

ROTHBARD ON MONEY: A CRITICAL TEXTUAL EXEGESIS

SALIM RASHID

In 1998 I presented a paper which argued that no *theory* of money was possible—in the sense of there being a stable relationship between a few explanatory variables. The argument was based on the assumption that we were dealing with an economy of informed maximizers. The good that individuals choose to use as money depends on the solution of an optimization problem—of all available goods, which has the lowest transaction costs. Mises felicitously called the process “indirect exchange” and so it is of course governed by the same optimization as direct exchange. The choice of a money good is the solution of a maximizing query and the solution depends upon the resources available, the nature of substitutes, current technology and the flexibility of institutions. It follows that there can be no determinate solution to the question, what is money?

The usual proofs of theories like the quantity theory, based on the existence of a stable demand curve for money, are no proof, since all they show is that money has a downward sloping demand curve. This is equally true for any other commodity. The historical facts on which the quantity theory was based are faulty, since the price rise of the sixteenth century *preceded* the inflow of gold and silver and the recent defenses of some supporters are not a little curious. (See the essays of Mark Blaug [1995b] and G.E.Wood [1995].)

I was told that a theory was possible on Austrian premises and that Murray Rothbard had provided such a theory. As I am much indebted to Murray Rothbard for having supported my critique of Adam Smith, I thought this a powerful rebuke. What follows is my attempt to show why Rothbard does not really contradict my position and how my position is actually a refinement of Austrian premises. Fortunately, Rothbard summarized all his insights into a short, clear pamphlet. (If only other scholars were as kind!) Throughout I will

SALIM RASHID is professor of economics at the University of Illinois. He wishes to thank participants at the Austrian Scholars Conferences in 1998 and 1999 for helpful comments.

quote from Rothbard's lucid pamphlet and then, regrettably, take issue with the marvelous exposition. I begin with a historical and sociological critique, then to that based on concepts, and finally to a critique based on the process by which money arises.

The monograph to be discussed is Murray N. Rothbard's (1990) *What Has Government Done To Our Money?* It is a marvel of exposition. All quotations are in italics and my own comments follow. Before I turn to my critique, let me emphasize some very valuable points raised by Rothbard. First, his critique of the use of mechanical analogies by all those who follow the "Irving Fisher school."

Rothbard, p. 36: *Economists err if they believe something is wrong when money is not in constant, active "circulation." Money is only useful for exchange value, true, but it is not only useful at the actual moment of exchange.*

Rothbard, p. 37: *"It is misleading, furthermore, to say that money "circulates." Like all metaphors taken from the physical sciences, it connotes some sort of mechanical process, independent of human will, which moves at a certain speed of flow, or "velocity." Actually, money does not "circulate"; it is, from time to time, transferred from one person's cash balance to another's.*

Very Good!

Second, the entire process by which warehouse receipts are converted to bank notes and thence to "money," and the limitations of the process, is another model of clarity.

Rothbard, p. 44: *Convenience inevitably leads to transfer of the warehouse receipt instead of the physical gold itself.*

Rothbard, p. 45: *There will be three limits on the advance of this substitution process. One is the extent that people use these money warehouses—called banks—instead of cash. . . . The second limit is the extent of the clientele of each bank. . . . Third, the clientele must have confidence in the trustworthiness of their banks.*

Clients may find it more convenient in many cases to waive their right to paper receipts—called *bank notes*—and, instead, to keep their titles as open book accounts, called *bank deposits*.

It should be clear that, economically, there is no difference whatever between a bank note and a bank deposit.

Rothbard, p. 46: *An increase or decrease in the use of substitutes, then, exerts no change on the money supply. Only the form of the supply is changed, not the total.*

This description of banks and warehouse receipts is followed by an acute critique of the modern bank.

Rothbard, p. 49: *A bank, then, is not taking the usual business risk. It does not, like all businessmen, arrange the time pattern of its assets proportionately to the time pattern of liabilities, i.e., see to it that it will have enough money, on due dates, to pay its bills. Instead, most of its liabilities are instantaneous, but its assets are not.*

The bank is already and at all times bankrupt; but its bankruptcy is only revealed when customers get suspicious and precipitate “bank runs.”

Banks are *always* bankrupt—eloquently and accurately stated. While it is peripheral to my main argument, it is worth pointing out that this characterization does pose a philosophical issue for scholars like Rothbard—if people still wish to use banks after they have been so informed, who are we to object?

Rothbard, p. 53: *None of this discussion is meant to impugn the general practice of credit.*

Rothbard, p. 69: *The advent of paper money and bank deposits, an economic boon when backed fully by gold or silver, provided the open sesame for government’s road to power over money, and thereby over the entire economic system.*

There are three great checks on the power of any bank to inflate under a “free-banking” system: (1) the extent of the clientele of each bank; (2) the extent of the clientele of the whole banking system; i.e., the extent to which people use money-substitutes; and (3) the confidence of the clients in their banks.

Rothbard clearly asserts the value of credit, so how do we stop people who want more of it than can be had under the above safeguards? (This is linked with Rothbard’s failure to directly address the question, Why is credit beneficial?)

I now turn to queries raised by the evolution of money as presented by Rothbard.

Rothbard, p. 19: *This process: the cumulative development of a medium of exchange on the free market—is the only way money can become established. Money cannot originate in any other way. . . . For embedded in the demand for money is knowledge of the money-prices of the immediate past. . . .*

A most important truth about money now emerges . . . money is a commodity.

It is not entirely clear how we can claim that the above historical process is the only way money can emerge. Even if the claim is true, why should this affect the analysis? The eighteenth-century Scots made language a primary example of the complexity created by unplanned consequences, but this does not deny the brilliance of those languages that were created by individuals, such as Hangul or Sequoia, or the utility of their inventions.

Rothbard, p. 20: *Money is not an abstract unit of account, divorceable from a concrete good; it is not a useless token only good for exchanging; it is not a “claim on*

society”; it is not a guarantee of a fixed price level. It is simply a commodity. It differs from other commodities in being demanded mainly as a medium of exchange.

Money is a commodity used mainly as a medium of exchange. Even if true, this use as a medium of exchange can be so overwhelmingly important as to drown out all other uses. Sharp objects may well have arisen as instruments of death. Let us suppose the historical evidence is clear on this. But what has this to do with the current use of kitchen knives and industrial saws? To assert that money is “simply a commodity” is to deny that its demand, for example, has been greatly altered once the commodity becomes chosen as money.

Rothbard, p. 33: *What is the effect of a change in the money supply? Following the example of David Hume. . .*

Rothbard follows Hume too closely in arguing that the quantity of money does not matter. Hume’s analysis is exactly what our modern theorists are pleased to call “comparative statics.” It assumes a sudden change, assumes instantaneous adjustment, and then looks at the result. By engaging in a process analysis, a practical merchant-laird, James Oswald, and a perceptive cleric, the Rev. Josiah Tucker, both noted several reasons why Hume’s arguments were unrealistic. What if the inflow of metals is small relative to the existing stock, what if there exist significant amounts of unemployed resources, what if labor is internationally mobile and can be tempted by the rising wages after the monetary inflow, and what if the speed of adjustment is very slow? On p. 92 Rothbard ignores Hume’s two-faced policy regarding inflation—it’s a good thing to do until the people learn what you are up to. Keynes follows Hume on this issue and I wonder whether Rothbard was aware how closely Hume adumbrates an attitude later made explicit in Keynes.

“A preference for truth or for sincerity *as a method* may be a prejudice based on some aesthetic or personal standard, inconsistent in politics, with practical good” (Frankel 1977, p. 71).

Rothbard uses Hume’s argument to come to the following conclusion.

Rothbard, p. 33: *The reason for this puzzle is that money is only useful for its exchange value. . . . Our law—that an increase in money does not confer a social benefit—stems from its unique use as a medium of exchange.*

Rothbard, p. 34: *We come to the startling truth that it doesn’t matter what the supply of money is.*

If the money supply is immaterial then why is the growth of banks, when natural, good?

Rothbard, p. 69: *The advent of paper money and bank deposits [was] an economic boon when backed fully by gold or silver.*

After having lain so much importance on history as a determinant of our exchange mechanisms, how can Rothbard now ignore the question that, at any point in time, contracts have been made and debts are due in monetary terms?

Two basic points of disagreement emerge; the first, in Rothbard's analysis of the functions of money.

Rothbard, p. 21: *"The establishment of money conveys another great benefit. Since all exchanges are made in money, all the exchange-ratios are expressed in money, and so people can now compare the market worth of each good to that of every other good. . . ."*

Many textbooks say that money has several functions: a medium of exchange, unit of account, or "measure of values," a "store of value," etc. But it should be clear that all of these functions are simply corollaries of the one great function: the medium of exchange.

All the functions of money, according to Rothbard, are corollaries of being a medium of exchange. This is an indefensible claim (incidentally, also made just as emphatically by Sir John Hicks). If all transactions are not to take place in frozen time, how can money be useful unless it is also a store of value? The money must preserve its value from the time it is initially received until the time that it is eventually used. Only the Walrasians know how to freeze time. This is an error based on the Walrasian imagery.

Rather, on Austrian premises, any store of value can be used as a medium of exchange. It all depends on the additional properties the commodity possesses. This is clearly implied in Rothbard's perceptive critique, quoted earlier, of the idea that money is useful only when it circulates.

Second, my disagreement lies with Rothbard's failure to follow through with the consequences of the process by which optimizing individuals set up and choose a good to be money. People do not *cease* their optimization once they choose, say, silver as the medium of exchange. The *process* continues. This is just what we mean by financial innovation. A reluctance to acknowledge this fundamental point is the fatal flaw in the modern attempts at a revival of the quantity theory.

Rothbard, p. 98: *The chaos and the unbridled economic warfare points up an important lesson: the grievous political flaw in the Milton Friedman-Chicago School monetary scheme for freely-fluctuating fiat currencies.*

The attack on Friedman doesn't show Friedman's attempt to salvage a quantity theory as equally futile. It ignores the creativity of individuals facing constraints.

Money economizes transactions. Whenever people find a new way to economize, they will do so. This is a corollary of the following premises – that people are greedy, that this leads them to be both economizing and inventive, that therefore we cannot rely on the continuance of any medium as money. Practical men have long since realized this. This part of my argument is so clearly illustrated by James Grant (1966) that I will just quote him.

There is such a thing as a money supply but it is quicksilver. Just when you think you've captured it, you haven't. There are all manner of ways for money not to be counted. However good the Fed has become at counting money, the private market has been that much better at reinventing it. The proof of the lack of utility of monetary aggregates is that people don't pay much attention to them. (p. 5)

Rothbard, p. 34: "*We conclude, therefore, that determining the supply of money, like all other goods, is best left to the free market.*"

And so it is; that is why so much of the money supply is endogenous—it arises from the optimization of agents.

REFERENCES

- Blaug, Mark, ed. 1995a. *The Quantity Theory of Money: From Locke to Keynes and Friedman*. Cheltenham, U.K.: Edward Elgar.
- . 1995b. "Why is the Quantity Theory of Money the Oldest Surviving Theory in Economics?" In Blaug 1995a.
- Frankel, S.H. 1977. *Two Philosophies of Money*. New York: St Martin's Press.
- Grant, James. 1966. "The Trouble with Prosperity: An Interview with James Grant." *Austrian Economics Newsletter* (Winter).
- Rothbard, Murray N. 1990. *What Has Government Done to Our Money?* Auburn, Ala.: Mises Institute.
- Wood, Geoffrey W. 1995. "The Quantity Theory in the 1980s: Hume, Thornton, Friedman, and the Relation Between Money and Inflation." In Blaug 1995a.