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## Article

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# Newly Discovered Gold Does Not Distort the Economy; It Is Not A Market Failure

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**Abstract:** We wish to “quibble” with Murphy (2019). We mean this literally. That is, we are in strong and enthusiastic agreement with virtually everything he writes therein, except for one point: we think him guilty of allowing the cloven hoof of market failure into the Austrian tent. Our purpose in the present essay is to banish market failure from praxeological premises. To wit, he maintains that pure market processes such as a gold discovery can “distort” prices and interest rates, and we argue to the contrary.

**Keywords:** distortion, interest rates, market failure, prices

**JEL Classification:** B53, E32, E42, E58, G21

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In our view, there is no such thing as a market failure. Before we go any further, we do well to define terms. A market failure is not an act that fails to maximize profits nor, one that leads to losses. These occurrences are legion in any economy occupied by flesh and blood mistake-making human beings. Opening a restaurant that has to close later on is a failure, but not a market failure. Being stuck with an inventory of hula hoops that no one wants to purchase, at least not at a price above all costs, is yet another example.

Ex-ante, every voluntary human action or interaction, is optimal from the perspective of the actor(s).<sup>3,4</sup> However, measured by some omniscient being, against some standard of perfection (virtually always the literally impossible, and therefore ludicrous, case of perfectly-competitive general equilibrium) – many voluntary action(s)/interaction(s) are found wanting. Such action(s)/interaction(s) are grist for the mill of market failure, provided that our all-knowing and all-wise leader(s) can imagine some coercion of the

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<sup>3</sup> That some third party(ies) may ex ante deem voluntary action(s) of another or others to be suboptimal is irrelevant to human action. Unfortunately, it all too often becomes relevant when the third party(ies) use coercion to impose his or their will(s) on the acting party(ies) for the benefit, of course, of the benighted latter.

<sup>4</sup> Ex post, any voluntary human action(s) or interaction(s) can be suboptimal, and that for a variety of reasons. Judgment of such action(s) is the realm of Monday Morning Quarterbacks and others blessed with 20-20 hindsight.

actor(s) that would lead to results superior – at least in the eyes of the leader(s) – to those of the voluntary action(s).

In sum, a market failure is assumed to exist in any situation in which, ex-ante, coercion can be supposed to yield superior results to voluntarism. Mainstream economists think such cases exist in the real world.<sup>5</sup> Austrians, however, are supposedly an exception to this general rule.

This brings us to Murphy (2019). This author is one of the most accomplished praxeologists now active, and, yet, we fear, he errs in this regard. Now, this mistake of his might well be no more than something akin to a typographical error, the misuse of one single word, “distort,” but, even if so, the error goes deeper than that, since it seemingly applies, as well, to Mises, Hayek, and Rothbard. If so, Murphy is in “good” company,<sup>6</sup> so it is even more important that we get to the bottom of this matter.

Consider this statement of Murphy’s (2019, emphasis added)<sup>7</sup>:

“Putting together all three of the block quotations from *Human Action* that we have provided above, we can summarize Mises’s position as follows: The unsustainable boom occurs when a newly created (or mined) quantity of money enters the loan market and *distorts* interest rates, before other prices in the economy have had time to adjust. In principle, this process could occur even in the case of commodity money with 100 percent reserve banking.

“However, *in practice* Mises believes such a theoretical possibility can be safely neglected, because (a) the quantity of new gold (or other commodity money) entering the economy will likely be relatively small over any short period and (b) *whatever* the stock of new commodity money entering the economy as a whole, typically only a small fraction of it would be channeled into the loan market upfront.

“Thus, even though in principle Mises’s theory of the boom-bust cycle is fundamentally about new quantities of money hitting the loan market early on, in practice the explanation revolves around *newly-created fiduciary media* being lent into the market....”<sup>8</sup> (Bold emphasis added by present authors).

We take exception to the one word, “distort.” This implies that gold discoveries resulting from voluntary actions are a market failure, and, in our view, the set of market failures is the null set. In logic, to point out a self-contradiction is a devastating blow. This is akin to an Austrian giving credence to the existence of a market failure. Can it be really true that he who supplies newly mined gold to the economy, whether it is used in the credit market, for jewelry, for teeth, or, for gold coins which are used as money, or

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<sup>5</sup> It would be silly to list publications articulating this view. Virtually all economists take this position. Instead, we content ourselves with mentioning critics of this pernicious doctrine: Anderson, 1998; Barnett, et. al, 2005; Block, 2001, 2002; Callahan, 2000; Cowen, 1988; DiLorenzo, 2011; Guillory, 2005; Higgs, 1995; Hoppe, 2003; MacKenzie, 2002; McCloskey, 2018; Rothbard, 1985; Simpson, 2005; Tucker, 1989; Westley, 2002; Woods, 2009A, 2009B.

<sup>6</sup> No, excellent company; these three are surely the leading lights in Austrian economics in general, and with regard to the business cycle in particular.

<sup>7</sup> Unless otherwise specified, our focus on Murphy is with regard to this one publication of his. For support of our position, see Shostak, 2019.

<sup>8</sup> We assume Murphy is referring to voluntarily mined commodity(ies).

for any other legitimate purpose, “distorts” the market? If so, there is a market failure lurking somewhere in the underbrush, and, if we are to achieve economic prosperity, the government would be justified in banning, or at least regulating such goings-on. This would be anathema not only to libertarians but to praxeologists as well.<sup>9</sup>

Whence the source(s) of these errors? There are several. One mistake is to think money to be a *sui generis* good, rather than to understand it as a capital good.<sup>10</sup> Capital goods may be classified either as work-in-process; e.g., steel that is in the process of becoming a part of a final good; or as fixed; e.g., a final good not intended for direct consumption, such as a delivery truck. The former move from being higher-order goods to lower-order goods as they are processed. The latter are used to transform higher-order goods to lower-order goods, without their own order necessarily varying, although it may.<sup>11</sup> So, also, is money *qua* money used to transform higher-order goods to lower-order goods, not by effecting a physical change in the higher-order good, but rather by mediating a change in ownership of another good(s) which lowers the order(s) thereof.

Another inaccuracy is to think that the optimal quantity of commodity money<sup>12</sup> is the quantity extant at any point in time and that therefore any increase in the quantity of such a money commodity, on the one hand, misallocates resources because the increment could have been put to alternative uses, while adding no value as money, and on the other alters interest rates and the structure of prices in ways not in keeping with the underlying preferences of individuals.<sup>13</sup>

A third mistake is the failure to properly distinguish between a voluntary increase in commodity money and an increase in money substitutes. Or, to quote Mises: “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 the creation of credit out of nothing. It is tantamount to the creation of fiat money ... It increases the amount of money substitutes...”<sup>14</sup>

Additionally, several other points need to be made. The interest rates under consideration are money rates of interest set in credit markets. In those markets, extant goods, specifically, capital goods in the form of quantities of money, are exchanged for promises.<sup>15</sup> Credit transactions do not involve saving and investment.<sup>16</sup> Rather, they involve the transference of ownership of preexisting goods for promises to be fulfilled

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<sup>9</sup> Murphy is careful to note that the quantity of the gold discovery is important. If only a small amount of newly mined gold enters the economy, the “distortion” will be small. But, still, there will be a “distortion” in his view, and we take the opposite perspective on this matter.

<sup>10</sup> Barnett and Block (2005).

<sup>11</sup> For example, a truck that is never used as a first-order; i.e., consumers’ good, is a higher-order, fixed capital good. However when used to make a delivery of furniture to a consumer it is a lower-order capital good than when it is used to bring furniture from the factory to the retail store. Money is a fixed capital good whose order depends on the nature of the exchange it is mediating.

<sup>12</sup> In contrast, the optimal quantity of fiat money is exactly the extant quantity. Barnett and Block (2004).

<sup>13</sup> Barnett and Block (2004) and (2012).

<sup>14</sup> Mises (1978, 218).

<sup>15</sup> We realize that the extant good(s) are not always money; credit in modern societies almost always takes the form of a loan of money, and thus we ignore exceptions as irrelevant.

<sup>16</sup> Barnett and Block (2007A).

in the future. These preexisting goods were a form of saving when they were first created/produced. But the transference of title thereto does not involve current saving. “A man’s savings are always embodied in concrete capital goods” (Mises, 1998, 519).<sup>17</sup>

The necessary implication of Murphy and thus also of Mises is that appropriate coercion is superior to purely voluntary action(s), when the latter consists of an increase in gold money, whether by converting gold from non-money to monetary uses or by producing new money from newly mined gold. Thus, a market failure necessitates apposite governmental coercion.<sup>18</sup>

The authors of the present paper change our cash balance holdings, or, stick some money into our mattresses, or release some from that source, and, behold, interest rates will change.<sup>19</sup> Yes, they will *change*, but from whence will spring any distortion? We claim no such thing will occur. In contradistinction to Murphy, along with Mises, Rothbard, and Hayek, Barnett and Block (2012, 2004) demonstrate that the optimal quantity of commodity money is whatever level is freely chosen by all market participants. Given that, any changes that emanate from the freely chosen decisions of people to mine gold, change their cash balances level, cannot possibly be a “distortion,” since the optimal quantity of money is *whatever* results from these voluntary decisions.

Jones purchases some bread, quite a bit of it, so as to overcome the objection based on quantity.<sup>20</sup> He thus *changes* the price of this foodstuff; it is no longer what it would have been in the absence of this commercial activity. But to say that he *distorts* this price is a horse of an entirely different color. The former objective fact; the latter is a subjective, value-laden, assertion. But, for those who wish to maintain the latter, it is incumbent upon them to furnish a reason for their conclusion, and this they have not done.

Murphy also avers as follows:

“According to the FRFB writers, all this shows is that commercial banks need to pay attention to maturity matching. It is not fraudulent, and it does not cause the business cycle if banks sell (say) 12-month CDs and lend the funds out for 2-year projects (hoping to roll over the CDs when they mature).<sup>5</sup> So by the same token, there is nothing especially risky or *distortionary* if we look at one end of the spectrum, where savers lend their funds to the bank for a loan that matures in “zero” time even though the bank uses those funds to invest in longer maturity projects” (emphasis added by present authors).

Here is a Murphy footnote attached to the above quote:

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<sup>17</sup> Barnett and Block (2007A) make the point that saving is embodied in concrete (durable) consumers’ goods, as well. Although in that paper those authors eschewed “any consideration of ‘human capital’ and its relation to saving and investment,” the present authors think that when an individual develops his mind or body he is saving/investing in a relatively durable capital good.

<sup>18</sup> Perhaps such coercion might even be performed by private individuals; i.e., criminals. E.g., in the famous (infamous?) case of lighthouses, might not some private ship-owners improve outcomes by coercing other ship-owners to pay to support a lighthouse, which they would not do voluntarily? See on this Barnett and Block, 2007B, 2009; Block, 2011

<sup>19</sup> To an infinitesimally-small amount, given our wealth, but we are not now concerned with the degree of “distortion,” only with whether or not it exists; i.e., whether or not this is a cogent argument.

<sup>20</sup> Or ceases to buy a like amount. Or starts to supply some.

“In the text above, I am paraphrasing a line of argument from the FRFB camp, which presupposes that the typical Rothbardian does not object to maturity mismatching per se. However, some Rothbardians do argue that maturity mismatching is the fundamental problem, of which fractional reserve banking on demand deposits is only the most prominent example. See Block and Barnett (2017) for such a claim, and see Bagus, Howden, and de Soto (2018) for a critical response, which contains citations to the volleys of the running debate. Of course, those in the 100 percent reserve camp who *agree* with Block and Barnett, this particular line of argument from the FRFB would fall flat.”

In principle, *ceteris paribus*, a spit in the ocean raises its level; however, in the real world magnitudes are often of great importance. To bring the point home, consider maturity mismatching, both with respect to the length of the mismatch period, and its temporal location, and the magnitude of the credit involved. Regardless of the length of the maturity mismatch, and the temporal length of the maturity mismatch, if the magnitude is small; e.g., \$1.00 in the circumstances of the U.S. in 2019, the consequences will be trivial, from the point of view of the business cycle, although it may be of immense importance to the parties directly involved.

Further, Murphy quotes Mises as follows:

“The notion of “normal” credit expansion is absurd. *Issuance of additional fiduciary media, no matter what its quantity may be, always sets in motion those changes in the price structure the description of which is the task of the theory of the trade cycle.* Of course, if the additional amount issued is not large, neither are the inevitable effects of the expansion.” (Mises 1998 [949], 439, n. 17; emphasis added.)

Murphy additionally quotes Mises:

“*Everything that has been asserted with regard to credit expansion is equally valid with regard to the effects of any increase in the supply of money proper as far as this additional supply reaches the loan market at an early stage of its inflow into the market system.* If the additional quantity of money increases the quantity of money offered for loans at a time when commodity prices and wage rates have not yet been completely adjusted to the change in the money relation, the effects are no different from those of a credit expansion... .

What differentiates credit expansion from an increase in the supply of money as it can appear in an economy employing only commodity money and no fiduciary media at all is conditioned by divergences in the quantity of the increase and in the temporal sequence of its effects on the various parts of the market. Even a rapid increase in the production of the precious metals can never have the range which credit expansion can attain. The gold standard was an efficacious check upon credit expansion, as it forced the banks not to exceed certain limits in their expansionist ventures. The gold standard’s own inflationary potentialities were kept within limits by the vicissitudes of gold mining. *Moreover, only a part of the additional gold immediately increased the supply offered on the loan market. The greater part acted first upon commodity prices and wage rates and affected the loan market only at a later stage of the inflationary process.*” (Mises [1949] 1998, 571–72; italics added.)

That is, according to Mises, in principle, an increase in commodity credit has the same effect as a rise in circulating credit, provided that the increase in money only finds its way into the credit markets after commodity prices and wage rates have completely adjusted to the change in the money relation; i.e., the increase in money. But, as we have seen, the magnitudes are important. Moreover, it is unreasonable to suggest that new money might wend its way through markets for goods and services, until those markets are fully adjusted, and only then find its way into credit markets.

## Conclusion

Murphy (21) states and agrees with: “The claim [of FRFBs] — from Mises and Hayek through Rothbard up to writers such as Salerno in the present day — has always been that credit expansion sets in motion an unsustainable boom.” That is, according to those thinkers and Murphy, commodity credit in the form of new commodity money, both in principle and under typical conditions, has the same distortionary effects as new circulating credit; to wit: such additions to the stock of commodity money and credit cause business cycles, and thus such additions constitute market failure. We reject this claim, based as it is on the assertion that such additions distort interest rates. Rather we understand such additions and the effects thereof regarding both prices and interest rates to result from voluntary human actions; i.e., legitimate market activity. Consequently, such actions distort *nothing* and *do not* constitute market failures, itself, the null set.

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