Ludwig von Mises and the Case for Gold

George Selgin

Ludwig von Mises is well-known for his uncompromising defense of the gold standard during a period when that standard was being denounced by most other prominent economists. Mises' reasons for preferring gold over a managed fiat money are not so widely understood. Some self-styled "Misesians" defend the gold standard (or an extreme "100 percent" gold standard) on ideological and moral ("natural rights") grounds, while portraying it as a practically flawless institution (Rothbard 1974, Sennholz 1975). Mises, in contrast, made a utilitarian case for the gold standard, while recognizing gold's drawbacks: Mises defended the gold standard, not because he considered it ideal or because he thought fiat money immoral, but because he was convinced that a managed fiat money would prove less stable than gold.

I plan to explore in some detail Mises' views, as conveyed in *Human Action* as well as elsewhere, concerning an ideally behaved money stock and his reasons for seeing a gold standard as the nearest practical approximation to this ideal. I will show how Mises' argument involves a peculiar and unsatisfactory blend of consequentialism and strict a priori reasoning. His case for gold was based in large part upon his denial of the possibility of measuring, even approximately, changes in money's purchasing power. Mises' argument is unsatisfactory, both because it exaggerates the problems involved in attempts to deliberately stabilize the "inner objective exchange value" of a fiat money, and because, taken at face value, it undermines Mises' ability to draw any meaningful comparison between the historical performance of the gold standard and that of fiat money.

Nor was Mises able to make a convincing a priori case for the gold standard using what would now be labeled public-choice style arguments: Mises claims that disagreements concerning the direction

---

Cato Journal, Vol. 19, No 2 (Fall 1999). Copyright © Cato Institute. All rights reserved.
George Selgin is Associate Professor of Economics at the University of Georgia.

and extent of changes in money's purchasing power must render a managed fiat money a plaything of politics. But Mises himself admits that this problem can be overcome by making deliberate changes to the growth rate of the money stock only in so far as these serve to avoid "obvious" changes in money's purchasing power—changes that reveal themselves in all credible price indexes. It is not clear that such a crudely managed fiat money would prove less stable than gold in practice, especially in light of Mises' acknowledgement of the failure of the classical gold standard to prevent "obvious" changes in money's purchasing power. That the most dramatic, historical fluctuations in the value of money—the kind that can be recognized without the aid of statistics—have involved fiat moneys is itself not conclusive proof of the superiority of gold, because (as Mises himself admits) most such episodes occurred during fiscal emergencies of a kind that would typically involve a suspension of gold payments. The relevant question, therefore, is whether a managed fiat standard can outperform a gold standard in "normal" times. And this question cannot be answered on a priori grounds or by appeals to *verstehen*.

I conclude my critique of Mises by suggesting that he might have made a more convincing case for gold by observing that fiat money is likely to be mismanaged, not only owing to the multiplicity of price-index targets, but also owing to constant pressure to target other economic variables, such as employment or interest rates. A regime aimed at stabilizing the value of fiat money is therefore likely to be short-lived. Although a gold standard administered by a central bank can also be abandoned "with the stroke of a pen," a gold standard based on a free-banking regime of the sort Mises favored, where individual banks of issue cannot renege on their promises with impunity, embodies a much more credible commitment to long-run price stability. Empirical evidence of the sort Mises disdained supports this argument, showing the tendency for inflation to persist under fiat money, but not under the classical gold standard, where private banks' promises to convert paper money into fixed quantities of gold were strictly enforced. Mises failed to make a convincing case for gold, both by refusing to make use of available statistical evidence and by failing to recognize the role of free banking in achieving a credible commitment to maintain gold payments.

The Ideal of a Money of Constant Inner Objective Exchange Value

Contrary to the impression conveyed by some of his followers, Mises did not defend the gold standard on ideological or moral grounds. His

defense of gold was based on his belief that the merits of particular monetary policies and regimes should be assessed according to their influence upon money's purchasing power or "objective exchange value" (Mises 1980: 258). Like modern-day monetarists, Mises recognized the potentially distorting effects of changes in money's objective exchange value, including the tendency of such changes to alter the distribution of income and wealth "because individuals are apt to overlook the variability of the value of money" and "because variations in the value of money do not affect all economic goods and services uniformly and simultaneously" (p. 225). The displacement of relative prices following excessive or deficient growth of the money stock "falsifies accounts of profit and loss" and thereby distorts real economic activity (p. 235). Although steady appreciation or depreciation of money may be fully anticipated and allowed for in the drawing of long-term money contracts, a variable objective exchange value of money is bound to distort other terms of exchange (p. 225).

It was natural for Mises, in preparing the second (1924) German edition of his *Theory of Money and Credit*, to devote more attention to the destructive consequences of inflation than to those of deflation. Still, Mises—unlike some of his later followers (e.g., Rothbard)—does not by any means overlook the damage that deflation can do. Indeed, he recognizes at least one special social cost of deflation that does not arise in the case of inflation: under a gold standard, deflation becomes equivalent to a rising relative price of gold, which in turn means a greater diversion of resources to gold mining. Mises concludes from this that even a *steady* increase in money's objective exchange value would be undesirable under a gold standard.[1]

Although my summary of Mises' arguments thus far may make him appear to share the basic ideals of past and present advocates of price-level stabilization or zero inflation, a closer look at those arguments shows that he actually rejected the ideal of a money of constant purchasing power. Like Carl Menger and other 19th-century economists, and unlike modern proponents of zero inflation, Mises drew a distinction between changes in the exchange value of money originating on "the goods (or commodity) side" and ones originating "on the money side." Although Mises rejected the equation of exchange as a device inconsistent with methodological individualism, his argument is most readily grasped by reference to the terms of that equation: let MV = Py, with the variables defined as usual. Rearranging gives 1/P = y/MV: the purchasing power of money depends on the quantity

[1]Milton Friedman's "optimum quantity of money" argument does not necessarily apply to a commodity standard (see White 1999: 110–11).

of goods supplied as well as on the level of nominal income or spending. Changes in money's purchasing power that originate "on the goods side" are changes due to changes in y—the real supply of goods; changes in money's purchasing power that originate "on the money side" are changes due to changes in M or V—the supply of or (income-compensated) demand for nominal money balances.

While recognizing that the more popular ideal was that of a money "whose objective exchange value is not subject to any variation at all, *whether originating on the money side or on the commodity side*" (emphasis in original), Mises held "a money with an invariable exchange value, *so far as the monetary influences on its value are concerned*" (emphasis added) to be the ideal "of enlightened statesmen and economists" (Mises 1980: 268–69). Mises drew a distinction between the "outer" and the "inner" exchange value of money, where the former is simply money's purchasing power as conventionally understood, while the latter reflects "the money side" determinants of money's purchasing power only and is therefore a measure of nominal expenditures. Mises' ideal of a money with a constant inner objective exchange value (but with an *outer* exchange value that varied directly with changes in real output) was thus, in essence, equivalent to the modern idea of a nominal income (GDP) target. Mises himself, however (perhaps because of his refusal to employ the equation of exchange as a tool of reasoning), never recognized the equivalence of a stable inner objective exchange value of money and stable nominal income. This failure caused Mises to exaggerate the difficulties involved in efforts to deliberately achieve an "ideal" money and to overstate the relative advantages of a gold standard.

Managed Money: The Measurement Problem

Mises differed from proponents of zero inflation, not only because he rejected the treatment of a money of constant purchasing power as a theoretical ideal, but also because he denied that either the outer or the inner objective exchange value of money could be measured with any degree of precision. He therefore did not think the concept operational, in the sense of being capable of serving as a useful guide to a deliberate stabilization policy. Moreover, he believed that the managers of a (fiat) monetary standard would inevitably yield to political pressure, and especially pressure from advocates of inflationism (a policy aimed at deliberately reducing the inner objective exchange value of money), who would exploit the measurement problem by arguing for repeated revisions of the monetary policy target in a direction allowing for greater and greater monetary expansion. The

practical result of this would be persistent depreciation of the (fiat) monetary unit.

In arguing against a policy of deliberate price-level stabilization, Mises recites the usual list of problems encountered in the construction of index numbers. These include the difficulty of allowing for changes in the quality and composition of available goods as well as the difficulty of assigning weights to prices of commodities in order to adjust for the commodities' varying degrees of prominence in consumer purchases (Mises 1990: 86–89; 1978: 87–89). Rather than merely concluding (as many other economists have) that such index-number problems prevent changes in the objective value of money from being observed with precision, Mises insists that they do not even allow us to say, except perhaps in extreme cases (when resort to index numbers would be otiose) whether the purchasing power of money is rising or falling. "The statements of the average man," Mises writes (1980: 177–78), "would almost form a better substantiation of the fact of a progressive fall in the objective exchange value of money than can be provided by all the contents of voluminous statistical publications." He concludes that, "Since it is impossible to measure fluctuations in the objective exchange value of money, even only approximately, we are not able to judge whether the increase of [the money stock] that has occurred during the last century [has] kept pace with the increase in the demand for money . . . or fallen behind it, or outstripped it" (p. 353). Because variations in the purchasing power of money cannot be measured with any degree of accuracy, efforts to adjust money growth in order to deliberately stabilize that purchasing power "run the risk of giving the wrong dose." Even if we could "roughly tell the direction in which we should work . . . we still have nothing to tell us how far we should go" (p. 257).

Mises assumes that the problems involved in attempts to measure and stabilize the purchasing power or *outer* objective exchange value of money are merely compounded by the need to distinguish between money's inner and its outer exchange value, so as to allow those "price movements which lie on the side of commodities" (Mises 1980: 218). Judged from a modern perspective, he seems to be mistaken: The norm of a stable inner objective exchange value of money is, as we have noted, equivalent to a stable nominal income norm. Although no unique and precise measure of nominal income exists, measures of nominal income are widely available and relatively closely correlated with one another, and the measurement of nominal income is at least not complicated by the sort of index-number problems involved in attempts to measure the outer exchange value of money. Mises' strictures against the employment of any price index as a monetary target

do not nowadays constitute equally compelling arguments against attempts to implement deliberately Mises' own preferred monetary policy ideal. The lack of good *historical* nominal income statistics, from the early 20th century or earlier, does nevertheless make it necessary to rely upon early price indexes for judging the *historical* performance of alternative monetary arrangements. Moreoever, even today the lack of perfect correlation among various nominal income indices suggests that they are also imperfect indicators of movements in money's inner objective exchange value.

Mises favored a gold standard, not because he believed that it would succeed in entirely avoiding fluctuations in nominal income (or the "inner objective exchange value of money"), but because he believed that the fluctuations that were likely to afflict a gold standard would be of minor significance compared with those that would characterize a managed fiat money. In 1934 Mises observed that, although a gold standard

> introduces an incalculable factor into economic activity . . . it does not lay the prices of commodities open to violent and sudden changes from the monetary side. The biggest variations in the [inner objective exchange] value of money that we have experienced during the last century have originated not in the circumstances of gold production, but in the policies of governments and banks-of-issue [Mises 1980: 24].

The deflation of the 1930s itself was, according to Mises, not proof of the instability of gold but rather evidence of the damage caused by attempts to circumvent the gold standard:

> The thing for which the monetary system of our time is chiefly blamed, the fall in prices during the last five years, is not the fault of the gold standard, but the inevitable and ineluctable consequence of the expansion of credit, which was bound to lead eventually to a collapse [Mises 1980: 30].

By substituting gold-bullion and gold-exchange standards for 19th-century gold coin standards, central bankers were able, starting in the 1890s, to stretch available gold reserves, but only provided that creditor nations resisted the temptation to redeem their holdings of foreign exchange. In the late 1920s, the entire superstructure of inter–central bank credits so carefully erected during the preceding decades came tumbling down. It was "not the old classical gold standard, with effective gold circulation," that failed after 1929; what failed was "the gold 'economizing' system and the credit policy of the central banks of issue" (Mises: 1990: 85).

In Mises' opinion, the gold standard should be held responsible, not for changes in money's purchasing power that stem from politically

inspired changes in the manner in which the gold standard is administered, but only for those changes in money's purchasing power that reflect "fluctuations in the conditions of production of the metal and variations in the industrial demand for it" (Mises 1990: 270). Although such fluctuations alone would render a gold standard imperfect, the variations in money's inner objective exchange value that could be attributed to them "are not immoderately great." Moreover, even if they were greater, a metallic base money "would still deserve preference over one subject to state intervention, since the latter sort of money would be subject to still greater fluctuations" (p. 270).

Tension in Mises' Arguments

A reader who has carefully followed Mises' arguments for gold up to this point may have noted a certain tension between them. On the one hand, gold is to be preferred to managed (fiat) money because of the lack of a reliable measure of money's purchasing power. On the other hand, gold is to be preferred to managed money because the gold standard is more stable in practice. Together these arguments beg the question: If the purchasing power of money cannot be measured with any degree of accuracy, how is it possible to conclude that the purchasing power of money is subject to greater variations under a managed monetary standard than under a gold standard? In *Human Action* Mises suggests that changes in the value of money, although they cannot be measured scientifically, are nevertheless capable of being assessed through the specific method of historical understanding (*verstehen*). It is hard to imagine, however, just how such understanding can be arrived at except by generalizing from observed movements in actual money prices (or nominal income). Statistical methods offer the best, albeit imperfect, means for making such generalizations in a more or less objective manner. In so far as they lack statistical support, Mises statements concerning the relative success of gold and fiat money in retaining a stable inner objective exchange value over time are hardly compelling. Mises, in other words, goes so far in attacking the very possibility of a scientifically managed money as to seemingly rule out the possibility of any scientific comparison of the historical performance of gold with that of irredeemable paper money.

Mises attempts to avoid self-contradiction by suggesting in places that very severe fluctuations in money's purchasing power can be recognized without statistical aids. In such cases "all people agree" that the value of money has moved in a particular direction (Mises 1966: 467). Price indexes, though they convey accurately enough the general direction of price movements during such episodes, are also

unnecessary since they can only be trusted to the extent that they confirm that which is already obvious even to persons unfamiliar with official statistics. Mises' argument then reduces to the claim that the most extreme (and therefore most obvious) fluctuations in the purchasing power of money—like the German inflation of 1914 to 1923—have all involved fiat base moneys.

But this argument, too, seems far from adequate: Even though the most dramatic changes in money's purchasing power have involved fiat moneys, it does not follow that fiat money is generally inferior to gold. If the gold standard should not be blamed for changes in gold's purchasing power that were linked to politically motivated changes in the way the gold standard was administered (such as took place in the years surrounding the First World War), why should fiat money be considered inherently defective just because it, too, has occasionally been mismanaged? In principle, any monetary regime can be dismantled in response to some change in the state of the economy. Mises himself observed (1980: 435) how even relatively well-established gold standards had been abandoned "with the stroke of a pen" during wars. The question, then, is whether a gold standard regime is likely to be more robust to external shocks, and hence more "credible," than a fiat money regime. Mises, unfortunately, never supplies theoretical reasons for his implicit belief that a gold standard is likely to last longer than a fiat-based regime aimed at deliberately stabilizing money's inner objective exchange value. Moreover, as we have seen, Mises resists offering any statistical evidence of gold's superior staying power. On the contrary, in observing how historical gold standards were often dismantled during emergencies, Mises leaves his readers with the impression that a gold standard offers no greater guarantee against sudden monetary depreciation than a managed fiat standard.

Mises is, in fact, unable consistently to adhere to his own strictures concerning the impossibility of tracking changes in the objective exchange value of money. Thus, he cannot resist contrasting the relatively large fluctuations in money's purchasing power that have characterized various fiat money regimes with the "slow and comparatively slight movements in purchasing power" that characterized the gold standard (Mises 1966: 425). He also observes that the purchasing power of money rose during the decades prior to 1896, but declined thereafter until the outbreak of the Great Depression (Mises 1978: 69; 1990: 83). It is hard to see how Mises could have based these claims on anything other than summary price statistics, notwithstanding his belief that such statistics "are based on entirely false assumptions and display ignorance of the fundamental principles of both economics and history" (Mises 1966: 467).

Ultimately Mises has no choice but to abandon his extreme position concerning the uselessness of index numbers. This allows him to suggest that gold has indeed performed better historically than irredeemable paper. It also serves to effectively undermine his claim that measurement problems alone must render a managed money standard impracticable: "The inadmissability of the methods proposed for measuring variations in the value of money does not obtrude itself too much if we only want to use them for solving practical problems of economic policy" (Mises 1980: 222; compare Mises 1966: 411).

Thus, Mises admits that measurement problems do not pose any insuperable barrier to a scientifically managed money. Although the ideal of a money of constant inner objective exchange value may be unachievable, there is no compelling reason to believe that measurement problems alone must render a managed paper money standard inferior to an (also imperfect) gold standard. The case for preferring gold to paper must rest on other than merely technical grounds.

A Public-Choice Case for Gold

Measurement problems are, in fact, only one of two potential drawbacks of managed money emphasized by Mises. The other, far more serious problem has to do with the tendency of a managed money to become subject to political pressures. According to Mises (1980: 258), once the principle is admitted that the state should deliberately attempt to influence the objective exchange value of money, "immediately the most violent and bitter controversy will break out as to how far this principle is to be carried." The reason is one that might have been given by a member of the modern public-choice school: While a stable inner objective exchange value of money might be most consistent with overall macroeconomic stability, changes in money's purchasing power involve costs and benefits that fall disproportionately on particular interest groups, some of which are more politically powerful than others. In a democratic, fiat-money-employing nation, interest-group pressures will then tend to pull monetary policy away from a stable (inner or outer) exchange value ideal. To these pressures one must add the bias of government authorities themselves, who may favor an inflationary policy owing to its ability to augment government revenues in a manner that circumvents the democratic process altogether (Mises 1980: 253–55). For all these reasons, schemes like Irving Fisher's compensated-dollar plan must ultimately prove "illusory and tantamount to open approval of the government's power to manipulate purchasing power according to the appetites of powerful pressure groups" (1966: 443).

The fact that there is no one precise and universally accepted way to measure money's purchasing power, even if it alone does not constitute a fatal flaw of managed money, does play into the hands of those interest groups that would abuse such a money. Once "the credit policy of the central banks" became "dependent on the results of the index measurement, the various interest groups would immediately take sides on behalf of this or that method of calculation, according to whether they were interested in a rise or a fall of prices" (Mises 1990: 87). This suggests that, at the very least, a managed-money policy should limit itself to preventing only "those changes in purchasing power . . . which are admitted without question by all parties" (p. 93).

Although this part of Mises' argument for gold may appear to rest upon a normative judgment favoring a particular distribution of income and wealth, Mises is quick to observe that the problem is not the government's desire to placate particular interest groups, but its employment of an inefficient and ultimately self-defeating means—manipulation of the purchasing power of money—toward this end simply because this instrument allows government agents to avoid the costs of passing new legislation (Mises 1980: 262). Thus, inflationism is bad policy not because of the manner in which it redistributes wealth, but "because it is incapable of fully attaining its goal and because it leads to consequences that are not, or at least not always, part of its aim. . . . Its popularity, in fact, is rooted in the difficulty of fully understanding its consequences" (p. 262).

Mises objects to deflationism—a policy aimed at deliberately increasing the inner objective exchange value of money—for the same reason that he opposes inflationism. Deflationism is, however, unlikely to be the actual outcome of a move to managed money, because it tends to erode government revenues while favoring interest groups that have "not been particularly numerous or influential at any time in any country" (Mises 1980: 264). Because he thought deflationism unlikely, Mises devoted relatively little attention to deflation as a theoretical topic.

Do Mises' claims concerning the likely politicization of a fiat standard amount to a convincing argument in favor of gold? That a fiat standard introduces an inflationary bias in monetary affairs seems indisputable. But whether that bias renders a fiat money on the whole less desirable than a gold standard does not seem to be a question that can be settled on a priori grounds. Yet Mises, in both *The Theory of Money and Credit* and *Human Action*, suggests that a managed fiat standard is *bound* to be less stable than gold precisely *because* fiat money is managed deliberately: "The main objection raised against

the gold standard is that it makes operative in the determination of prices a factor which no government can control—the vicissitudes of gold production" (Mises 1966: 473). But freedom from political control "is not a defect of the gold standard; it is its main excellence. . . . The gold standard removes the determination of cash-induced changes in purchasing power from the political arena [and thereby] checks large-scale inflationary ventures on the part of governments" (pp. 474–75).

A managed fiat standard, on the other hand, derives its popular support not from its ability to achieve in practice the first-best outcome of a money of stable inner objective exchange value, but from the fact that it alone is perceived as being capable *in principle* of fulfilling not only the aforementioned ideal, but also other, often conflicting, desires of various special interest groups.

In defending gold against the more politically popular alternative of a managed fiat money Mises implicitly employs something like a Rawlsian "veil of ignorance" argument. It makes sense to advocate fiat money if one belongs to a particular interest group that can benefit from inflationism or deflationism and if that interest group is part of a politically successful coalition. On the other hand, if one were forced to choose a monetary standard before knowing one's place in society, one would opt not for a potentially "perfect" fiat money, but for the more "accidental" consequences of a money "independent of deliberate human intervention" (Mises 1990: 90; 1980: 270).

It is from this point of view—the view from behind the veil of ignorance—that the pre-World War I gold standard can be said to have "functioned on the whole satisfactorily." Although that standard "did not secure the unattainable ideal of a money with an invariable [inner] objective exchange value . . . it did preserve the monetary system from the influence of governments and changing policies" (Mises 1966: 430).

The problem with Mises' argument is that it confuses the ignorance induced by donning a Rawlsian veil with ignorance *tout court*. In order to choose a gold standard over fiat money, the man behind the veil must know, not only that a fiat standard is likely to be deliberately manipulated in a manner that may be contrary to his self-interest, but also that the vicissitudes of gold, however unplanned, will not harm his interests even further. The argument for gold cannot, in other words, proceed on entirely a priori grounds, but must be empirically grounded—and this means in practice that it must be grounded at least in part in the sort of statistical evidence Mises disdains. It is not sufficient simply to list the shortcomings of fiat money and then declare gold the winner. The gold standard must be shown to be, first of all, a potentially credible arrangement and, second, an arrange-

ment that, once in place, is relatively successful at stabilizing money's purchasing power.

The lack of any sufficient a priori grounds for preferring gold to a managed fiat money becomes especially evident if one allows, as Mises does at one point (1990: 94), that a fiat money might be managed so as to prevent only those changes in purchasing power that have "been ascertained over a considerable period with such unquestionable certainty that no one can dispute" them. In such a case, the purchasing power of money would be allowed to vary between upper and lower estimates that would move further apart as time passed. But more dramatic fluctuations in purchasing power would be resisted, because political pressure groups would not be able to justify them scientifically. Despite its evident crudeness, it is not clear why such a limited stabilization scheme would be worse than a gold standard. Indeed, there might be grounds for preferring it to the classical gold standard, since the latter did (according to Mises) allow even "obvious" purchasing-power movements to occur, like the deflationary movements of the last quarter of the 19th century.

Mises' public-choice argument against fiat money thus appears to be seriously undermined by his insistence upon the impossibility of assessing alternative monetary regimes according to their statistical performance. If price indexes are as unreliable as Mises claims, so that the only certain knowledge we have of changes in money's purchasing power is knowledge about those changes that are "admitted without question by all parties" and evident in *all* credible price indexes (Mises 1990: 93), then monetary management must limit itself to avoiding only such obvious price movements if money is not to become a plaything of politics. Evidently, the result would be a very crude form of managed money. Yet, crude as it might be, there would seem to be no grounds whatsoever for claiming that such a money would be worse than a pure gold standard. On the contrary, the gold standard, in its classical, gold-coin form, was "admitted by all parties" to have sponsored secular deflation—the kind of deflation that even a crudely managed fiat money might have avoided.

Making the Case for Gold

In insisting that a managed fiat money must become a plaything of politics, Mises hinted at the true advantage of a gold standard. A gold standard regime may in fact be more robust—less subject to sudden abandonment—than any rule-bound fiat regime. The reason for this, never articulated by Mises, has to do with the differing nature of enforcement mechanisms under gold and fiat regimes. Under the

classical gold standard, paper bank notes embodied enforceable redemption contracts: their issuers were bound by the laws of contract to honor their promises to noteholders. Government monetary authorities that promise to stabilize the value of their fiat moneys operate under no similar contractual constraints: their "promises" are mere pledges, lacking the force of law. Because they incur costs that are low relative to the benefits they may derive from reneging on their promises, fiat-money–issuing institutions are more easily tempted to renounce their promises, that is, to disobey rules. Their immunity from prosecution by those holding their "liabilities" allows them to switch regimes with relative impunity, and this fact undermines the credibility of their commitments.

Although the classical gold standard only crudely approximated a rule for stabilizing money's inner objective exchange value, that standard had the advantage of being more strictly enforced and therefore more credible than later fiat regimes. Michael Bordo and Finn Kydland (1996) argue that the gold standard involved a credible commitment to return to a former parity following suspension, which served to lower expected and actual wartime inflation rates. Importantly, their claims are borne out by statistical evidence, which suggests that, although the classical (pre-1914) gold-standard era may have involved greater short-run price level variability than post-World War II arrangements, it also provided greater long-term price level stability, avoiding *persistent* inflation (Bordo 1993). In general, institutions that promised to obey the rules of the gold standard kept their promises. The lack of complete consistency of these promises with the goal of a stable inner objective exchange value of money was, to an important extent, compensated for by the fact that the promises were generally adhered to. Under fiat money, in contrast, a promise can be made that is more strictly in keeping with a stable inner objective exchange value of money; but this advantage is of little value because the promise is likely to be broken.

Commitments to uphold the classical gold standard were credible, not on account of any special attribute of gold itself, but because the institutions responsible for making the commitment were often private entities instead of being public or semipublic ones enjoying a kind of sovereign immunity from legal sanctions generally applicable to defaulting creditors. Under this interpretation, a completely free banking system, where no bank enjoys special government privileges or immunities, would be most likely to stick to its commitments. Thus, Mises' preference for free banking complements well his preference for a gold standard. Unfortunately, Mises himself, although he did emphasize the advantages of free banking in regulating the money

stock, did not explain the bearing of limited state involvement in banking upon the credibility of a convertible monetary regime.

Conclusion

Although I find Mises' own arguments in defense of gold unsatisfactory, I have tried to suggest how an extension of those arguments could make for a more convincing defense of gold. This defense cannot, however, be sustained on purely theoretical grounds. Ultimately the merits of gold must be assessed in light of empirical (and statistical) evidence comparing the gold standard's performance with that of historical fiat standards.

References

Bordo, M.D. (1993) "The Gold Standard, Bretton Woods, and Other Monetary Regimes: A Historical Appraisal." Federal Reserve Bank of St. Louis *Review* 75(2) (March/April): 123–91.

Bordo, M.D., and Kydland, F. (1996) "The Gold Standard as a Commitment Mechanism." In T. Bayoumi, B. Eichengreen, and M.P. Taylor (eds.) *Modern Perspectives on the Gold Standard*. Cambridge: Cambridge University Press.

Mises, L. von (1966) *Human Action: A Treatise on Economics*. 3rd ed. Chicago: Henry Regnery.

Mises, L. von (1978) "Monetary Stabilization and Cyclical Policy." In von Mises, *On the Manipulation of Money and Credit*, 57–171. Translated by B. Bien Greaves. Dobbs Ferry, N.Y.: Free Market Books.

Mises, L. von (1980) *The Theory of Money and Credit*. Translated by H.E. Batson. Indianapolis: Liberty Classics.

Mises, L. von (1990) "The Suitability of Methods of Ascertaining Changes in Purchasing Power for the Guidance of International Currency and Banking Policy." In R.M. Ebeling (ed.) *Money, Method, and the Market Process: Essays by Ludwig von Mises*, 78–95. Norwell, Mass.: Kluwer Academic Publishers.

Rothbard, M. (1974) *The Case for a 100 Percent Gold Dollar*. Washington, D.C.: Libertarian Press.

Sennholz, H. (1975) *Gold Is Money*. Westport, Conn.: Greenwood Press.

White, L.H. (1992) "Mises on Free Banking and Fractional Reserves." In J.W. Robbins and M. Spangler (eds.) *A Man of Principle: Essays in Honor of Hans F. Sennholz*, 517–33. Grove City, Pa.: Grove City College Press.

White, L.H. (1999) *The Theory of Monetary Institutions*. Malden, Mass.: Blackwell.

Ludwig von Mises and Price Indexes

Richard H. Timberlake

George Selgin's paper on Ludwig von Mises' monetary theory and Mises' advocacy of a gold standard is instructive and timely. Selgin emphasizes the "tension" between Mises' theory of money—particularly what Mises rejected in the way of a price level concept and price indexes—and his advocacy of a gold standard. Selgin concludes by showing that Mises' case for a gold standard is compatible with the favorable view he gave to free banking, and logically should have been married to it.

Treating Mises' writings critically and professionally has been difficult in the past.[1] His insistence on deductive reasoning as the exclusive means to truth not only violated scientific norms that routinely include inductive reasoning from empirical data, it also cut him off from many of his contemporaries in dealing with current issues. By contending that only individual preferences determine values, Mises carried the principle of subjectivism beyond its rational limit.

Perhaps Mises' attitude was defensible when his economic career was just starting because in that era data collections, time series, and statistical methods for dealing with them were crude and incomplete. Consequently, Mises may have felt justified in rejecting price indexes (inverted) as legitimate measures of money's value. He regarded money prices as an indispensable means for valuing economic goods and services. However, since he presumed that money prices—"objective exchange values"—were exclusively the result of subjective utilities, he could not accept an objective statistical construction of a general price level (Mises 1978: 62). A price index was an unacceptable means to "measure" an unmeasurable quantum.

Cato Journal, Vol. 19, No 2 (Fall 1999). Copyright © Cato Institute. All rights reserved.

Richard Timberlake is Professor of Economics Emeritus at the University of Georgia.

[1]Austrian economists too often and too uncharitably have bristled at any criticism that their mentor, Mises, could have been less than omniscient. For good reason, a creative scholar who errs is more believable than one whom his followers regard as inviolate.

The Austrian Principle of Money

Selgin traces Mises' argument in deriving what might be labeled the Austrian Principle of Money: "Every variation in the quantity of money," Mises wrote, "introduces a dynamic factor into the static economic system." When the stock of money changes, even if money is gold, the circumstances of the situation inevitably result in relative price changes, and in wealth and income changes (Mises 1978: 62). Money to Mises was not neutral under any conditions, not even in thought experiments.

Mises' conclusions about price indexes and the Quantity Theory of Money are in sharp contrast to those of Irving Fisher, an earlier contemporary of Mises (14 years older). Fisher also recognized the impossibility of measuring subjective utilities. However, to Fisher the unmeasurability of utility was a good reason to use a price index as a guide to "corrections in the monetary standard," that is, the "compensated dollar." By this means the quantity of gold defining the gold dollar would be increased or decreased to keep a general price index from fluctuating unduly due to the vicissitudes of gold production (Fisher 1911: 22, 248–50). At the time Fisher made this proposal, world gold production was generating a mild gold inflation.

Fisher was acutely aware of the fact that without the concept of a price index, the distinction between relative prices and the value of money is almost opaque. "Individual [real] prices," Fisher (1911: 175) observed, "cannot be fully determined by supply and demand, money cost of production, etc., without surreptitiously introducing the price level itself."

Selgin notes Mises' refusal to use a price index at the same time that he (Mises) denounced statist inflationary policies and championed the gold standard. "It is hard to see," Selgin argues, "how Mises could have based these claims [concerning money's purchasing power] on anything other than summary price statistics."

Throughout his discussions of monetary policies and episodes of price level changes, one gets the impression that Mises is advising his readers not to do as he does—use an implicit price index to evaluate monetary phenomena—but to do as he says and avoid such devices. Apparently he felt that a price index in the hands of the unwashed would lead to the excessive political interventionism that he rightfully deplored. However, Selgin shows that the failure to admit the qualified use of a price index made Mises' plea for a gold standard unsound and unconvincing.

With the demise of metallic standards, all existing media became nominal—that is, fiat legal-tender moneys issued by central banks.

Nevertheless, fiat or not, legal tender or not, paper notes or bank demand deposits, contemporary money is also real because it will buy real things. However, to cross the intellectual bridge from nominal fiat money, which is itself worthless, to the real things that a unit of fiat money will buy requires a statistical apparatus.

Price indexes are such devices. No index can ever be perfect, as Mises insisted and as all economists admit. However, it seems a vain subtlety to insist that a price index (inverted) is not an acceptable approximation of the value of money just because it is not "perfect." It says that the bridge from nominal to real money is impossible to build.[2] Yet, Mises and many Austrian economists, including the late Murray Rothbard, found that they had to use an implicit price index concept in order to write anything meaningful about the paper money inflations of the 20th century.

The Austrians' Misinterpretation of the Great Depression

Their unsympathetic view of price indexes is largely responsible for the Austrians' continuing and intransigent misinterpretation of the Great Contraction and Great Depression of the 1930s. Selgin cites Mises' passing remark that "*the fall in prices* [emphasis mine] during the last five years [1929–34] is not the fault of the gold standard, but the inevitable and ineluctable consequence of the expansion of credit [during the 1920s]."

Mises' principal disciple, the late Murray Rothbard, taking his cue from Mises, wrote extensively on this episode (see especially Rothbard 1963: 87). Rothbard argued that the Federal Reserve banks of the 1920s initiated an "inflation," even though the price indexes of the time fell slightly. He then extrapolated this "inflation," which he defined as "any increase in the stock of money not . . . covered by an increase in gold," into the argument that the stock of money in the 1920s was excessive (Rothbard 1963: 88). Had Rothbard used a price index to examine the monetary data of the 1920s, which because of his fealty to Mises he would not do, he would have realized that a mild deflation rather than an inflation marked the period. He then could have correctly interpreted the Federal Reserve System's subsequent deflationary policy for the disaster it was (see Timberlake 1999).

A Constitutional Gold Standard and Free Banking

Selgin claims that Mises' eloquent advocacy of free banking logically complemented his case for a gold standard. In arguing this position,

[2] Mises' "Regression Theorem," even though valid, does not serve this purpose.

Selgin compares implicitly two different gold standards: (1) a Treasury or central-bank gold standard, in which most of the monetary gold is held in government vaults and serves as the basis for issues of government currency or "lawful money"; and (2) a more durable constitutional gold standard, under which private banks issue media of exchange redeemable in gold.

Under the first type of gold standard, fiscal "emergencies," worldly "shocks," and unforeseen "crises" inspire the governmental "authority" to renege capriciously on its promise to redeem its paper money with gold. Supreme Courts then legitimize the Treasury or central bank default (see Timberlake 1991). Without the authority to make their media legal tender and with the courts ready to enforce the banks' contractual obligations, private issuers of money would force each other to limit their issues prudently. Their gold reserves would be out in the open and constantly in use, moving between banks and the nonbank public in fulfillment of the banks' avowed commitments.

The complementarity of a gold standard and free banking, therefore, depends on which type of gold standard one is featuring. Even at best the Treasury or central-bank gold standards of the late 19th and early 20th centuries were all too vulnerable to governmental repudiation. Selgin's constitutional gold standard with free banking would be much more resilient.

Though Mises did not explicitly link free banking to a gold standard, he devoted five full pages of *Human Action* to a thorough analysis of the institution. "Free banking," Mises claimed, "is the only method available for the prevention of the dangers inherent in credit expansion. . . . Only free banking would have rendered the market economy secure against crises and depressions. . . . [T]he blunders committed by liberalism in handling the problems of banking were a deadly blow to the market economy. There was no reason whatever to abandon the principle of free enterprise in the field of banking" (Mises 1966: 443).

Free enterprise banks, Mises argued, could not overissue either banknotes or deposits. Any amount of overissue would find banknote holders, particularly other banks, returning the notes to the issuing banks for redemption in the promised medium. "It is a mistake," Mises emphasized, "to associate with the notion of free banking a state of affairs under which everybody is free to issue banknotes and to cheat the public ad libitum. People often refer to the dictum of an anonymous American quoted by [Thomas] Tooke: 'Free trade in banking is free trade in swindling.'" However, Mises noted, "freedom in the issuance of banknotes would have narrowed down the use of

banknotes considerably" from the inflationary issues then current (Mises 1966: 446).

Mises very clearly intended his quotation of Tooke to be a foil for his emphasis of the true state of affairs that would develop under free banking. A little more thinking and Mises might have found Selgin's happy union between gold and free banking. But then what would Selgin have done?

References

Fisher, I. (1911) *The Purchasing Power of Money*. New York: Macmillan.

Mises, L. von (1966) *Human Action: A Treatise on Economics*. 3rd ed. Chicago: Henry Regnery.

Mises, L. von (1978) *On the Manipulation of Money and Credit*. Translated by B. Bien Greaves. Dobbs Ferry, N.Y.: Free Market Books.

Rothbard, M.N. (1963) *America's Great Depression.* Kansas City: Sheed and Ward.

Selgin, G. (1999) "Ludwig von Mises and the Case for Gold." *Cato Journal* 19(2): 259–72.

Timberlake, R.H. (1991) *Gold, Greenbacks, and the Constitution*. Berryville, Va.: The George Edward Durell Foundation.

Timberlake, R.H. (1999) "Money in the 1920s and 1930s." *The Freeman* 49(4) (April): 37–44.