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Where the Classical Economists Went Wrong

By Nikolay Gertchev^[1]

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As I pointed out in [my last column](#), the classical economists were not only advocates of the *laissez-faire*, *laissez-passer* credo; they were also opponents of a fiat paper money, viewing it as a corruption of the idea and integrity of money itself. However, their views on monetary matters were far from perfect. They made subtle errors that undermined their case for sound money and even paved the way for political intervention.



Error #1: An increase of the quantity of money is beneficial to the economy

The same Hume who concluded that the absolute quantity of money is irrelevant in respect to individuals' wealth argues also "the increase of gold and silver is favorable to industry."^[2] He quickly adds that this is true only in the intermediate period between the increase of the stock of money and the consequent rise in prices, during which an entrepreneur is enabled to attract additional labor and thus intensify production.

Hume then states the policy-oriented conclusion, which logically follows from this belief: "The good policy of the magistrate consists only in keeping the quantity of money, if possible, still increasing."^[3] The most suitable means to put into practice this advice, of course, is to endow the magistrate with the power to produce money (i.e. paper money).

There is no particular problem in Hume's line of reasoning, except for the false generalization that the new money "must first quicken the diligence of every individual." Given the sequential manner in which the new money enters the economy, which Hume himself describes perfectly well, it is evident that the attraction of factors of production by one entrepreneur prevents another entrepreneur from fulfilling his project.

Consequently, there can be no *general* advantage in an increase of the quantity of money; rather somebody benefits at the expense of somebody else. Hume's argument would be valid only if there were unemployed factors of production, and their owners agree to sell or rent them not because of a higher remuneration (after all people are aware of the imminent rise in prices), but simply because there is more money in the economy. In short, psychology alone helps to quicken the economy, and it does not require further developments to prove that things may not happen in this way, but rather in the opposite way.

Hume was not the only economist who favored an increase in the stock of the currency, creating thereby a rationale for governmental involvement in monetary affairs. On similar grounds, Malthus and Mill contended that augmenting the stock of money stimulates capital accumulation in the economy.

Anticipating the doctrine of forced savings, Malthus points out "that it is not the *quantity* of the circulating medium which produces the effect here described [an increase of the national capital], but the *different distribution* of it."^[4] The idea is indeed very subtle. The quantity of money is irrelevant, but since an additional quantity of it "throws the command of the produce of the country chiefly into the hands of the productive classes," then each increase in the stock of money is more than welcomed.

Mill substantiates virtually the same doctrine and extends it to the case of paper currency. He first reminds us that money and credit are neither a producers', nor consumers' goods, and that therefore an additional quantity of bank notes does not augment the stock of commodities in the country. However, a greater part of "that stock now comes by purchase into the hands of producers and dealers"[\[5\]](#) and goods which would have been unproductively consumed are now invested in productive processes. In this sense, there is an increase in the stock of capital, followed by an increase in future production.

Malthus and Mill made the case for paper money extremely appealing, by emphasizing those alleged advantages a constant increase in the quantity of money is supposed to produce. It does not bring riches in the immediate present, but it does bring wealth in the future. As with all plans for magical enrichment, careful examination will show that there is no economic law which brings about the promised increased capital accumulation with an apodictic certainty.

Even if the "productive classes" do receive the greatest part of the new bank notes, they do not automatically obtain the ownership over goods which would have been consumed otherwise. The current owners of those goods must first agree to sell or rent them. Such an agreement would be impossible without the offer of a higher buying price, and it is therefore doubtful whether the "productive classes" could attract a bigger quantity of goods, given the necessarily higher prices.

Contrary to what Malthus's and Mill's ideas teach, the choice is not between a situation *a* with given quantities of money and capital and a situation *b* with higher quantities of both, the transition from *a* to *b* being achieved by a simple increase of the stock of paper currency. It is clear that nobody in the economy faces these two alternatives.

Rather, individuals have to decide whether, given the additional quantity of money, they prefer to lower their present-day consumption in order to save and invest more goods and thus obtain more commodities in the future. Such a decision, i.e., a lowering of the degree of time preference, may follow an increase in the stock of money, but there is no praxeological law saying that it must necessarily follow. Again, the contrary could happen as well, since the causal relation is a matter of pure psychology.

Thus, whatever the explanation for the alleged benefits stemming from an increase of the stock of money, it is not based on sound economics, but on hypothetical psychology. Another strong criticism is that, even if the quantities of goods available tomorrow are indeed increased, with or without the sacrifice of goods available today, nothing implies that this future quantitative increase amounts to an amelioration of the individuals' welfare.

Error #2: Money must have a constant exchange value

The classical economists committed a second fallacy, which also provides a rationale for governmental intervention in the production of money. Inspired by their objective value theory, they put the emphasis on the so-called "standard of value" function of money. They considered that money has to be the measure of exchange value, and that consequently it should have a constant exchange value.

Mill, for example, condemns "all variations in the value of the circulating medium" as "mischievous", which leads to policies to combat this "great evil."[\[6\]](#) Thus, the opportunity is present for central bankers to claim that the fiat paper money they are offering provides better services than a commodity money selected on the free market. The government argues that its paper money will protect the future value of contracts, which would have been otherwise endangered by a commodity money with variable purchasing power subject to the vicissitudes of the market.

Wicksell brings the "unattainable ideal of a money with an invariable objective exchange value,"[\[7\]](#) to its apex. Legal conflicts about the future value of present engagements must be reduced by the overthrow of the commodity money, if necessary. Wicksell considers the

inconstancy of the exchange value of gold as its most important problem, and suggests that a solution could not be found "so long as metals are used as standards of value and free minting of the standard money on private account is permitted." [8] He himself does not invite the government to solve the alleged problem, but governments do use this argument for justifying their monetary interventionism. As a matter of fact, all famous plans for monetary reform, like those of Irving Fisher, Henry Simons, Benjamin Graham, or James Buchanan, are based on the principle that money must have a stable, if not constant, exchange value.

But why should money be subject to this particular requirement? Value is subjective and its measurement is impossible; the idea of constructing a standard of value is simply absurd. Individuals do not even need such a standard in order to discover whether they benefit from an exchange or not. All that is needed prior to engaging in profitable market transactions is monetary prices, and those exist without any reference to a standard of value. The classical economists imposed upon money a fictitious requirement, which is unnecessary for a capitalist economy to function and expand.

It is common today to hear that the monetary policy follows a *target*, whose goal often is to attain a given growth rate, or that it observes a *rule*, whose aim is to preserve the stability of prices. Both of those objectives, which serve as a justification for having paper money and a central bank regulating its production, are inspired by two fallacies perpetrated by the classical economists. By correcting these errors, the case for commodity money is thereby strengthened.

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[2] William Rees-Mogg (ed. by). 2002. *The Case for Gold*. London: Pickering & Chatto (I, p. 116).

[3] Ibid., I, p. 117.

[4] Ibid., II, p. 49 (author's emphasis).

[5] Ibid., I, p. 117.

[6] Ibid, II, p. 157.

[7] Mises, Ludwig von. [1912] 1980. *The Theory of Money and Credit*. Indianapolis: Liberty Classis (p. 430).

[8] William Rees-Mogg (ed. by). 2002. *The Case for Gold*. London: Pickering & Chatto (III, p. 129).

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