redistribution of real wealth and incomes, only differing depending on where it enters the economy. Of course, if the addition to the money supply is small, then the redistributive effects will also be small, but nevertheless, money is, by its very nature, nonneutral.

It is true that both Austrians and Chicagoans subscribe to a more sophisticated version of the quantity theory of money; however, the Chicago version is still, at the end of the day, within the bounds of the aggregate, mechanistic theory to which Mises and his followers always strenuously object. Friedman (1956) has a more sophisticated formula and emphasizes the demand function for money, but he is still working within the framework of Irving Fisher's equation, $MV = PQ$. Mises, on the other, hand reformulated the quantity theory as a qualitative law that is built up by the coordinating actions of individuals, which move the economy from the disequilibrium caused by the inflow of new money to a new equilibrium at higher prices. In the plain state of rest, every individual holds just enough money that the utility of the marginal unit just outweighs the foregone utility of the highest unsatisfied want on his value scale. When more money enters the economy, the individuals who receive this money suddenly find that their cash balances are larger than they want them to be. Since their supply of money is now greater, individual actors find that the utility of the marginal unit of money is now lower than the utility of the goods they can buy with it. The first receivers of new money will therefore spend it until their cash balances are again in accordance with their value scales. The next receivers of the new money—the persons who supplied the first receivers—find themselves in the same position and act accordingly. And so on, until the new money has been spread through the economy, driving up prices in the process. Unless we make restrictive assumptions à la Friedman, this process clearly has more than temporary effects: a permanent redistribution of wealth is effected, from the last receivers (and nonreceivers) of the new money to the first (Mises 1953, 240). In the resulting equilibrium,

¹ Friedman in his paper goes beyond this point and shows that the continual inflow of money is not really neutral, even given this restrictive assumption.

the prices are higher, but which prices and by how much, as well as who can afford to pay, depend on the specific pattern of exchanges that led to the increases. When the overall view is adopted, all this is hidden from view and there is simply an increase in M leading to an increase in P . As a first approximation, that may be good enough, but it skips over the most important (and most interesting) aspects of the phenomenon of inflation.

ON THE BALANCE OF PAYMENTS

When it comes to the distinction between nominal and real balances, it is true that, as Professor Salin argues, Austrians and Chicagoans should agree that demand for money is always demand for real purchasing power, not simply for a nominal amount of money. However, the principal Austrians always make this distinction—Professor Salin expresses some uncertainty about Mises, but as Salin says himself, the uncertainty may be due to Mises's presentation of the issues more than anything else. In any case, since Mises was always adamant on what Salin identifies as the second point of agreement between Austrians and Chicagoans in this field—namely, that the nominal quantity of money is always sufficient because the value of money varies to accommodate changes in demand. To reject the distinction between nominal and real balances would suggest hopeless confusion on Mises's part.

However, although the majority of Austrians agree that any nominal quantity of money is sufficient due to the real cash balance effect and that it is therefore wasteful to produce the desired amount of real cash balances through changes in the quantity of money, this position in fact hides a subtle fallacy. To be clear, the fallacy is not Salin's, or not his alone. Among Austrians, Mises and Rothbard share it, as do monetarists advocating a completely fixed money supply. We may call it the Classical fallacy or the Smith-Ricardo fallacy, for its originators.

The fallacy is this: although it is true that any nominal quantity of money can provide all the benefits of money, since the value of money can adjust to yield each and every person's desired real cash balance, it does not follow that this is necessarily always the best way to adjust the (real) money supply to the demand for money. Only if this adjustment

process accords with consumer wishes can it be said that a purely qualitative change (as opposed to a change in the quantity of money) is optimal. Important in this connection is how money is produced. If money is produced in a competitive process like any other commodity, then increases in the nominal supply of money can only come about for two reasons: either the demand for money increases, leading to a rise in the purchasing power of money, which in turn leads to larger profits in money production and increased production (until the factors of production are bid to a level that eliminates the profit opportunity and stops the inflow of money) or a change in technology increases the productivity of some factors of production used in money production, resulting in a profit opportunity and an inflow of money (which will cease once the prices of the factors rise and eliminate the profit opportunity). In both cases, the nominal money supply increases to adjust to changes in the data of the market, because this is deemed by consumers to be the best use of resources.²

It is understandable that monetary theorists have emphasized the point made by Salin, that any quantity of money is socially optimal, since they have generally had to contend with inflationists of one sort or another, who all maintain that increasing the money supply is necessary for economic adjustment of one sort or another. However, when the production of money is not divorced from the market, when it is subject to the law of costs like the production of all other commodities, then any changes in the nominal quantity of money can be the optimal way of adjusting real and nominal cash balances to the desires of the economic actors.

An example contrasting balance of payments movements may illustrate the point. In a world of national fiat currencies, a balance of payments problem can never be cured by pursuing inflationary monetary policies—indeed, as Mises (2011, 1–44) masterfully pointed out in 1923, such policies are the only cause of balance of payments problems. Undesirable outflows of money are symptoms of government policy and the working of Gresham's law. A lasting imbalance has nothing to do with trade and cannot be cured by attempting to limit imports, since trade essentially depends on price differences, not on the flow of money.

² The principles have been stated in greater detail by Salerno (2010b) and White (1999, 31–39) in relation to the workings of a pure gold standard.

The undesirable outflow of money must always be simply the result of a governmental intervention which has endowed differently valued moneys with the same legal purchasing power. All that the government need do to avoid disrupting the monetary situation, and all it can do, is to abandon such interventions. (Mises 2011, 27)

By contrast, there is no problem of changes in domestic money supplies, nor in the global supply, under a global commodity standard. In this scenario, money flows between countries will be the result of changes in the demand for money in the long run, as imports in all countries are paid for by exports. Domestic changes in the quantity of money will therefore reflect either a higher reservation demand for money or a higher exchange demand; that is, greater productivity in the domestic economy (Rothbard 2009, 756ff.; Salerno 2010a). A steady increase in the global supply of money is likely if we assume global economic expansion. Then the money-producing regions will have a permanent current account deficit, but this deficit is hardly problematic. Rather, it is the principal means—or one of them, at any rate—by which the new money enters the global economy and is distributed to the most eager holders.

Finally, one last comment about the idea of money as a factor of production. Money is the odd one out in the classification of goods, for while it is true that the individual businessman will benefit from a larger cash balance, global productivity does not increase from an increase in the money supply. In the older terminology, money is a component of private capital but not of social capital, and for this reason Mises found it necessary to classify it as a third category of good in addition to consumption and production goods (Mises 1990). When Mundell (1971) and Friedman (1969, 14) describe money as a sort of factor of production, this is only a loose description; it is true only *per analogiam*. That is, money is not truly productive, like an engine or a field is, but money allows the individual businessman to be more productive—or, rather, more profitable. Mises is clear that money is desired for its utility; he writes only very briefly to describe the bedrock of that utility. It can be inferred from the way Mises (1998, 247–51) connects the existence of money to uncertainty that money's core function is to help acting man bear uncertainty. This, in fact, is how later Misesians have explained the function of money and the demand for money. Hutt (1956, 206) showed that in reality “people want money so as to be in a position to acquire other things

at the most profitable time, or at least most convenient time." Hoppe (2012, 182) then took the next step in clearly formulating the holding of cash balances as "an investment in certainty or an investment in the reduction of subjectively felt uneasiness about uncertainty."

Instead of saying that money is a factor of production, it would therefore be better to say that it is a factor of profitability: the individual only wants to hold some cash instead of productively investing all his capital due to his judgment that there are future uncertain opportunities from which he might profit. "Only because people expect changes about the kind and extent of which they have no certain knowledge whatsoever, do they keep money" (Mises 1998, 415).

CONCLUSION

These brief comments have mainly been of a critical nature, but as expressed in the introduction, engagement with monetarism can be very fruitful. The more critical nature of this article is due to an impression that Austrians have generally been willing to engage and learn from monetarists and others, while Austrians themselves have been mostly ignored. Although Austrians can indeed learn something from Chicagoans, they still have much more to learn from Austrians.

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