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DEFLATION AS A RECIPE FOR A PROSPEROUS EUROPE

Why the ECB should not inflate

Josef Šíma [1]

Despite the fact that central banks all over the world have been producing never-ending inflation resulting in an unprecedented pace of money depreciation lasting almost a century,[2] it has recently become fashionable among professional economists to revive the bogey of deflation. "Deflation had its 15 minutes of fame", reported Business Week in its "What happened to deflation?"[3]. Deflation, taken to be the cause of crises and economic breakdowns, put the central banks again in the position of indispensable guardians of a "non-deflationary" economy. This makes it easier for them now to justify activist "stabilization" policies and get economies in the "new" and "old" EU, USA and anywhere else back on the central banks' beloved inflationary

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[2] Viz. Šíma, Josef and Štastný, Dan: "Centrální bankovnictví – iluzorní *výdobytek* civilizace", introduction to Rothbard, Murray: *Peníze v rukou státu*, Liberální institut, 2001.

[3] Nov 3, 2003., Iss. 3856; p. 28.

track. Do we understand the danger of this development? Are we going back, as The Economist suggests, to the 1970s, the age of global inflation?[4]

In the following text we will therefore analyze the problems stemming from incorrect definitions of inflation and deflation. Then we will put forth a taxonomy of deflation, which will enable us to abandon the confused "macro" view of the deflation issue and to show the flawed comparison between two evils: the smaller one – inflation, and the bigger one – deflation. The analysis will enable us to demonstrate the complete impossibility of justifying an "anti-deflationary" (i.e. inflationary) policy from an economic point of view, and to prove the thesis about the grave and disastrous consequences of state interventions in the field of money. Short case-studies will shed light upon the main monetary problems in the U.S. and Argentina, and it will also help to understand the necessity of a methodologically anchored, and therefore economically sound, analysis of the deflation problem.

Inflation and deflation: basic concepts

Many authors are astonished at the fact that the concepts of inflation and deflation don't have their current meaning from time immemorial.

> "The semantic revolution which is one of the characteristic features of our day has also changed the traditional connotation of the terms inflation and deflation. What many people today call inflation or deflation is no longer the great increase or decrease in the supply of money, but its inexorable consequences, the general tendency toward a rise or a fall in commodity prices and wage rates. This innovation is by no means harmless. It plays an important role in fomenting the popular tendencies toward inflationism. First of all there is no longer any term

[4] *The Economist*. London: Jun 19, 2004, Vol. 371, Iss. 8380; p. 11

> available to signify what inflation used to signify. It is impossible to fight a policy which you cannot name."[5]

The classic definition of inflation has its origins in the mid-19th century controversy between the British *Currency School*, which stood ready to defend hard money, and the *Banking School* advocating inflationary policies. The *Currency School*, whose ideas finally prevailed, claimed that if it is allowed to produce notes in larger quantities than the existing stock of gold (i.e. production of fiat money), and these notes are channelled into the economy through the loan market, there will be a tendency for domestic prices and wages to rise, which will bring about a deficit in the balance of payment. In order to finance this deficit, gold will flow out of the country. As this situation will make banks limit the quantity of loans (since gold is still money!), the initial prosperity will be followed by an economic downturn. Such a *business cycle* will recur as long as inflation, i.e. producing paper money not backed by gold, will be initiated. By the end of the 19th century, however, more and more often the *Banking School* definition started to be used.[6] This school defined inflation *only* as an increase of fiat money exceeding "needs of trade". Whilst, for example, the Austrian economists, writing their books from the end of the 19th century until WWII (most notably Mises and Hayek), stuck to the original definition and elaborated on the business cycle insights of the *Currency School*, the overwhelming majority of the economic community – also due to the infamous effort of then well-established economists led by Irving Fisher – opted for the latter concept. Over time, the definition underwent gradual

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[5] Mises, Ludwig: *Human Action*, Fox & Wilkes, 1966, p. 423.

[6] Over time authors writing in the tradition of *Currency School* got closer to this too. These authors did not count deposits as money (as opposed to their American counterparts), which then made it impossible to achieve their major goal – to avoid a business cycle recurrence by stopping inflationary credit expansion. When inflation continued after the Peel Act of 1844 (which required that *additional* bank notes of the *Bank of England* must be 100%-backed by gold), the Currency School members, instead of admitting an error of not counting deposits as money and correcting it correspondingly, started to soften their theory. For more details on this evolution see Rothbard, Murray: *Classical Economics*, vol. II, Edward Elgar, 1995, pp. 225–274.

metamorphoses, so that ultimately inflation took the meaning of any increase, and deflation of any decrease in the price level.[7]

"Modern" definitions of inflation and deflation are causing evident and unavoidable difficulties for the economic analyses that were of course included in centuries old arguments. They are the following:

- **Conceptual problems.** Unavoidable problems arise from the fact that any construction of the consumers' basket used for calculating an index of (i.e. consumers') prices suffers from pure arbitrariness. It is impossible to find any satisfactory way to calculate "the" index, i.e. to "measure" inflation. How then can we figure out which amount of money issuance is still "non-inflationary" and which is already "inflationary"? By virtue of the problem, no scientifically satisfactory method can ever be found.[8]

- **Unscientific nature.** Even if, however, we were able to draw the line between an "inflationary" and "non-inflationary" increase in the quantity of money, we would still face unavoidable difficulties. If issuing new money into the economy has far-reaching consequences, then these consequences are irrespective of the changes of "price level".

  "… even zero inflation would have involved some failure of money price signals to reflect transparently and accurately the true state and progress of real production possibilities."[9]

  Or as Hayek put it:

[7] For more details on the slow, step-by-step change in terminology see Salerno, Joseph: "Money and Gold in the 1920s and 1930s: An Austrian View", *The Freeman*, October, 1999.

[8] More on problems of index number construction in Mises, Ludwig von: *The Theory of Money and Credit*, Liberty Fund, 1981, part II, chap. 11 and Hayek, Friedrich: *Prices and Production*, Augustus M. Kelley Publishers, 1967, pp. 99–100.

[9] Selgin, George: Less Than Zero, *The Case for a Falling Price Level in a Growing Economy*, IEA Hobart Paper, no. 132, 1997, p. 13.

"So long as the volume of money in circulation is continually changing, we cannot get rid of industrial fluctuations. In particular, every monetary policy which aims at stabilizing the value of money and involves, therefore, an increase of its supply with every increase of production, must bring about those very fluctuations which it is trying to prevent"[10]

Economic theory teaches us, for example, that any increase in the quantity of fiat money has *necessarily* redistributive effects. This increase adulterates the purchasing power of money and works as a "cash holdings tax". That is why inflation *necessarily* brings about – putting aside legal and ethical issues – a *principal* economic problem:[11] some people are harmed by this policy (those who never get the new money or get it after a long delay), and some profit from it (the first and early recipients of the new money).[12] How then can someone claim that there are beneficial effects of fiat money issuance in this situation without violating the foundations of economic science and engaging in the indefensible interpersonal comparison of utility? To wit, how else can one proclaim such activity beneficial, if not by asserting that the increase in utility for some outweighs the losses of others? Once this is done, we cannot claim anymore to be scientists-economists. By engaging in interpersonal comparisons of utility, we instead qualify to be called plain state planners. We would through *violence* or *threat thereof* (i.e. monopoly privilege to issue fiat money granted and enforced by the State) advocate benefiting one group of people at the expense of another group of people, which would amount to a "transfer" of property from one group to another.

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[10] Hayek, F. A.: *Profits, Interests, and Investment and Other Essays on the Theory of Industrial Fluctuations*, Augustus M. Kelley Publishers, 1969, pp. 262–63.

[11] See more detailed analysis of the impact of inflation in Rothbard, Murray: *Peníze v rukou státu*, Liberální institut, 2001, pp. 61–65.

[12] This situation arises because we do *not* live in a simplistic monetarist's (Friedman's) world of a flat and equal impact of increase in money supply upon all prices in the economy, but in a world which is not timeless and where money therefore spreads *step-by-step* throughout the economy causing a redistribution of wealth in society.

- **Politicization and Cumulative Effects.** Any decline in the price index, which – according to the modern definition – means deflation, embodies a germ of pressure to start anti-deflationary (i.e. by old standards, harmful inflationary) policies bringing along additional redistribution, the erosion of economic calculation and other destructive consequences, the underlying causes of which are, however, overshadowed by the effort to avoid an even more dangerous evil – deflation. (At this point we face again the unavoidable problem of utility comparison!)

Thus as Mises trenchantly pointed out:

> "It is obvious that this new-fangled connotation of the terms inflation and deflation is utterly confusing and misleading and must be unconditionally rejected."[13]

In the following sections we will therefore use the terms inflation and deflation in their original meaning. When referring to changes in the "price levels" (the modern definition), the terms are put in quotes – i.e. "inflation" and "deflation".

Taxonomy of "deflation"

The main focus of our interest in this text is the general problem of deflation, which will now be thoroughly discussed. In order to be able to systematically analyze this issue, which is interwoven with so many myths and errors, we will abandon standard "macroeconomic" lamenting about the fall of prices in favour of a taxonomy of "deflation" as the basis for a subtler discussion.

[13] Mises, Ludwig: *Human Action*, p. 424.

"Deflation" as a result of economic growth

This kind of (money-demand) "deflation" is a natural state of a dynamically developing economy. As a result of growing productivity, more and more goods are produced in the economy and consequently, producers have to compete over existing money units, against which they supply their products. Assuming a given quantity of money, it follows that the value of money will go up, which means that more goods can be bought for a unit of money. Prices will have a tendency to fall. Money will keep acting as the medium of exchange and the resulting prices will precisely mirror market participants' preferences and underlying resource scarcity patterns. The economy will not therefore waste resources, which is a precondition for further growth. As rational economic calculation is possible under these conditions (prices correctly reflect the relevant market "data"), there is no reason to expect any obstacles for successful economic development. The opposite is true. Such a development is a typical one for periods between several inflationary episodes in history generally initiated by states for the sake of waging wars. In the U.S. between 1880 and 1896 we can, for example, see a decline of wholesale prices by some 30 % (which amounts to an annual fall of 1.75 %), whereas real income went up by some 85 % (which is 5 % annually).[14] Even today, despite the continual inflation orchestrated by central banks, there are sectors experiencing a boom within a "deflationary" environment (decline of their products' prices) – the most flagrant example being the electronics industry (computers, video- and DVD-players, TV-sets, mobile-phones etc.). What is of interest to producers is the spread between buying and selling prices, i.e. input-output spreads that give rise to profits. Changes in some "price level" are of no importance to them.[15] Alternatively,

[14] Friedman, Milton and Schwartz, Anna: *A Monetary History of the United States: 1867–1960*, Princeton University Press, 1960, p. 94–95.

[15] Moreover, in a world where "deflationary" tendencies resulting from economic growth are not frustrated by the central bank, the price decreases precisely reflect the increases in productivity. Prices will fall most in those industries where productivity increased most. This is in line with the standard view of prices informing market participants about relative scarcity. The central bank, by trying to neutralize the effect of increased productivity, imposes an extra round of costly adjustment

employees do not suffer from the possible fall in their "nominal" wages, since with higher productivity and the higher purchasing power of their money unit their "real" purchasing power is growing.

Consequences of the fight against "deflation" as a result of economic growth

What will happen if the state (its central bank) as part of its *anti-deflation strategy* happens to launch monetary expansion in order to cause an increase in prices?

- The price pattern will be upset, which will lead to coordination problems and consequent waste (this process will be intensified also due to the emergence of a business cycle[16]).
- The pattern of income, which originally corresponded to the productivity of market participants (employees, managers, capital owners etc.), will be redirected – a necessary redistribution will take place. People will be rewarded not only according to their own productivity, but also in accordance with the sympathies and at the mercy of the central bankers.
- Unemployment, which may result due to "sticky wages" during "deflation", would normally hit *only* those who (e.g. by their labour union membership) "succeeded" in making their wages sticky (as a result of *their own* decision not to take market prices into account). When this kind of unemployment is being tackled with an "anti-deflationary" policy, the result is that *all* market participants are harmed. This is so because by means of its policy the central bank is *de facto* making an attempt to cheat those unionized people (increasing only nominal wages and destroying what these people fought so long for) and deprive them of the necessary consequences of their own choice.

processes on the economy.

[16] The problem of the business cycle as a result of credit expansion was dealt with in a separate text. Therefore in this paper we just mention this consequence without any elaboration. For more details see Šíma, Josef: *Trh v case a prostoru*, Liberální institut, 2000.

Because of this the bank cripples the monetary nexus of the whole economy! Inexorable results of this policy are relative poverty and incentives for perverse social behaviour, where one group of people bears the consequences of another group's actions as a result of the fact that the third group deceives the first group and at the same time taxes both groups (by inflation tax) to get funds for financing its fraud and redistribution.

"Deflation" as a result of hoarding

For many economists, hoarding embodies a veritable bogey – this is true especially after the "Keynesian Revolution", as THE Keynesian problem of money leakage from the economy turned the hoarders into national enemies. On the other hand the hoarders' activities lead other economists to celebrate them as heroes – precisely because they bring about "deflation", which enables other people (non-hoarders) to be able to buy more goods than they otherwise could.[17] How can we explain such an eventuality?

What hoarding means is that some people for certain reasons voluntarily decide to increase their cash holdings.[18] In this situation it is only natural that selling the existing stock of goods for less money units will be possible only if the purchasing power of the money unit increases – the higher demand for money units pushes their price, in terms of goods, up (modern economists speak in this situation about a decrease in the "price level"). This adjustment is, strictly speaking, a productive activity – some people decided voluntarily not to exchange *their* money for so many goods offered

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[17] Block, Walter: "The Miser" in: idem., *Defending the Undefendable*, Fox & Wilkes, 1991, pp.105–109.

[18] We have to remember that economics as a value-free science does not analyze people's ends, i.e. in this case reasons behind people's willingness to hold more cash. Though it is not very difficult to name some "good" economic reasons why this is the case: the fear of the future e.g. due to instability in the banking system. See the case of American Great Depression (short description in Šíma, Josef: *Trh v case a prostoru*, Liberální institut, 2000, chap. 6).

Putting this fact aside, it is of course completely impossible to distinguish the normal "demand for cash-balances" from irrational and socially destructive "hoarding".

as before, because they value holding cash more than the goods they could obtain for that amount of cash. The result is "deflation", i.e. a new structure of prices corresponding to the new market situation that emerges in the same way as any new price pattern accommodating any change in people’s behaviour (e.g. a change in fashion). Changes in people's preferences typically, in any dynamic economy, bring about changes within the price structure.

Consequences of the fight against "deflation" as a result of hoarding

If under these conditions the central bank endeavours to *fight "deflation"*, its policy will have the same disastrous effects mentioned above (redistribution, business cycle ...). In addition there is an additional consequence. Someone made an attempt to hoard money for reasons he considered important, and by not undertaking some of *his* purchases (by his market behaviour) affected the market as if his tastes had changed. His peaceful act calls forth the reaction of the central bank that starts its attempt to "add liquidity", to *correct* the market and stabilize the "price level". New money, however, gets into the hands of *different* people. These people will be able to make additional purchases (i.e. purchases that would otherwise not take place) of goods of *their* choice, which is likely to be goods from different sectors than those from which the money "disappeared".[19] The price structure is therefore heavily crippled as the central bank attempts to neutralize the productive (value-creating) acts of a peaceful actor with an activity that destroys the coordinating properties of an economy and thus leads to waste. To call such a value-destroying activity a goal of economically justified state policy aimed at limiting peoples non-productive behaviour is highly dubious and from the point of economic science totally fallacious.

[19] It is necessary to realize that stability of some sort of index measuring "general prices" does not guarantee in any way that prices in different sectors of the economy will be "stable". Individual producers are used to their particular market settings and deal routinely with rising and falling prices in their market activities.

Bank credit deflation

We will now explore one of two cases of "money-supply deflation". The situation is as follows. In modern history we can find several situations (see box), in which people, as a result of financial crises, started to withdraw their demand deposits from banks *en masse*. As they redeem *their* money (gold), banks are driven into liquidity problems that may ultimately lead to their bankruptcy. This intensifies the crises even more, as more and more clients lose confidence in the overall health of the banking sector and therefore come to their banks and demand that the deposits on their (current and checking) accounts be paid off, i.e. they appeal to their banks to keep their promises. Banks attempt to accumulate their reserves in order to become able to fulfil their obligations. The accumulation of reserves (historically gold) leads towards a decrease in money supply, resulting in an increase in the value of money – prices fall, deflation is underway.

It is evident, however, that the problem of "insufficient reserves" and the resulting inability of banks to keep their promises is not caused by any mysterious "shortage of gold",[20] but by the plain fact that banks endeavoured to print property titles for non-existent money (non-existent gold), i.e. to operate on fractional reserves.[21] The emergence of such a system is necessarily

[20] As professor Revenda states: "There is simply not enough gold to cover the continually increasing quantity of money in the economy." Revenda, Zbynek: *Centrální bankovnictví*, p. 704.

[21] The operation of a fractional reserve bank is analogous to the following situation: imagine a man who brings his suitcase to the baggage depository at a railway station (which is identical to the suitcases of other clients); he gets a receipt on which the depository promises to return his suitcase immediately on demand. The owner of the depository, however, decides to get rich by issuing and selling receipts confirming the deposition of (and claims to) non-existent suitcases (he decides to operate on fractional reserves), and then only hopes that not all his clients come at one moment to discover his fraud. Even if a professor – specializing in the operation of a depository on a modern, fractional reserve system – insists that "there are simply not enough suitcases to cover the continually increasing quantity of claims to suitcases in the economy", it would be crystal-clear to everybody that the problem is not the insufficient quantity

accompanied by initial inflation (an increase in the money stock through the issuance of fiat money), which brings along all the already mentioned negative effects – redistribution, business cycle, waste etc. As if this was not enough, a stable system of 100% backing of demand deposits – the system in which any number of clients may at any one time ask their bank to get their own money (since the structure of a bank's assets corresponds to the structure of its liabilities) – gets transformed onto an unstable system of fractional reserves. Whenever the amount of money the clients intend to withdraw from their deposits in the banks exceeds the statistically "regular" level, the fractional reserve banking system is liable to panic and a consequent disintegration of the whole banking system is likely to follow. The financial crisis is only a logical final step.

Deflation, i.e. decrease of money stock as a result of eliminating the consequences of previous inflation is therefore an activity which brings back the health of the banking system and normalizes relations within the economy – a market situation, where property rights are not violated, which is a precondition for market coordination and the existence of waste-reducing activities. This was the reason why before WWI central banks themselves several times initiated such a deflation to prevent the breakdown of the banking system. Deflationary periods were typically very short and swift, and so was the elimination of unavoidable results of previous inflations (see box). Bank credit deflation is for those reasons a healthy and thus positive economic phenomenon with close link to reestablishment of law – respect for private property.

The Economic Crisis of 1839–1843

In the fall of 1839 there occurred a financial crisis in the U.S., which resulted from a massive expansion of the money supply during the 1830's that was initially stimulated by the legally privileged Second Bank of the United States. From the peak of the business cycle in 1839 to its trough in 1843, the money supply contracted by about one-third (34 percent), almost one–quarter of

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of suitcases, but the existence of fraudulent receipts.

the nation's banks collapsed (23 percent), including the Bank of the United States, and wholesale prices fell by 42 percent.

Despite – or rather because of – the massive deflation of prices, real GNP and real consumption actually increased during this period by 16 percent and 21 percent, respectively. However, real investment did decline during this period by 23 percent, which was a benign development, because the malinvestments of the previous inflationary boom needed to be liquidated.

Unfortunately such benign episodes of property retrieval have been forgotten in the wake of the Great Depression. Despite the fact that the bank credit deflation that occurred from 1929 to 1933 was roughly proportional in its impact on the nominal money supply to that of 1839–1843, the rigidity of prices and wage rates induced by the "stabilization" policies of the Hoover and early Roosevelt Administrations prevented the deflationary adjustment process from operating to effect the reallocation of resources demanded by property owners. With the free exchange of property titles thus hampered, the economy contracted by roughly one-third and consumption fell by one-fifth during the years from 1929 to 1933.

Salerno, Joseph: "An Austrian Taxonomy of Deflation" (inside quotes omitted)

Consequences of the fight against bank credit "deflation"

Putting aside the general effects of inflation, there will be a special outcome stemming from it. Incentives to the honest provision of banking services are relaxed (the private property system is crippled), because at the moment when clients figure out that a bank is cheating on them and start the process of getting back their property through the courts – and by so doing cause the dishonest entrepreneur to crash – the central bank covers this dishonest activity with the smoke-screen of "supplying liquidity". No change in banking behaviour can then be expected. They can only further continue with their problematic business.

Confiscatory deflation

So far we have analyzed deflationary processes that came about as a market reaction to natural developments, or were a kind of corrective adjustment after state-initiated inflation. We were thus talking about beneficial processes in the economy, because they were market (adaptation) processes of adjustment to new conditions. This is precisely the reason why markets exist! There is, however, as Rothbard and Salerno have shown, another kind of deflation principally different from the previous ones. This deflation is orchestrated by the state, which has, by means of crippling market exchanges and violating property rights (through confiscating cash holdings), prevented the inevitable bank credit deflation (which would start a healthy process of liquidating fractional reserve banking) from taking its course. Such a confiscatory deflation is currently underway in Argentina (see box), repeating the story of the Soviet Union and Ecuador from recent years. This state policy's goal is to prevent people from using their cash, which is meant to be a method of solving problems with "imbalance" on the money market which the preceding inflation created. Deflationary policy is not and cannot be a reasonable cure for the effects of inflation.

> "In truth, price inflation is not a disease to be combated by government; it is only necessary for the government to cease inflating the money supply."[22]

The harm is already done. By producing a new wave of deflation this harm cannot be undone. As already explained, inflation distorts the price structure and leads therefore to waste, redistribution and the business cycle. If the government gives up its attempts to enrich itself by means of inflation at the expense of the general public, the economy will after a while recover from this inflationary shock and prices will again fall to their natural (though not original!) level. However, if the government now launches its deflationary policy and starts preventing people and entrepreneurs from discovering the real consequences of the previous inflationary

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[22] Rothbard, Murray: ”Deflation: Free or Compulsory” in: idem., *Making Economic Sense*, Mises Institute, 1995, pp. 239–40.

policy, the economy will suffer from an additional shock. This is so because the process of re-establishing a new reasonable price pattern will be stopped, new price distortions will take place, and so an additional round of waste and redistribution with far-reaching social effects will necessarily follow. While during bank credit deflation and the breakdown of fractional reserve banking, people remain free to use their appreciating money and take part in creating the new market price structure, during deflation orchestrated by the state, people are partly prohibited from using their money at all. A tendency to leave the monetary nexus and turn to ineffective barter gains momentum. Such an economy starts losing the mechanism through which it can promptly cure its inflationary (and deflationary) wounds – see box on Argentina.

Argentinean Case

In 1992, after yet another bout of hyperinflation, Argentina pegged its new currency, the peso, to the U.S. dollar at the rate of 1 to 1. In order to maintain this fixed peso/dollar peg, the Argentine central bank pledged to freely exchange dollars for pesos on demand and to back its own liabilities, consisting of peso notes and commercial bank reserve deposits denominated in pesos, almost 100 percent by dollars. Unfortunately this arrangement – which inspired confidence in international lenders because it was approved by the IMF and therefore carried its implicit bailout guarantee – did not prevent a massive and inflationary bank credit expansion. As investment dollars flooded into the country, they found their way into the central bank enabling it to expand the amount of reserves available to the commercial banks. As fractional reserve institutions, the latter in turn were able to inflate bank credit in concert by multiplying bank deposits on top of each new dollar or peso of reserves. As a result, Argentina's money supply (M1) increased at an average rate of 60 percent per year from 1991 through 1994. After declining to less than 5 percent for 1995, the growth rate of the money supply shot up to over 15 percent in 1996 and nearly 20 percent in 1997. With the peso overvalued as a result of inflated domestic product prices and foreign investors rapidly losing confidence that the peso would not be devalued, the influx of dollars ceased and the inflationary boom came to a screeching halt in 1998 as the money supply increased

by about 1 percent and the economy went into recession. In 1999, money growth turned slightly negative, while in 2000 the money supply contracted by almost 20 percent.

The money supply continued to contract at a double-digit annual rate through June of 2001. In 2001, domestic depositors began to lose confidence in the banking system and a bank credit deflation began in earnest as the system lost 17 percent or $14.5 billion worth of deposits... the central bank only possessed $5.5 billion of reserves ultimately backing $70 billion worth of dollar and convertible peso deposits. President Fernando de la Rua and his economy minister, Domingo Cavallo, responded to this situation on Saturday, December 1, announcing a policy that amounted to confiscatory deflation to protect the financial system and maintain the fixed peg to the dollar. Specifically, cash withdrawals from banks were to be limited to $250 per depositor per week for the next ninety days and all overseas cash transfers exceeding $1,000 were to be strictly regulated. Anyone attempting to carry cash out of the country by ship or by plane was to be interdicted. Finally, banks were no longer permitted to issue loans in pesos, only in dollars, which were exceedingly scarce. Depositors were still able to access their bank deposits by check or debit card in order to make payments. Still, this policy was a crushing blow to poorer Argentines, who do not possess debit or credit cards and who mainly hold bank deposits not accessible by check.

By January 6, the Argentine government ... devalued the peso by 30 percent to a rate of 1.40 pesos per dollar. Even at this official rate of exchange, however, it appeared the peso was still overvalued because pesos were trading for dollars on the black market at far higher rates. The Argentine government recognized this and instead of permitting the exchange rate to depreciate to a realistic level reflecting the past inflation and current lack of confidence in the peso, it intensified the confiscatory deflation imposed on the economy earlier. It froze all savings accounts above $3,000 for a year ... Unlike the bank credit deflation ..., which permits monetary exchange to proceed with a smaller number of more valuable pesos, confiscatory deflation tends to abolish monetary exchange and propels the economy back to

grossly inefficient and primitive conditions of barter and self-sufficient production that undermine the social division of labor. Meanwhile, unlike the deflation-phobes in academia, the media, and supranational bureaucracies who have turned a blind eye to confiscatory deflation or hailed it as a responsible "austerity measure" many of its unfortunate Argentine victims have recognized it for what it essentially is: bank robbery by the political elites.

Unfortunately, things were to get even worse for hapless Argentine bank depositors ... President Duhalde announced in late January that the banks would be permitted to redeem all deposits in pesos. Since the peso had already depreciated by 40 percent against the dollar on the free market in the interim, this meant that about $16 billion of purchasing power had already been transferred from dollar depositors to the banks.

Salerno, Joseph: "An Austrian Taxonomy of Deflation" (inside quotes omitted)

Conclusion

As we have shown in the analysis above, there are not any good economic reasons for conducting an active monetary (including the "anti-deflationary") policy. Anyone who attempts this will have to violate a fundamental economic truth – the building blocks of economic science. He would have to say something like this:

"For economic reasons I am advocating an inflationary policy, which distorts the market allocation of resources. A *necessary* consequence of my policy is harm inflicted on some and benefits conferred to others, i.e. redistribution of wealth."

Such an advocate of inflation would, by doing this, engage in an interpersonal comparison of utility and would therefore discredit himself *completely* as an economist. He will have to admit not to be a value-free scientist-economist, but a plain state planner, who denies the distribution of wealth in a society that results from the

voluntary exchange of justly owned property titles and forces upon the people his own will as a paramount value they have to conform to. The reasons for such behaviour do not matter at all – the impossibility of an economic justification for redistribution through inflation cannot be undone by any (even the noblest) motive.

Moreover, the effects of flawed economic reasoning concerning inflation on the quality of law cannot be overemphasized.[23] For centuries laws have defined fraud (i.e. getting something for nothing) as crime – e.g. counterfeiters (people who devalued gold coins and sold them then as fine gold coins) were prosecuted as criminals. Modern law is however heavily influenced by flawed economic doctrines and this principle was trampled. Since the current activities of central bankers cannot in principle be distinguished from activities of these counterfeiters, even criminals-private-counterfeiters started to be treated as good-doers (see box).

Long live the counterfeiters!

"More than a quarter of a century ago [written in 1937], an astonishing and ingenious crime was committed which resulted in the institution of a most interesting civil suit. A band of international swindlers succeeded in convincing the well-known London firm of Waterlow & Sons, engravers of postage stamps and bank notes, that they were the representatives of the Central Bank of Portugal come to place an order for printing a large quantity of Portuguese bank notes. The order was duly filled and the bank notes delivered to the swindlers. When the fraud was finally discovered, the Bank of Portugal caused all of its extant notes (of whose genuineness there was, naturally, no question) to be withdrawn from circulation and replaced with a new issue. Since it proved impossible to catch the criminal, the Bank of Portugal sued Waterlow & Sons, demanding that the engraving firm make good the losses resulting from the issue of the

[23] Such an analysis would deserve a separate detailed treatment, which would trace the history of law degeneration due to flawed economic doctrines.

fraudulent notes. The English courts presently discovered that the case involved issues of unusual subtlety and complexity, adjudication of which necessitated the admission of testimonies by leading monetary theorists. The question before the courts was: how great were the actual losses incurred by the Bank of Portugal? If it had been postage stamps instead of bank notes in which the swindlers had trafficked, it is perfectly clear that the loss of the Portuguese government would have equaled the total value of the stamps. With respect to the bank notes, however, no such simple calculation could be made. Among the many questions which troubled the experts the following stand out as particularly relevant to our study: would the Bank of Portugal have issued the same amount of notes even if the swindlers had not done so? If not, did the increase in the supply of money resulting from the introduction of the fraudulent notes disrupt the orderly processes of the Portuguese economy looking to the regulation of the volume of money; it would depend, in other words, on whether the additional notes served to avert an otherwise imminent deflation, or whether they resulted in an inflation. If the first supposition were true, then the swindlers would have unintentionally done a favor to Portugal. These and other considerations did, in fact, influence the highest English court to award the Bank of Portugal only a fraction of the damages it had claimed."

Roepke, Wilhelm: *Economics of the Free Society*, Libertarian Press, 1994, pp. 103–104.

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Discussion about money issuance involves both economic and legal problems. As long as economics is based on subjective utility which cannot be interpersonally compared, and law considers fraud (counterfeiting) to be a crime, both disciplines will give us an identical conclusion: inflation (including the inflationary "anti-deflation" policy) was and still is an evil causing a breakdown in peaceful economic relations and leading to relative poverty. Continually falling prices are therefore a necessary economic phenomenon featured in every prosperous economy in which private property is respected.

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