Chapter 7. The Root of All Prosperity: Money and the Danger of Centralized Monetary Policy

Introduction

“Money is the root of all evil” is a common adage. It is said that if not for the pernicious role of money in society, fellow man could get along, and both greed and the violence of desperation would subside. Socialists were not alone in wishing for a future society in which money would first lose its importance and then be eradicated entirely. It is an old Utopian dream. The Bible is one source of this idea saying, “For the love of money is the root of all kinds of evil,”[1] but Marx gave it a “scientific” foundation.

Socialists understood the central role of banking in the economy. It was the Bolshevik plan first to control all banks and centralize lending into a single central bank, then to direct investment using the power of this central bank, and finally to eliminate money in the economy and close the bank. Banks would therefore be a key tool for directing the economy; and in turn, central direction of the economy would allow the socialist government to put an end to the use of money.

Some of the potential problems of bad central banking policy are well known today. Germany suffered hyperinflation in the 1920s. Since then, Hungary after World War II, Yugoslavia in the early 1990s, and most recently Zimbabwe experienced severe hyperinflation. Central banking policy is also blamed for some of the severity of the Great Depression, and many blame it for causing the Great Depression. The inflation of the 1970s in the United States is blamed on inflationary banking policy. Today, industrialized nations no longer imagine that printing money can solve a recession—at least we claim to know this. We have a "nuanced" position, which is a compromise between the awareness of inevitable inflation and the temptation of short-term stimulant effects.

But this nuanced position only considers the magnitude of the obvious aggregated effects of the policy—the rise (or fall) in average price level. It overlooks the *process* by which the price level rises (or falls), so it does not capture any other distortions that the policy may cause. However, Marx and Lenin considered the process. They knew well that control over the banks meant control over this process. They understood the power of printing money and lending it from a central position. What they did not understand is that the power of this centralized control does not imply the power to use it effectively or efficiently.

The Socialist Argument

The vision of money as a great evil that must be abolished permeated many divergent socialist and anarchist (or anarcho-communist) strands of thought.[2] "Wage-slavery" and money-wages were tightly linked. Moses Hess, a contemporary and friend of Marx and Engels, argued:

> So we all have to peddle our life-activity in order to buy in exchange the life-activity of other men — and what is the sum total of all our faculties and of all our forces, which we throw on the market and which we must turn into money, but our own whole life? It is not our body, which we only touch from the outside, but its real force that constitutes our life. When we sell this force of ours we ourselves sell our very life. Money is the mark of slavery; is it not

> therefore but human value expressed in figures? But men who can be paid, men who buy and sell each other, are they anything but slaves? How can we begin to escape from this traffic in men as long as we live in isolation and as long as each person has to work for himself on his own account in order to gain the means of existence?[3]

Ultimately, the only way to abolish this society of slavery would be to abolish money. Marx argued that money was a result of the private property and exchange (commodity production, in his words) of the market economy.[4] Under social ownership, money would cease to be necessary. In *The Principles of Communism*, Engels called for "Centralization of money and credit in the hands of the state through a national bank with state capital, and the suppression of all private banks and bankers." He argued that "when all capital, all production, all exchange have been brought together in the hands of the nation, private property will disappear of its own accord, money will become superfluous, and production will so expand and man so change that society will be able to slough off whatever of its old economic habits may remain."[5]

More succinctly, Marxist Sylvia Pankhurst said, "Full and complete Socialism entails the total abolition of money, buying and selling, and the wages system."[6] Until then, power over money would offer power over the economy. If socialists could take control of it, it could be used to advance social goals and work toward a socialist society. Socialists interested in reform of capitalism aimed to increase government's power over money for use toward progressive ends and to reduce corporate influence on the use of monetary policy and bank policy. Radical socialists called for nationalization of the banks and complete control of the money supply and lending as a tool for economic planning and a first step toward the elimination of money.[7]

Reform socialists and other progressives favored expansionary monetary policy when used for redistribution and economic stimulus, but also argued for its use in directing investment. The elimination of the gold standard empowered government with levers to control the economy. Garet Garrett, a journalist specializing in economic policy during the 1930s, explained this power in an article describing a 1933 law that outlawed payments made with gold.

> The law reads: "That every provision contained in or made with respect to any obligation which purports to give the obligee *a right to require payment in gold*, or a particular kind of coin or currency, or in an amount of money of the United States measured thereby, *is declared to be against public policy*; and no such provision shall be contained in or made with respect to any obligation hereinafter incurred." Garrett explained:

> It follows, literally, that it is now unlawful in this country for a borrower, be it the Government, a corporation or a private person, to promise that the value of what is to be paid back shall equal the value of what was borrowed. The ostensible reason for this amazing prohibition is that the Government shall be free by fiat to fix the dollar at any value it may deem expedient; that it shall have the power to say of a 50-cent dollar, a 25-cent dollar or a 5-cent dollar, as it has already said of a 60-cent dollar, "This is the standard dollar and full legal tender in settlement of all obligations." It follows again, literally, that no one knows today what the value of the dollar will be tomorrow, or a month hence, or a year from now. The Government itself does not know. And that is now the

> state of the currency.[8]

This was a radical change; government could now determine that contracts made for payment of a certain sum would now be worth another sum, as set by the state at its own whim. Garrett saw the dangers contained in such a policy. After this law, how can any lender know the value of the loans he makes?

A lender may imagine that he knows the value of his loans. He may think he knows the level of inflation or can accurately predict it. But inflation is not only difficult to predict, it is impossible to accurately measure.[9] This is because the value of money does not affect all products and loans equally and in unison, but instead spreads its influence slowly through the economy. Prices rise at different rates, and the broad measure of inflation—the average price rise across the whole economy—cannot distinguish between those prices that rise due to scarcity, government regulation, changes in demand, or other factors, and those that rise due to the devaluation of money. Furthermore, some prices are held low by government mandate, and taxes and subsidies affect many other prices.

In practice, inflation is measured by tracking only a few prices in the economy in question. Hence, even if a loan is made with an interest rate that rises with inflation, the lender still cannot be sure of the actual value of the earned interest. The oblique nature of money and inflation makes monetary policy more powerful for the state. Marxist writer William Ward, writing in the 1940s, explained the power of this deceptive tool:

> The people know from personal experience what the high cost of necessities means in terms of reduced standards of living. But all the agencies of capitalism work in unison in order to prevent them from grasping the connection between the high cost of living and the financial policies of the

> government. When new money is issued without any corresponding backing, the gold value of all the money in circulation is decreased. This means that each unit of the currency, each dollar, can buy less goods. But since the dollar *appears* to remain what it was, people have the illusion that the value of the dollar is the same while the value of the commodities has risen. They do not say: We have been deprived of half our income by this monetary manipulation. They say: The cost of living has gone up.[10]

Socialists argued that the burden of inflation was on the worker, not the capitalist or the state. Capitalists and the state worked together and took on debt, and the debt would then be reduced as money lost its value. Workers essentially paid part of this debt through an increased cost of living, as prices rose. The prices of necessities would go up, hurting the worker and peasant, but the capitalist passed on the price increases to the consumer, so he did not feel the burden. In the hands of socialists, of course, this tool could be used for good—to help instead of hurt the worker.

http://www.marxists.org/subject/art/visual_arts/satire/vadill/vadill1.htm

Capitalists could also trade and speculate, and make money off of inflation, especially if they obtained inside information from those in power. Monetary policy is a powerful tool for government. As Garrett explained, it gives government the ability to devalue money at will, and it also gives the government the ability to take from one group and give to another, often without the losers even noticing. Speaking about the progressives—many of whom had socialist sympathy—and their desire to use the power of inflation to advance social goals, Garrett asks:

> Who wanted inflation and why? All distressed debtors, naturally, because it would cheapen the money with which debts are paid…. But there were others who saw only and clearly the power of inflation as a social instrument, and how, once control of it was set in the popular hand, it could be employed to redistribute the nation's wealth and income…. [T]he political power to regulate money and credit might be employed, not simply to give and take, not simply to ruin creditors for the happiness of debtors, but to control the distribution of the nation's wealth and income symphonically, for the purposes of the new order. These [progressives] wrote the laws of inflation and took care to put plenty of power in it.[11]

Although Marxists criticized the use of inflation by capitalist governments, they were not averse to using it themselves if it were used for progressive purposes. Marx recognized the power of the control of banks and credit—control that could be used for good or ill. He also saw the relationship of credit and banking to production and the "crises" of capitalism. He observed that central control over interest rates and the value of loans could bankrupt lenders and cause credit crunches and panics:

> By means of the banking system the distribution of capital as a special business, a social function, is taken out of the hands of the private capitalists and usurers. But at the same time, banking and credit thus become the most potent means of driving capitalist production beyond its own limits, and one of the most effective vehicles of crises and swindle.[12]

Monetary policy could cause these “crises” if the currency was inflated. Marx explained that this is done by extending production beyond what is required by the consumer. Marxist writer Ted Grant explains Marx’s insight as follows:

> [B]y means of credit policies…[c]apitalists produce more than is required by the market. This is due, on the one hand, to the fact that the producers of capital goods have credit extended to them and, on the other, that through hire purchase, mortgages and other means the consumers, too, actually purchase beyond the limits of their levels of income. When the serious representatives of the social system realise that this process has gone too far and threatens its very foundations, they are compelled by economic necessity to call a halt.[13]

The expansion of the money supply facilitates production and consumption that cannot be sustained, and when it ends there is a “crisis.” This analysis is very similar to the analysis made by the anti-socialist economists (for example, Ludwig von Mises) of the Austrian school.[14] However, while Austrian economists saw this as a reason to avoid centralized control over banks, Marx argued that control over the banks would be critical for the transition to socialism. Finally, he argued, credit would cease to exist under communism:

> Finally, there is no doubt that the credit system will serve as a powerful lever during the transition from the capitalist mode of production to the mode

> of production of associated labour…. As soon as the means of production cease being transformed into capital (which also includes the abolition of private property in land), credit as such no longer has any meaning.[15]

Lenin also understood that monetary power could effect large swings and crises. He also recognized that business could be controlled through the banks. The control of investment and production through a monopoly of investment funds and close monitoring of all purchases could only be made possible by nationalizing the banks. In 1917, Lenin argued:

> Only by nationalising the banks *can* the state *put itself in a position* to know where and how, whence and when, millions and billions of rubles flow. And only control over the banks, over the centre, over the pivot and chief mechanism of capitalist circulation, would make it possible to organise real and not fictitious control over all economic life, over the production and distribution of staple goods, and organise that "regulation of economic life" which otherwise is inevitably doomed to remain a ministerial phrase designed to fool the common people.[16]

This control is most powerful when the state can use it to fund industry, but by controlling the money supply, central banks can take on this role in part. Under true socialism, this power over the money supply could be used to direct all investment toward the ends of the planners. Of course, the state's executive committee must control the central bank to do this. As Trotsky explained:

> In order to create a unified system of investments and credits, along a rational plan corresponding to the interests of the entire people, it is necessary to merge all the banks into a single national institution. Only the expropriation

> of the private banks and the concentration of the entire credit system in the hands of the state will provide the latter with the necessary actual, i.e., material resources—and not merely paper and bureaucratic resources — for economic planning.[17]

The central banking system would be in complete control of money circulation and lending. Nationalization of the banks and use of them for central planning would allow the socialist government to eliminate "unearned income," in the form of interest and capital gains, and to control loans, wages and investment.

The abolition of unearned income was a key goal of socialists. The "speculator" was seen as a parasite, and the investment and lending function that he played would be played by a benevolent state, so that the "exploitation" would end. Although clearly someone or some process must govern the investment in an economy—so that borrowing and investment are possible—socialists argued that private investors and lenders making profit from doing this were simply exploiting the people. They played no useful role, and hence their profit was "unearned income."

Socialists were not alone in this belief. Rex Tugwell, part of President Roosevelt's "brain trust," asked "who thinks of the securities he buys or sells as having anything to do with an economic function?" Tugwell argued that speculators seeking profit "have a considerable effect on the distribution of capital amongst the various enterprises" but that the result "seems clearly enough inefficient so that other methods might easily be better."[18] The leading German Marxist Karl Kautsky explained that socialists were not interested in just redistributing labor income along egalitarian lines, but in abolishing unearned income to end the exploitation of workers by the capitalists. He said:

> What is decisive for Socialism is not the fixing of a special formula of just distribution, but the abolition of the exploitation of labour, or the abolition of unearned incomes. The abolition of rent, interest, and profit. This is only possible through the abolition of private property in the means of production.[19]

Hence, the end of interest payments was a core feature of theory, and control over the banks was a key to implement the socialist program. This would be a significant step in ending exploitation and implementing planning. Only then, after the economy was planned and the people took control over production, could the need for money dissolve away and bring true communism.

The Soviet Experience

One of the first steps that Lenin took after gaining power was the nationalization of the banks. In Year One of the Russian Revolution, Victor Serge recounts:

> The economic program of the Bolsheviks called for workers' control of industry and the nationalization of the banks. The decree on workers' control was passed on November 14. It legalized the introduction of workers into the control of business, made the decisions of the control commissions binding, and abolished trade secrets… By exercising control, the working class would learn to direct. By the nationalization of the banking establishments and credit institutions, the working class would recover through the state a part of the profits levied on their work by capital, and thus their exploitation would be diminished.[20]

Nationalization would take time; however the Soviet government could make use of its control over the banks right away. In the early days of the Soviet Republic the belief in sound money was widespread, but the new government was not shy in taking advantage of its new power. One memoir of the very early years recounts the new government's bank policy:

> I took in my hands bars of gold worth ten thousand dollars each. I saw also high piles of English fivepound notes and smaller piles of American paper money.
>
> "You have made all this gold in one year from paper?" I asked President Scheinmann in wonder.
>
> "Not at all," he answered quickly. "But from the resources of a great nation."
>
> "How did you do it?" I asked. He was quite willing to explain, for his job does not depend on secrecy but on public service.
>
> "We loaned money, for instance, to the Timber Trust. We gave them paper roubles, which they used to pay all their bills in Russia. They exported timber to England. They paid us in English pounds. They paid us not only the loan with interest, but part of their profits. Sometimes as much as half of all they made! The fur industry also has been very profitable, making as much as 200 and 300 per cent. in export trade. On all of these profits the State Bank demanded its share, for making the first loan."
>
> I gasped at this. "No wonder the State Industries call you a robber," I said, "when you make terms like that."
>
> President Scheinmann smiled. "It is a question of public policy. The next Congress of Soviets may decide on a different method. At present we are

building up a gold reserve for Russia."[21]

The Soviet central bank did not restrict itself to lending; it also engaged in currency speculation.

Even out of the fall of the rouble, the State Bank made money. There is a private semi-legal exchange where men speculate in the sale of dollars and pounds and roubles. Here also the State Bank had its agents, sometimes known, sometimes unknown. No tricks of high finance were alien to it. With its superior knowledge it could unload dollars or pounds to force down the price, and buy in again till it increased its reserve. It could not prevent the rouble from falling, for roubles were being printed for State needs, uncovered by gold. But the State Bank knew beforehand when the money was to be issued; it knew what transactions were under way in the big industries. It speculated with its knowledge on the Black Exchange; the little private traders who gambled there sometimes lost and sometimes won; the State Bank always won.[22]

This is similar to casino owners who know more than the gamblers and thus always win in the end. Economist John Maynard Keynes similarly described stock market speculators, "When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."[23] Yet speculation among traders that all have a stake in the outcome and stand on equal footing is different from casino gambling, in which the house has a permanent advantage.

During this early period, the Soviet government also worked toward the future moneyless society of the socialist vision. The 1919 Communist Party program read in part:

> The Communist Party of the Soviet Union, having set itself the aim of consistently completing the work started by the Soviet government, brings to the forefront the following principles:
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> (1) The monopolization of the whole banking system by the Soviet state.
>
> (2) A radical change and simplification of banking operations by transforming the banking apparatus into an apparatus for uniform registration and general accounting in the Soviet republic, in proportion as planned national economy is organized; this will lead to the *abolition of the bank and to its transformation into the central bookkeeping department of communist society.*
>
> ….Basing its policy on the nationalization of the banks, the Communist Party of the Soviet Union strives to carry out a number of measures which will widen the sphere of non-cash transactions, *measures preparatory to the abolition of money*: the compulsory depositing of money in the people's bank, the introduction of budget books, the replacement of money by checks, short term notes entitling the possessor to receive products, etc.[24]

This period, the war communism period, or "military communism" in Trotsky's terminology, was an attempt to introduce a planned economy and to move toward direct distribution and the abolition of money. Significant steps were taken in this direction, but they led to chaos and impoverishment. Trotsky describes the period in *The Revolution Betrayed*:

> The Soviet government hoped and strove to develop these methods of

> regimentation directly into a system of planned economy in distribution as well as production. In other words, from “military communism” it hoped gradually, but without destroying the system, to arrive at genuine communism. The program of the Bolshevik party adopted in March 1919 said:
>
> > “In the sphere of distribution the present task of the Soviet Government is unwaveringly to continue on a planned, organized and state-wide scale to replace trade by the distribution of products.”
>
> Reality, however, came into increasing conflict with the program of “military communism.” Production continually declined, and not only because of the quenching of the stimulus of personal interest among the producers. The city demanded grain and raw materials from the rural districts, giving nothing in exchange except varicolored pieces of paper, named, according to ancient memory, money…. The collapse of the productive forces surpassed anything of the kind that history had ever seen. The country, and the government with it, were at the very edge of the abyss.[25]

Money had lost its value, and hence its role in helping to coordinate production, exchange, and distribution. Yet even when Trotsky wrote this in 1932, he maintained faith in a future moneyless economy and advocated taking steps in that direction: “In a communist society, the state and money will disappear. Their gradual dying away ought consequently to begin under socialism.”[26]

The currency fell apart for several reasons. In part, it was on purpose. The goal of moving to a moneyless economy led the Soviet government to ignore the effect that its policies were having on the currency. Incredible inflation was followed by a “money shortage”[27] in many areas, which may have been the result of the destruction of banks as well the price policies enacted by the new government. Direct distribution and barter replaced money exchange in many areas—both where this was the intention of the new government and where there was simply a lack of currency.

The government, with the goal of abolishing money, instituted rationing and a number of free goods and services. Return to barter due in part to lack of sufficient currency was hailed as a step toward socialism. Among those who cheered the collapse of the money economy was Grigory Zinoviev, a member of the Party Central Committee.

"We are approaching," Zinoviev declared, "the complete abolition of money. We are making the wages of labour a payment in kind; we are introducing free trams; we already posses free education, free dinners, even if of a poor quality, free housing and free lighting."[28] A decree on April 30, 1920, established that wages were to be paid in kind. In the same year, Lenin wrote to the Commission for Abolishing Cash Taxes, "There is no doubt about switching from money to the exchange of products without money,"[29] but it could not occur just yet. First, it was necessary to end direct appropriation of the peasants' surplus and temporarily move to a tax in kind. A declaration on February, 3, 1921, stated the intention to "abolish all money payments of taxes."[30]

But the economy was falling apart. What Zinoviev saw as a positive step on the road to socialism was actually the collapse of modern trade, and the return to a crude system of barter. The Soviet government came to realize this. At the Congress of the Soviet of National Industry in 1918, the People's Commissary of Finance said that "finance should not exist in a socialistic community, and I must therefore apologise for speaking on the subject." In 1922, the official in the same post said "Now we see that it is not so."[31]

During those few years, the complete chaos and poverty of the barter economy had convinced these officials that money was necessary. Direct distribution and rationing could not provide for the economy. Despite harsh laws against private trading, the majority of the food that entered the cities came through the black market.[32] Lenin soon realized that a "temporary retreat" to the use of markets was necessary, but the more the Soviet government was forced to reintroduce markets, the more the necessity of money became clear.

In 1921, in the first months after trade in agricultural products was declared free, the opinion prevailed that it was possible even with uncontrolled trade to manage without money and to carry on trade in the form of so-called "direct-barter." However,

> These survivals of the illusions of "direct-barter" were abandoned some months later, when the utter failure of all attempts to organize an exchange between town and country without the medium of money became evident. At the end of 1921 the Soviet Government not only considered it necessary to re-establish the monetary system, but had definitely expressed the opinion that it must try to build up a circulation of money on a gold basis.[33]

This was not the first time that socialists had expressed a belief in "sound money," or commodity-backed currency. Although many socialists saw the value in using inflationary monetary policy for redistribution and direction of the economy, others pointed to dangers of using monetary policy in conjunction with other kinds of economic direction. They argued that a variable unit of exchange would confuse the planners' valuation, making planning more difficult. Trotsky explained in 1934 how planning was only possible with a stable monetary supply:

> It is impossible to regulate wages, prices and quality of goods without a firm monetary system. An unstable ruble in a Soviet system is like having variable molds in a conveyor-belt factory. It won't work.
>
> Only when socialism succeeds in substituting administrative control for money will it be possible to abandon a stable gold currency. Then money will become ordinary paper slips, like trolley or theater tickets. As socialism advances, these slips will also disappear, and control over individual consumption—whether by money or administration—will no longer be necessary when there is more than enough of everything for everybody!
>
> …As a matter of fact, during the first few years a planned economy needs sound money even more than did old-fashioned capitalism. The professor who regulates the monetary unit with the aim of regulating the whole business system is like the man who tried to lift both his feet off the ground at the same time.[34]

Lenin's temporary retreat, the New Economic Policy, put the moneyless economy on hold, but the intention to one day abolish money never disappeared. In 1932 the Commissar of Finance described the policies as preparation for when money would be "handed over to the museums."[35] Although many Soviet economists lost faith in the goal (One Polish economist said in 1968 that given recent developments, "Perhaps not all paths leading to Communism must deviate from money."[36]), the official Party line remained that when socialism underwent its transformation into communism, the state and money would both wither away.

Planners also used in-kind benefits in addition to money bonuses throughout the Soviet period to introduce the inequality which they found to be important to the economy (as discussed in Chapter 2). Sometimes workers earning lower wages found themselves better off than those with higher nominal wages, because the former had privileges such as the right to buy cheap meals in factory restaurants, while the rents charged for living space were on a sliding scale according to income.[37] Part of the reason for this choice may be the doctrine that a privilege, while still a privilege, is less devastating to the ideal of equality if it is received in-kind, rather than in cash. This is, after all, what the superiority of the moneyless economy depends upon.

However, if anything, it seems to be the reverse. Some of the more elite privileges granted to top Party members, such as limousines, parties with caviar and champagne which only the top Party members could attend, and “foreign dignitary” and “hard currency” shops, probably separated this class from the masses more than income differentials alone ever could. In fact, things are often coveted simply for their rarity—so that if they are given as a privilege in place of money, they may stir envy even more than cash would. Logan Robinson tells the story of the rare Bulgarian toothpaste he acquired in Leningrad. One shop clerk was hiding away the rare tubes for her friends, while another had ensured that Logan could obtain one, probably because he was foreign. But it turned out to be awful—no better than the Soviet toothpaste.

> Why then, I asked, if the Soviet toothpaste was awful at eleven kopeks, and the Bulgarian toothpaste was awful at thirty-two, was this clerk going to the trouble to hide away the imported stuff for her friends? Well, Slava pointed out, there is after all a certain status in brushing your teeth with hard-to-come-

> by Bulgarian toothpaste![38]

After the repeal of NEP, allocation of resources was based on a plan, but planners used money to track accounting costs, and as a flexible way to guide firms, in conjunction with allocation certificates. They used money as a tool for aiding allocation according to the plan. Evgeny. Preobrazhensky, coauthor with Nikolai Bukharin of *The ABC of Communism*, predicted how nationalization of the banking system would aid planners in his 1921 book, *From NEP to Socialism: A Glance into the Future of Russia and Europe*. Writing as if it had already occurred, he said:

> As regards new enterprises, it was almost impossible to establish these without the Bank's participation.... Consequently, the Bank not only ensured itself exceptional profits but also obtained influence on the management of enterprises. At the same time…[it] enabled the state to implement its economic plan, encouraging the establishment only of such enterprises as were expedient from the standpoint of this plan.[39]

This is, in fact, how the state bank worked under planning. Not only could the state bank determine which firms would be allowed to open and could keep an eye on the management of the firm, but it could precisely determine how the firms could spend their money. This allowed the bank to act as the right hand of the planners, ensuring that only planned exchanges were made.

Although money was used, purchases by enterprises generally required allocation certificates, so that, as the saying went, money became only "pieces of paper, which, with enough other documentation, allow you to purchase something." The enterprise's budget was also divided into "funds" to be used for individually specified purposes, such as wages, investment, or maintenance. In fact, “all but the pettiest of petty cash must be kept at the state bank, and the bank is under an obligation to disallow payments which are improper (e.g., for an unauthorised purchase, or at the wrong price).”[40]

Investment was not only tightly regulated, but it was also allocated to firms without interest charges. Marx had argued against all forms of “unearned” income including interest. However without interest, it was impossible to determine the best way to allocate investment funds. Not charging interest made borrowing highly attractive, and left planners with no way to determine which investments were worthwhile.

Alec Nove provided a simple example: “To put the matter crudely, if building operations are suspended for two years, the extra cost [that planners calculate] is limited to keeping a night-watchman plus perhaps deterioration of the half-completed building.”[41] In such a case, the opportunity cost of not using the building for two years would be ignored: this is a huge waste. A capital charge would prevent this waste, because the building would have to be used for something productive enough to pay the charge. In the 1960s, these problems led to the introduction of capital charges, which were then ideologically “justified”:

> Until the early 1960s, a large proportion of the enterprises’ investment needs in the European [Communist bloc] countries was met by interest-free non-repayable grants from the state budget. But this practice only encouraged enterprises to place extravagant demands for larger and larger allocations, leading to an alarmingly increasing capital-output ratio and tremendous waste.... However this wasteful practice has been almost completely discontinued since the mid-1960s by the introduction of annual capital charges.

> It is now recognized that interest is ideologically justified because capital is nothing else but materialized labour, and as such it should be rationally distributed, because it represents a means of economizing live labour.[42]

Soviet economists had realized by the 1960s that “rational allocation” of capital requires charging of interest. By this time there was debate about the use of profitability as an indicator. Reform economists argued that a firm should keep costs below revenue if the investments were to prove worthwhile. However, planners were invested—ideologically and practically—in subsidizing firms that were unprofitable. Still, planners realized that they would still need to keep track of interest costs. Even if unprofitable firms were subsidized, it would still be important to know the relative costs of investments in order to determine the best use of resources. As with profitability more generally, the planners may want to know the status of the firms’ budget, but still subsidize losses.
However, planners soon learned that the soft budget constraint—the subsidizing of loss-making firms—affected how the firm responded to their queries about investment needs. Firms had no need to keep their costs low and hence lied to planners about their true needs. Soviet reform economist L. Gatovsky described the problem in his proposal for the 1965 reforms. He explained that, in designing new construction plans,

> [Design firms] become interested in an artificial lowering of the estimated cost of construction, which exists only on paper, and in effect, bear no material responsibility for the actual high outlays which are really incorporated in the design though in a concealed way.[43]

The true costs of the investment are unknown when there is a soft budget constraint.[44] If interest is used only for accounting purposes and firms can run a loss, firms can disregard the length of time that the investment will ultimately take. Soviet firms would bid and overbid for more and more projects, especially as unfinished products often counted toward production targets, and the projects would end up costing much more than was planned and take longer than alternative projects may have taken.

Shortages resulted from excess demand for resources, and many projects were left unfinished.[45] Often, technology advanced between when the projects were started and when they were completed.[46] Along the way, some projects were abandoned entirely, and others probably should have been abandoned. An article in the *International Socialist Review* on the 1965 reforms commented:

> There are cases where these delays in completing investment projects reach the proportions of a real scandal. Thus, the chemical combine of Gurjec has been under construction for ten (!) years. Seven large wood and cellulose combines in Siberia have been under construction for thirteen (!) years; machinery imported from Great Britain in 1952 was never used and has by now become obsolete and gone to rust, etc., etc.[47]

The 1965 reforms aimed to curb the practice of over-investing and abandoning investment projects by charging for capital and holding the enterprises accountable. The importance of the capital charge was not limited to helping the planners determine the most worthy projects. Soviet economists discovered several interrelated functions of the charge on capital. First, the capital charge made some projects uneconomical, saving the state from investing in projects that were not worthwhile given the investment costs. Second, revenue from the capital charge allowed planners to reduce the prices of the products produced, and some revenue used for production could come from the resource use (the interest charge), not from consumption (the products sold). This helped to ensure efficiency in production because more efficient production would be re-funded.[48]

In short, the interest charge helped prices better reflect true costs and helped to stimulate better use of resources. As Alec Nove pointed out, "A capital charge…has both macro- and micro-economic effects, and reminds one that the distinction between these categories is often blurred in practice."[49] Soviet planners learned that investment is best allocated when costs reflect the time taken in production and prices of the final products reflect this cost, otherwise the demand for the products may not be in line with the ability to supply them.

Planners also learned that each price in the economy affects the prices facing other firms, and every investment uses resources that could be used elsewhere. Because of the interrelated nature of pricing and investment, every poorly priced resource or product and every poorly chosen investment affected the ability of planners to price the other items in the plan. (See Chapter 6.) Planners ultimately came to realize that charging interest was important in order to invest in the most worthwhile projects and to have any chance of pricing planned production effectively.

This was a significant step toward understanding rational allocation by the market's economic mechanism. It also indicated the birth of awareness of non-labor-based value. It was an early recognition by socialists that "capitalists" provided value by lending their capital out and had a *justification* for charging interest. Perhaps it is not exactly right to call it "unearned income." If the profit earned by the capitalist from charging interest is reinvested, then this would have the same benefit that planners discovered: When revenue from investment (rather than only from consumption) is used for additional investment, it reinforces efficient use of capital.

Although planners and Soviet economists came to realize the need for interest charges, they still kept interest rates incredibly low and even negative in practice.[50] When real (inflation-adjusted) interest rates were negative, as they often were in the Soviet Union and other socialist countries, there was a great incentive to incur as much debt as possible. The debt would offer a small subsidy from the state. Although investment resources were limited, firms were driven to start as many projects as possible and to borrow as much money from the bank as they could possibly justify.

Although many socialists believed in sound money, without a banking system isolated from political influence, they were unable to maintain a sound currency in practice. They also could not effectively control the economy through the monetary system. In a planned economy, the demand for resources as inputs and the supply of those resources are both centrally controlled. If the two are balanced and the supply of consumer goods is able to fill increasing and changing demand, then prices can remain steady, and there should be no inflation.[51] However, the planners were never able to accomplish this feat. Inflation was hidden in such various forms as "shortages, queues, grey or black markets, high prices in the legal free markets, unspent or unspendable cash balances in the hands of enterprises or individuals" and "disguised price increases."[52]

One of the ways that firm managers regularly disguised a price increase was by introducing a "new" product that was essentially the same as the old product and obtaining permission to sell it at a higher price. The price of the old product would be fixed for the plan period, but a new product could essentially skirt this price control, and a recommended higher price would be enforced until such a time as the product could be evaluated and given an official price. These prices increases would not be reported as inflation because the product with the higher price was "new." Logan Robinson tells a story about his experience with buying cheese in Leningrad in the 1970s that captures this phenomenon.

> Cheese in the Soviet Union comes in three or four varieties. There is "Russian" style, which is a kind of Mozzarella, and "Holland" style, which approximates a Gouda; then there is "Rokfort," which is like an inferior Danish bleu or a very inferior French Roquefort. Rokfort is the cheapest, at 2.30 rubles a kilo, but is usually not available. Russian and Holland were three rubles a kilo and usually were available. About halfway through my year a "Swiss" brand appeared, patterned on an Emmenthaler. It was more expensive, at 3.90 rubles for a kilo. By the end of the year it was frequently the only cheese available, replacing Holland and Russian. This is the pattern of Soviet inflation. First, more expensive products will be introduced, slightly different but no better. Then the cheaper product slowly disappears from the market. Technically, prices have not changed, and Rokfort still costs 2.30 rubles a kilo, but if you want to actually eat some cheese it will be Swiss at 3.90.[53]

Interestingly, American businesses used nearly this exact method to evade price controls that were enacted during World War II to prevent inflation. The policy froze the prices of all products that a firm sold at the start of the war, but the rules that determined the price of a new product were more complex and hence had wiggle room. This led many entrepreneurs to change their product lineup.[54]

Socialists had hoped to use the levers of the banking system to apportion investment rationally and stabilize the economy. Instead, they found no way to rationally choose investment projects because their interference in the process *displaced the forces that create the signals necessary for rational allocation*. They could also not stabilize the economy because their method only hid the instability they were creating, but could not actually control it. They did not eliminate inflation. Instead their price controls just led to the same evasions seen in market economies when prices are fixed centrally. Finally, they were never able to eliminate money. Their first attempt was disastrous, and over time they learned that the use of money could aid both in their attempts at planning and as they moved toward more market-oriented pricing.

Lessons

Socialists essentially argued that money is "the root of all evil." To do away with money once and for all would be freeing, allowing true equality. It would allow everyone to live free of necessity and without having to buy and sell his soul and person. The need for money and the disparities in amounts of money are chains upon society. Therefore, eradicating money would allow for true freedom and compassion.

However, this argument conflates the existence of money with the phenomenon of scarcity. The free feeling of not worrying about money comes from abundance or having one's needs met,[55] not from the lack of use of money. If neither money nor goods existed, there would be no feeling of freedom, but there would be starvation. With limited goods and no money, there is just confusion over how to distribute the limited goods. A lack of money is only workable in situations of absolute abundance. There would be no need for it because absolute abundance would eliminate the need for trade. But these are unattainable, Utopian circumstances.

The argument for a moneyless society also assumed that without money there would not be any disparity in wealth, but this is not true either. The existence of scarcity would still mean that some could own more resources than others. Money is simply a means of exchange. It is what we each trade to each other to enable us to trade with a third person for what we truly desire. Scarcity, and the way that society copes with it, were the true objects of distaste. Yet scarcity cannot be eliminated by eliminating money or by collectively managing production, or by any other means known to man. Sadly, as Alec Nove bluntly put it, "Soviet economists have long shown a dislike for the concept of scarcity."[56]

Money emerges naturally out of barter. If you want a coat, and I want a roast pig, we can trade if you have the pig and I have a suitable coat. However, if we do not both have exactly what the other wants, we may need to trade with several other people before we are all satisfied. As societies everywhere and always run into this problem, money—some kind of means of exchange—must always emerge. The economist Rudolf Hilferding, a Marxist that Lenin frequently cited, wrote about this, even describing how it could emerge without the help of the state:

> Money thus originates spontaneously in the exchange process and requires no other precondition…. Neither the state nor the legal system determines arbitrarily what the nature or medium of money shall be….
>
> In the absence of state intervention an agreement with respect to a specific money can also be worked out by private persons—for example, by the merchants of a city.[57]

There is nothing more natural to an economy than the emergence of a medium of exchange. Yet socialists wanted to abolish money and essentially return to barter by creating a direct-distribution economy. It is no wonder that they succeeded in wiping out all economic activity with war communism, because indeed they had wiped out the most basic tool of the economy: the means of exchange. They did essentially succeed in their task, returning the economy to barter.

Any call for an end to money is a destructive call for a return to a primitive barter economy. Money is the most primary tool of a functioning economic system—one that will emerge from the basic social interactions between people because it is a function of exchange. As Hilferding pointed out, money will emerge even in the absence of the state's minting and coinage. There are many historical cases of this.[58] The state tends to take over this function, but it is not clear that it does so for the sake of society, rather than for the sake of its own treasury. Once the state holds this function, it can leverage this power to inflate its own budget and reduce its debts at the expense of the purchasing power of the public.

The government may then go so far as to use the power of the central bank to direct investment in the economy. A 1999 Congressional Research Service report discussed the use of interest rates and bank lending to direct investment in Asia. In many ways the attempt to do so through the central bank, and the results, are reminiscent of the Soviet experience:

> The financial difficulties in Asia stemmed primarily from the questionable borrowing and lending practices of banks and finance companies in the troubled Asian economies. Companies in Asia tend to rely more on bank borrowing to raise capital than on issuing bonds or stock. Governments also

> have preferred developing financial systems with banks as key players. This is the Japanese model for channeling savings and other funds into production rather than consumption. With bank lending, the government is able to exert much more control over who has access to loans when funds are scarce. As part of their industrial policy, governments have directed funds toward favored industries at low rates of interest while consumers have had to pay higher rates (or could not obtain loans) for purchasing products that the government has considered to be undesirable (such as foreign cars). A weakness of this system is that the business culture in Asia relies heavily on personal relationships. The businesses which are well-connected (both with banks and with the government bureaucracy) tend to have the best access to financing. This leads to excess lending to the companies that are well-connected and who may have bought influence with government officials.[59]

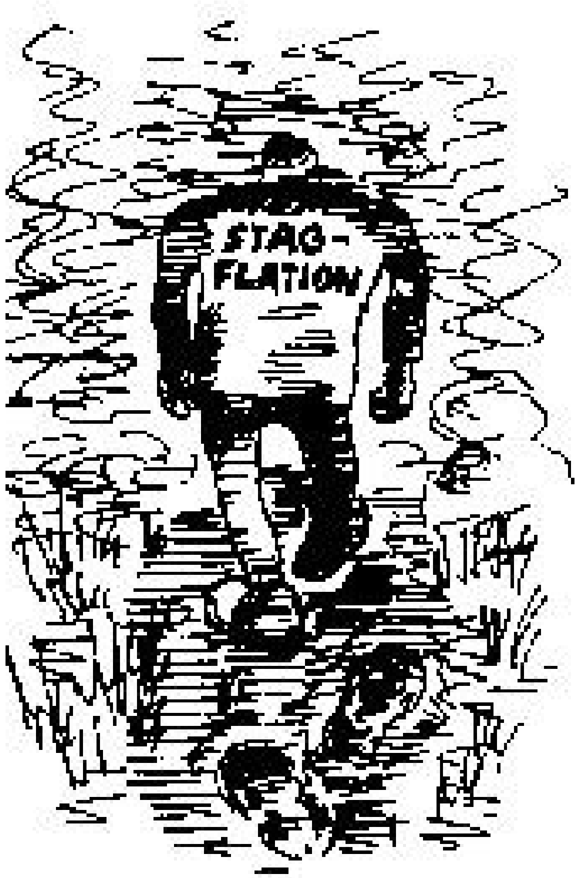
An even more common use of central bank control is inflationary monetary policy. In 2006, a US law banning the melting down of pennies and nickels was introduced.[60] This was necessary because these coins have greater inherent value as metals than as currency. This control of coinage has existed in most societies over the course of history, but combined with inflationary monetary policy it has tended to empower and enrich the state at the expense of the majority of the people. Adam Smith spoke of it and cited cases of governments using the "juggling trick" of inflationary policy to reduce their own debt:

> When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least

dishonourable to the debtor and least hurtful to the creditor. The honour of a state is surely very poorly provided for when, in order to cover the disgrace of a real bankruptcy, it has recourse to a juggling trick of this kind, so easily seen through, and at the same time so extremely pernicious.

Almost all states, however, ancient as well as modern, when reduced to this necessity have, upon some occasions, played this very juggling trick.[61]

Adam Smith described inflationary policy introduced in ancient Rome. The law which enacted the inflation was popular. It was introduced and carried through the assembly of the people by a tribune. In Rome, as in all the other ancient republics, the poor people were in debt to the rich, and any law which could reduce that debt was popular. In one stroke of the pen the law abolished half the debt of the people, and the state. While printing money may rapidly abolish half of all debt in one stroke with a massive depreciation of the currency, it also makes taking out debt easier and saving harder, thereby creating a debtor's society, and creating uncertainty for lenders and investors. Centralized control over money can cause more damage than just raising the price level (with inflation) and redistributing from savers to borrowers (by lowering the interest rate). Keynesian economic theory, developed during the Great Depression, argued that deficit spending and inflationary monetary policy could bring about full employment without crowding out private growth, at least when used during a recessionary period. However, these policies can lead to "stagflation," the phenomenon of simultaneous inflation and stagnation in the economy.



A NEW MONSTER...

This phenomenon was a shock to many economists when it surfaced in the 1970s, because they had believed that inflation stimulated the economy, and unemployment and inflation could be traded-off. Keynesian models were based on aggregates of economic activity—aggregate demand, savings, investment and government spending. These aggregates, and their interaction in the simple Keynesian economic models, did not distinguish between efficient investments and investments driven by low interest rates that might turn out to be inefficient. Although "stagflation" was introduced as a concept in the 1970s, the Great Depression itself may have been a prolonged downturn in part because deficit spending and monetary interventions altered the allocation of resources, making recovery difficult.

As Soviet planners learned, interest is necessary for efficient use of the economy's resources because of the need to economize these resources in time and space. The same machinery cannot be used for every potential project. There is a scarcity of time, space, labor, raw materials, capital, and other goods. Because of this, interest must be charged to test whether a project is still worthwhile even though it must use certain resources. Yet state control over the money supply will affect the interest rate and therefore affect the choice of projects undertaken in the economy.

For example, if project A costs $1 million and project B costs $950,000, without any interest payment project B will be chosen. But if the equipment necessary for project B costs an additional $75,000 in interest (calculated for the number of years of use) then project A will be chosen. If the two projects produce the same output, this is a more efficient use of resources because the interest rate is a real cost. The interest rate is determined by the competing demands on that capital equipment. A third project that demands capital, but is still economically viable after interest is taken into account, has competed to set that interest rate. In this way, the interest charge represents not only the time needed to complete project A or B, but also the relative value of those projects compared with all other existing and potential projects in the economy.

Eliminating the interest rate in the Soviet Union meant that the projects undertaken took no account of the amount of resources necessary – and planners did not know which ones were worthwhile and which were wasteful. It also meant that the costs and prices set for the goods created by these projects did not reflect the true costs of the investment. This meant that the disregard for investment costs was passed throughout the economy in the form of incorrect prices, affecting other cost calculations and yet other prices.

In the market economy, policies that affect interest rates, including inflationary monetary policy, may also cause inefficiencies in investment and therefore in the allocation of resources. Lowering the interest rate through monetary policy, government in effect induces “forced savings” by driving more money into long-term investment projects (which will pay off later) at the expense of present consumption. Inflation reduces consumption because prices are higher, while low interest rates encourage business to borrow and invest in long-term projects that are cheaper because of the low rate. However, because consumers did not actually save more to drive the interest rate down, when the government ends the policy (to prevent hyperinflation) the rate must ultimately rise again, because there are not enough investment funds to go around. This means some of the projects will have to be abandoned. Projects that require borrowing for especially long periods (that rely on delaying consumption the longest) will be most likely to fail, because they were the ones receiving the greatest subsidy from the government-set interest rate.

“Explain to me again why enjoying life when I retire is more important than enjoying life now.”

Centrally controlled interest rates may also fuel bubbles. In fact, these policies may drive the business cycles we experience, *just as socialists argued*. When inflationary policy is used to try to spur the economy out of recession, it may drive investment into areas that it would not otherwise go. This is because, like projects A and B described above, one might be cheaper with a zero or low interest rate, but too expensive if the interest rate is high. When the interest rate inevitably rises again, these projects will be seen as wasteful, and have to be abandoned – causing the crash that we tend to see after a bubble.

Just as government employment, as we saw in Chapter 2, may be inefficient *even if workers were unemployed when initially hired by the state*, investments triggered by inflationary policy being used to "stimulate" the economy during a downturn may be inefficient. Idle resources brought online by interest rates that are low *only because the government has inflated the currency* may be channeled into areas where they do not fill true demand or fill it inefficiently. The artificially low interest rate hides the fact that the investment is not worthwhile.

These "malinvestments" may then cause further problems in the economy.[62] Because capital investments are at the top of the supply chain of the economy, mistakes in new investments can affect the entire economy, and quickly fixing these mistakes can be difficult. As discussed in Chapter 6, Soviet planners learned how the prices of raw materials, inputs, and capital trickle through the whole economy, affecting the calculations of many other firms and the allocation of resources. Planners saw that the low price given to coal and iron led to inefficient pricing in a large number of industries that relied on coal, iron, and steel.

A recent economic paper made the case that economic models should account for the many different kinds of capital goods used for production because generically spurring investment may sound good, but what happens if the wrong investment is promoted? The authors argue that "in a world of heterogeneous capital resources, spending on some assets but not others alters the pattern of resource allocation, and, in a path-dependent process, the overall performance of the economy in the future."[63] In other words, the stimulation of investments in potentially inefficient projects and areas of the economy may have downstream and lasting effects. "Even idle resources can be misallocated," the authors argue, "if invested in activities that do not produce the goods and services the economy needs."[64]

Economists often simplify this problem away, looking only at the aggregates: the total amount of consumer spending, the total amount of investment in the economy, and the total income. Once the picture is aggregated and simplified, the economist can easily suggest that what government should do is "spur investment" or "spur consumption" because the potential pitfalls of the approach will never show up in the model. This then leads to, or justifies, policies that spur investment with low interest rates.

Yet how could the model predict the results of this policy if it assumes away the differences for which the interest rate is purposed? Interest is a charge levied for the time that capital equipment is to be used (or money is to be borrowed). Yet, these models simplify investment to such a degree that the length of time different investments will take is ignored. Economist Kenneth Boulding described the danger of these simplifications in 1946:

> [I]t is a question of acute importance for economics as to why the macroeconomics predictions of the mathematical economists have been on the whole less successful than the hunches of the mathematically unwashed. The answer seems to be that when we write, for instance, "let *i*, *Y*, and *I* stand, respectively, for the interest rate, income, and investment," we stand committed to the assumption that the internal structures of these aggregates or averages are not important for the problem in hand. In fact, of course, they may be very important, and no amount of subsequent mathematical analysis of the variables can overcome the fatal defect of their heterogeneity.[65]

In other words, modeling investment as an aggregate (represented by the letter I) when analyzing a policy that affects interest rates may not be defensible.[66] It may yield results entirely inconsistent with the actual results of such a policy. For example, projects that require long-term use of expensive capital equipment may be made cheaper by the policy, while other projects that do not are unaffected. Hence the relative cost of the former is reduced, and more such projects are undertaken. This may affect the viability of the economy, especially after interest rates rise again.

An economist's predictions are only as good as the assumptions that he makes. Many economists have rejected this common sense notion, arguing that if a model can make accurate predictions,[67] the assumptions do not matter. However, the real economy is too complex for this to be a workable solution. Many macroeconomic models appeared to produce accurate predictions for many years, but then began to fail. Sometimes the earlier predictions do not hold upon closer scrutiny.

Just as in biology or any science, one can use a simple model, but one must remember that the results based on this model only apply to it. If we want answers for a complex world, the simple model may not provide them. The model is only as good as the assumptions that go into it. Yet many economists spend more time on the model-building, equation-crunching, and mathematics that follow after their assumptions, than on choosing the most appropriate initial assumptions. Even when aware that monetary policy may affect decisions of investors, economists may still make this simplification. For example, even though Keynes was guilty of making exactly these sorts of simplifications, he was aware that "changing views about the future are capable of influencing the present situation. *For the importance of money essentially flows from its being a link between the present and the future.*"[68]

This is an important lesson because any centralized monetary policy will affect the interest rate. If the interest rate is not zero, but is still lower than the rate that free supply and demand for investment would produce (the "market rate"), then investment will be undertaken that would not have been otherwise. The true cost of the use of resources over the investment period will not be taken into account. This undervaluation will then affect other cost calculations and prices throughout the economy. The 2007–2008 housing crisis and the subsequent financial collapse and recession may be an example of this—30-year mortgages include a lot of interest. Economists from across the spectrum have argued this.[69] The reason is simple: mortgages are affected more by changes in interest rates than most anything else. Economist Lawrence H. White explained it this way.

> Because real estate is an especially long-lived asset, and thus has an especially large part of its value depend on the discounting of far-distant future cash flows, its market value rises relative to those of other assets with a fall in the interest rate used for discounting. The dramatic fall in interest rates made 2001 real estate prices seem like bargains.[70]

However, this was not the only effect of lowering interest rates. Monetary policy also helped to fuel greater use of risky types of mortgages. The Federal Reserve directly controls only the short-term interest rate, although this rate tends to affect other rates. Lowering the short-term rate also caused a distortion because some mortgages are more closely connected to the short-term rate than others:

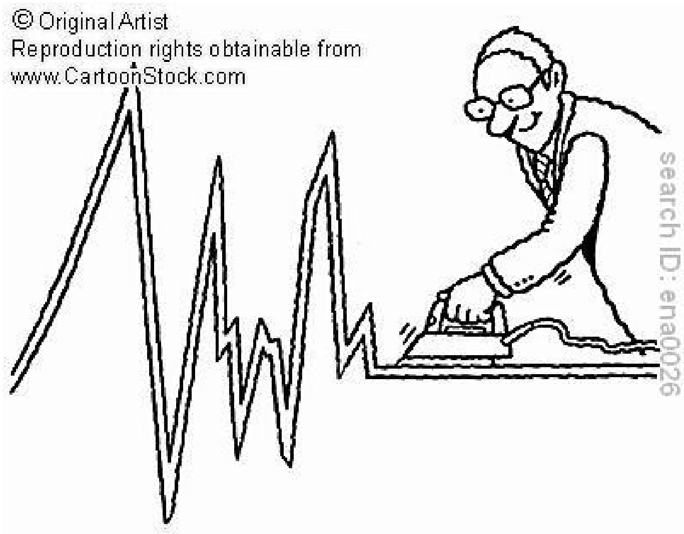
> The dramatic lowering of short-term interest rates not only fueled growth in the dollar volume of mortgage lending, but had unintended consequences for the type of mortgages written. By pushing very short-term interest rates down so dramatically between 2001 and 2004, the Fed lowered short-term rates relative to 30-year rates. Adjustable-rate mortgages (ARMs), typically based on a one-year interest rate, became increasingly cheap relative to 30-year fixed-rate mortgages…. Not surprisingly, increasing numbers of new mortgage borrowers were drawn away from mortgages with 30-year fixed rates into one-year ARMs. The share of new mortgages with adjustable rates, only one-fifth in 2001, had more than doubled by 2004. An adjustable-rate mortgage shifts the risk of a rise in interest rates from the lender to the borrower. Many borrowers who took out ARMs implicitly (and imprudently) relied on the Fed to keep short-term rates low for as long as they kept the mortgage. As is well

> known, they have faced problems as their monthly payments have reset upward. The shift toward ARMs compounded the mortgage-quality problems arising from other sources such as regulatory mandates.[71]

This also sheds light on how the financial markets—lenders and investors—help to allocate resources efficiently by seeking profit and responding to supply and demand information through price signals. They also help to allocate resources more evenly across time by responding to interest rates. Both firms as investors and capitalists as speculators help to do this, and monetary policy creates confusion and distortion in all these areas.

Profit-driven firms' demand for investment funds drives the level of the interest rate. When new investment funds are in little demand—overall in the case of a slump or in certain industries when demand for something drops—the interest rate falls. When demand is very high for investment, the interest rate rises, rationing the investment funds to only the most worthy projects. In this way, the private activities of consumers, firms, and investors create a price signal that helps to allocate resources efficiently. The signal attracts new investment (in the case of a falling interest rate) or weeds out unneeded projects (when the rate rises).

Similarly, speculators bid on expected price changes in different industries, which helps to plan for efficient future use. Speculators are often accused of "creating volatility" or "profiteering" at the expense of the public,[72] but in truth speculation reduces volatility by helping to predict future needs and by bringing prices in line with those needs. Profit is not made at the expense of the public, but is made by fulfilling the very important role of allocating resources more evenly across time.



Periodically, the U.S. Congress rounds up speculators from Wall Street and questions them about their supposed misdeeds. One recent article presents evidence suggesting that such congressional accusations are misguided:

> Before the US Commodity Futures Trading Commission starts scrutinizing the role that speculators may have played in driving up fuel and food prices, investigators may want to take a look at price swings in a commodity not in today's news: onions.
>
> The bulbous root is the only commodity for which futures trading is banned. Back in 1958, onion growers convinced themselves that futures traders (and not the new farms sprouting up in Wisconsin) were responsible for falling onion prices, so they lobbied an up-and-coming Michigan Congressman named Gerald Ford to push through a law banning all futures trading in onions. The law still stands.
>
> And yet even with no traders to blame, the volatility in onion prices makes the swings in oil and corn look tame, reinforcing academics' belief that futures

trading diminishes extreme price swings.[73]

The reason for this is simple: The traders have a vested interest in obtaining knowledge about future conditions of supply and demand, and they have the trade specialization and time to do so thoroughly. This information and incentive allows them to push the price in the direction it must go a little bit at a time through their trades, and as the price moves suppliers can respond to the movement.[74] Without speculation, the market is left in confusion as to the future supply until the last moment. Thus, when the supply or demand change finally becomes obvious to traders, the price of the commodity will shoot up or fall suddenly.

STOCK EXCHANGE

However, centralized monetary policy may affect the ability of speculators to accurately predict the future direction of prices. Artificially low interest rates and inflation confuse the speculator's valuation of the industry and individual investments. Although financial speculators have been blamed for their role in creating an unsustainable financial and credit bubble, they may have played a positive role if not driven by inflationary policy into investments that would cease to be profitable after interest rates and prices eventually returned to Earth.

Speculators and investors were unable to predict the 2007–2008 housing and financial collapse in part because their view was fogged by the inflationary (and other) policies that spurred the bubble. Many of them lost their fortunes during the crash. It seems reasonable to suspect that the prices on ultimately unprofitable mortgages would not have risen so dramatically if investors were able to predict their ultimate crash, but inflation and artificially low interest rates made this much more difficult.

Conclusion

Although socialists sentimentally wished for an end to money—as many people sometimes do—money itself is not the villain. Scarcity is the culprit for the ills perceived, and scarcity makes money (and the market influences on it that produce prices and interest charges) necessary for the allocation of those scarce resources. Because scarcity cannot be wished away, money is not only necessary, but critical. It must be left free, or all of the important market signals that facilitate efficient investment and allocation will be compromised.

Centralized monetary policy, especially policy that inflates the currency or tends to direct investment by affecting interest rates, drives inefficient investments and therefore has long-term consequences. Driving down interest rates may also affect certain industries more than others, creating bubbles and crashes. Those industries in which costs are affected most by interest rates will tend to be the most distorted during an artificial boom caused by inflationary monetary policy. These bubbles must eventually burst, and when they do all of the miscalculations will be revealed.

Socialists were wrong to think that their own control over this tool would cause fewer "crises" than its use by the "capitalist" governments. They were unable to eliminate money or use it to control the economy. Attempting to control prices did not prevent inflation, it only hid it. First eliminating and then controlling interest rates both led to an inability to make rational investment choices. Although they had aimed to take control of the money supply and use this power for the good, socialists learned that anyone attempting to centrally control the money supply will tend to cause the same types of malinvestment and crises as had occurred under capitalism.

[1] 1 Timothy 6:10.

[2] Probably the most complete eradication of money by a socialist regime was under Pol Pot in Cambodia. It was a markedly unsuccessful experiment, and even Pol Pot admitted it was a mistake. In 1979, he told ABC News that it was the one thing he regretted. Anthony C. LoBaido, "Face to Face with Pol Pot's Evil," WorldNetDaily.com, April 18, 2001, at http://www.wnd.com/news/article.asp?ARTICLE_ID=22460 (December 2, 2009).

[3] Moses Hess, "Speech on Communism," February 5, 1845, at http://www.marxists.org/archive/hess/1845/elberfeld-speech.htm (December 2, 2009).

[4] For example, see Karl Marx, "The Chapter on Money," in *Grundrisse der Kritik der Politischen Ökonomie*, trans. Martin Nicolaus (New York: Penguin, 1973), at http://www.marxists.org/archive/marx/works/1857/grundrisse/index.htm (December 2, 2009).

[5] Frederick Engels, "The Principles of Communism," in *Selected Works*, vol. 1 (Moscow: Progress Publishers, 1969), pp. 81–97, at http://www.marxists.org/archive/marx/works/1847/11/prin-com.htm (December 2, 2009).

[6] E. Sylvia Pankhurst, "Future Society," August 2, 1923, at http://www.marxists.org/archive/pankhurst-sylvia/1923/future-society.htm (December 2, 2009).

[7] This was not limited to the Russian Bolshevik program. Communist parties in many countries included the abolition of money in their programs. For example, the communist party of Ireland included in its program: "(4) Closing of banks and abolition of money." E. Sylvia Pankhurst, "Communism Versus Reforms," 1922, at http://www.marxists.org/archive/pankhurst-sylvia/1922/ireland.htm (December 2, 2009).

[8] Garet Garrett, *Salvos Against the New Deal* (Caldwell, IN: Caxton Press, 2002 [1934]), p. 105.

[9] See A. Alchian and B. Klein, "On a Correct Measure of Inflation," *Journal of Money, Credit and Banking*, 1973, pp. 173–191, for some of the problems of inflation indices known in the early 1970s.

In 1996, the Boskin Commission, a panel of experts led by Stanford economist Michael Boskin, put forward reasons why the Consumer Price Index (CPI) had been overstating the rate of inflation in the American economy. It was so persuasive that no one contested it. They determined that for two decades the real rate of inflation had been 1.3 percent per annum below the official figure. This had major implications for Social Security pensions (indexed to the CPI) as well as the perception of real wage increases. Linking Social Security to the lower CPI saved $1 trillion over one decade. In 1996, the conventional wisdom that American families experienced a decline of 9 percent in real hourly earnings from 1975 to 1996 was contradicted by the alternative CPI figures, which yielded a 35 percent increase instead of a 9 percent decrease. Irwin M. Stelzer, "Lies, Damned Lies, and Statistics Revisited," *Weekly Standard*, December 23, 1996, at http://www.aei.org/article/16905 (December 2, 2009). In contrast, the website Shadow Government Statistics argues that this change was a convenient government ploy. They make the case that payments to Social Security recipients should be doubled from current levels because "inflation, as reported by the Consumer Price Index (CPI) is understated by roughly 7% per year…due to recent redefinitions of the series as well as to flawed methodologies, particularly adjustments to price measures for quality changes." Walter J. Williams, "The Consumer Price Index," Shadow Government Statistics, updated October 1, 2006, at http://www.shadowstats.com/article/consumer_price_index (December 2, 2009). Which of these is "correct" is debatable. Either way, inflation was calculated in one way for decades and then in a significantly different way after that for at least a decade. Whether such a thing as generalized inflation can ever be accurately calculated is debatable.

[10] William F. Warde, "The Progress of Inflation," *Fourth International*, Vol. 4, No. 10 (October 1943), pp. 305–307, at http://www.marxists.org/archive/novack/1943/10/inflation.htm (December 2, 2009).

[11] Garrett, *Salvos Against the New Deal*, p. 37.

[12] Karl Marx, *Capital*, Vol. III, *The Process of Capitalist Production as a Whole* (New York: International Publishers, 1894), chap. 36, at http://www.marxists.org/archive/marx/works/1894-c3/index.htm (December 3, 2009).

[13] Ted Grant, "Campbell Somersaults—The Communist Party and the Slump," *Socialist Fight*, Vol. 1, No. 2 (February 1958), at http://www.marxists.org/archive/grant/1958/02/campbell.htm (December 3, 2009).

[14] A good introduction to the Austrian analysis of the business: Richard Ebeling, *Austrian Theory of the Trade Cycle and Other Essays* (Auburn, AL: Ludwig Von Mises Institute, 1996).

[15] Marx, *Capital*, Vol. III, chap. 36.

[16] V. I. Lenin, "The Impending Catastrophe and How to Combat It," *Collected Works*, Vol. 25, at http://www.marxists.org/archive/lenin/works/1917/ichtci/04.htm (December 3, 2009) (original emphasis).

[17] Leon Trotsky, "The Transitional Program," 1938, at http://www.marxists.org/archive/trotsky/1938/tp/tp-text.htm (December 3, 2009).

[18] Rexford G. Tugwell, "Planning and the Profit Motive," pp. 38–39, in *Socialist Planning and a Socialist Program*.

[19] Karl Kautsky, *The Labour Revolution* (1924), at http://www.marxists.org/archive/kautsky/1924/labour/ch03_c.htm (December 3, 2009).

[20] Victor Serge, "Year One of the Russian Revolution," *New International*, Vol. XIV, No. 6 (August 1948), chap. 4, pp.186-191, at http://www.marxists.org/archive/serge/1930/year-one-ni/part04.html.

[21] Anna Louise Strong, *The First Time in History* (Boni & Liveright, 1925), chap. 4, at http://www.marxists.org/reference/archive/strong-anna-louise/1925/first_time/index.htm (December 3, 2009).

[22] *Ibid.*

[23] John Maynard Keynes, *The General Theory of Employment, Interest and Money and Essays in Persuasion* (New York: Classic Books America, 2009), p. 128.

[24] Eighth Congress of the Russian Communist Party, "Political Program of the CPSU," March 22, 1919, *International Socialist Review*, Vol. 22, No. 4 (Fall 1961), pp. 115–124, at http://www.marxists.org/history/ussr/government/1919/03/22.htm (December 2, 2009).

[25] Leon Trotsky, *The Revolution Betrayed*, chap. 2.

[26] *Ibid.*, chap. 4.

[27] M. N. Krestinsky, "Russia's New Financial Policy," *Soviet Russia*, Vol. 5, No. 6 (December 1921), p. 267.

[28] Waldemar Gurian, *Bolshevism: Theory and Practice* (New York: Sheed & Ward, 1935), pp. 129–130.

[29] V. I. Lenin, letter to S. Y. Chutskayev, November 30, 1920, in *Collected Works*, Vol. 45 (Moscow: Progress Publishers, 1976), p. 58, at http://www.marxists.org/archive/lenin/works/1920/nov/30b.htm (December 3, 2009).

[30] A speech on the ideological justification for the tax in kind explains that "we do not want the peasants' products to be delivered to the workers' state as appropriations of surplus grain, or a tax. We want them in exchange for all the goods the peasants need delivered to them by our transport system." In other words, the tax in kind was the first step toward socialist exchange without money. V. I. Lenin, "Report on the Tax in Kind," April 9, 1921, *Lenin's Collected Works*, Vol. 32, 1st English Edition, (Moscow: Progress Publishers, 1965), pp. 286–298, at http://www.marxists.org/archive/lenin/works/1921/apr/09.htm.

[31] Gurian, *Bolshevism*, p. 98, note 1.

[32] Pipes, *The Russian Revolution*, pp. 701–702.

[33] S. S. Katzenellenbaum, *Russian Currency and Banking, 1914–1924* (London: P. S. King, 1925), pp. 98–99.

[34] Leon Trotsky, "If America Should Go Communist," August 1934, at http://www.marxists.org/archive/trotsky/1934/08/ame.htm (December 3, 2009).

[35] Barbara Wootton, *Plan or No Plan,* p. 57. Soviet officials felt the need to apologize for the use of money in the socialist economy. Officials explained that the existence of finance and credit at that time was due to the fact that under socialism (the lower state before communism) there was necessarily still commodity production and commodity circulation. Hence, with two forms of socialist ownership (state and collective) plus personal ownership, there must be exchange between them, "Moreover similar inter-relations also arise within the State sector," as state firms must exchange between themselves. Hence, there is a "need for money as a universal equivalent or, in other words, the need for a monetary form of expressing the value of goods." K. N. Plotnikov, *Banking in the USSR: The Financial and Credit System of the USSR*, pp. 43–44, in S. S. Katzenellenbaum, *Russian Currency and Banking, 1914–1924.* Yet would not exchange be required between socialized firms under any system? How could this dissolve under communism? The answer expressed by Soviet officials was that, under the first phase, "social production does not reach a level of development that can ensure an abundance of consumer goods for distribution to members of society according to their requirements." But this was expected to occur under communism. Because this "abundance" did not yet exist, officials explained that "there must be the strictest accounting and control by the State over the measure of labour and the measure of consumption," which is only possible using money. V. A. Vorobyev, *Banking, Planning of Money Circulation and Credit in the USSR*, p. 110. in S. S. Katzenellenbaum, *Russian Currency and Banking, 1914–1924.* Soviet officials learned that any kind of cost accounting, by firms or by the state, requires money. Money emerges naturally from exchange, and with free exchange, prices emerge and allow for cost accounting. This was imagined to not be necessary in the future communist society after great abundance allowed goods to be taken freely or distributed according to needs alone. Of course, such a society has never come to be.

[36] J. Wilczinski, *The Economics of Socialism* (London: Allen & Unwin, 1977), p. 143.

[37] For a detailed study of the Soviet wage system in the Stalin period, see Abram Bergson, *The Structure of Soviet Wages*.

[38] Robinson, *An American in Leningrad*, p. 124.

[39] E. A. Preobrazhensky, *From NEP to Socialism: A Glance into the Future of Russia and Europe*, trans. Brian Pearce (London: New Park Publications, 1973), Lecture 9, at http://www.marxists.org/archive/preobrazhensky/1921/fromnep/index.html (December 3, 2009).

[40] Nove, *Political Economy and Soviet Socialism*, p. 178.

[41] *Ibid.*, p. 219.

[42] Wilczinski, *The Economics of Socialism*, pp. 147–148.

[43] L. Gatovsky, *Ekonomicheskaya Gazeta*, No. 48 (December 1965), in *Soviet Economic Reform* (Moscow: Novosti Press Agency, 1967).

[44] Alec Nove describes the other ways that a soft budget constraint affects the firm's willingness to share true costs. "For firms and control over their spending and investment, a further problem occurred in obtaining resources with the money allocated. Inputs were centrally coordinated, but it often occurred that those firms with the money to purchase inputs could not obtain them, while those firms which were able to locate materials did not have the necessary funds. When an enterprise was lucky enough to have both, it would often 'hoard' resources, purchasing more than it needed so as to have reserves in case of later shortage. For this reason, the claimed level of inputs needed was often much higher than the actual amount the firm required" (Alec Nove, *Political Economy and Soviet Socialism*, p. 183).

[45] Nove, *The Soviet Economy*, p. 219, makes this case.

[46] O. Nekrasov, *Voprosi Ekonomiki*, No. 11 (1965), in *Soviet Economic Reform* (Moscow: Novosti Press Agency, 1967).

[47] Germain, "Soviet Management Reform," pp. 77–82.
[48] Nove, *The Soviet Economy*, p. 223.
[49] *Ibid.*
[50] Kornai, *The Socialist System*, p. 545.
[51] Nove, *Political Economy and Soviet Socialism*, p. 179.
[52] *Ibid.*, p. 181.
[53] Robinson, *An American in Leningrad*, pp. 179–180.
[54] Rockoff, *Drastic Measures*, p. 94.
[55] Because one can feel more free sometimes by ceasing to desire greater material wealth, this is sometimes overlooked. The free feeling still depends on having one's basic needs met, allowing one to forget the most urgent material needs and enjoy the freedom from concern over accumulating more. If these basic needs were not met, instead of feeling free, one would feel the fear and hardship of the struggle for survival.
[56] Nove, *The Soviet Economy*, p. 292.
[57] Rudolf Hilferding, *Finance Capital: A Study of the Latest Phase of Capitalist Development* (London: Routledge & Kegan Paul, 1981), chap. 1, at http://www.marx.org/archive/hilferding/1910/finkap/index.htm (December 3, 2009).
[58] See, for example, George Selgin, *Good Money: Birmingham Button Makers, The Royal Mint, and the Beginnings of Modern Coinage* (The Independent Institute, 2008). Also see Steven Horwitz, "Complementary Non-Quantity Theory Approaches to Money: Hilferding's Finance Capital and Free-Banking Theory," *History of Political Economy*, Vol. 26, No. 2 (Summer 1994), pp. 221–238.
[59] Dick K. Nanto, "The 1997-98 Asian Financial Crisis," Congressional Research Service *Report for Congress*, February 6, 1998, at http://www.fas.org/man/crs/crs-asia2.htm (December 3, 2009).
[60] CNNMoney.com, "Mint: Don't Melt Money," December 14, 2006, at http://money.cnn.com/2006/12/14/news/melting/index.htm (December 3, 2009).
[61] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (London: Methuen & Co., 1904), Book 5, chap. 3, at http://econlib.org/library/Smith/smWN22.html#B.V,%20Ch.3,%20Of%20Public%20Debts (December 3, 2009).
[62] Austrian economists have focused on this problem probably more than any other school. See, for example, Richard Ebeling, *The Austrian Theory of the Trade Cycle and Other Essays*. As mentioned earlier, this is similar to the arguments made by Marx about the causes of "crises" under capitalism.
[63] Rajshree Agarwal, Jay B. Barney, Nicolai J. Foss, and Peter G. Klein, "Heterogeneous Resources and the Financial Crisis: Implications of Strategic Management Theory," Copenhagen Business School, Center for Strategic Management and Globalization *Working Paper* No. 6/2009, July 28, 2009, at https://openarchive.cbs.dk/bitstream/handle/10398/7906/SMG%20WP%202009-06.pdf (December 4, 2009).
[64] Nicolai J. Foss and Peter G. Klein, "Management Theory Is Not to Blame," *Mises Daily*, March 19, 2009, at http://mises.org/story/3375 (December 3, 2009).
[65] Kenneth E. Boulding, "Samuelson's Foundations: The Role of Mathematics in Economics," *Journal of Political Economy*, Vol. 56, No. 3, (June 1948), p. 189, at http://ideas.repec.org/a/ucp/jpolec/v56y1948p187.html (December 3, 2009).
[66] Similarly, an article from 1948 in Voprosi Ekonomiki, a Soviet economics journal, remarked about the absurdity of making such assumptions and then applying the conclusions to the real world. The author declared, "[The mathematical economist] has 30 pages of mathematics, and at the end there emerge the assumptions he put in at the beginning." The following statement is attributed to Nobel Prize-winning mathematical economist Wassily Leontief, a major early founder of input-output techniques and equilibrium modeling: "We move from more or less plausible but really arbitrary assumptions, to elegantly demonstrated but irrelevant conclusions."
[67] Milton Friedman, "The Methodology of Positive Economics," *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953). Part of the essay can be found online at http://www.marxists.org/reference/subject/philosophy/works/us/friedman.htm.
[68] Keynes, *The General Theory of Employment*, p. 249 (original emphasis).
[69] For example, John B. Taylor (of the "Taylor Rule"), Joseph E. Stiglitz (a left-wing economist), Steven Gjerstad, Vernon L. Smith, Juliusz Jablecki, and Mateusz Machaj make this argument. See Jeffrey Friedman, "Introduction: A Crisis of Politics, Not Economics: Complexity, Ignorance, and Policy Failure," *Critical Review*, Vol. 21, Nos. 2–3 (2009), p. 138.
[70] Lawrence H. White, "Federal Reserve Policy and the Housing Bubble," *Cato Journal*, Vol. 29, No. 1 (Winter 2009), p. 119, at http://www.cato.org/pubs/journal/cj29n1/cj29n1-9.pdf (December 3, 2009).
[71] *Ibid.*, pp. 118–119.
[72] For example, see Ianthe Jeanne Dugan and Alistair Macdonald, "Traders Blamed for Oil Spike," *The Wall Street Journal*, July 28, 2009, at http://online.wsj.com/article/SB124874574251485689.html (December 3, 2009).
[73] Jon Birger, "What Onions Teach Us About Oil Prices," *Fortune*, June 30, 2008, at http://money.cnn.com/2008/06/27/news/economy/The_onion_conundrum_Birger.fortune (December 3, 2009).
[74] In a letter to *The New York Times*, economics professor Donald Boudreaux humorously suggested to the Obama Administration that, rather than "reining in" speculators to address oil price volatility as they were contemplating, they should become speculators themselves. "Not only will these brilliant public servants earn personal fortunes in the oil market, they'll also, in the process, mute the allegedly excessive price fluctuations," Boudreaux quipped.

“And because Mr. Obama & Co. would use their own resources, we the public will be better assured that their actions aren’t driven by opportunistic politics.” Don Boudreaux, “A Win-Win,” Cafe Hayek, July 8, 2009, at http://cafehayek.com/2009/07/a-winwin.html (December 7, 2009).