A Footnote to the Wolfson Economics Prize Contest

Antal E. Fekete

Last year Lord Wolfson announced the Economics Prize Contest of 2012. At stake was the £250,000 Wolfson Economics Prize the richest economic award after the Nobel Prize. Theessays were to address the sovereign debt crisis in Europe, in particular, the problem *howto ensure the stability of the new European currencies after the possible dissolution of the euro-system*. The five essays shortlisted for the award were published on April 3. The winner will be announced in July.

The present author submitted his essay without the slightest illusion that he may win, or that he may even be on the short list of the 5 hopefuls. His only motivation to participate in the contest has been to test whether the Establishment is now ready to accept the suggestion that it was no accident that the "Big Bang" of debt explosion occurred on the very same day, on August 15, 1971, whengold was exiled from the international monetary system. A glance at the chart of total debt will make the validity of that suggestion plausible.

As witnessed by the tables of contents of the five short-listed essays, only one of them mentions the gold standard explicitly, and thatin the voice of disdain. Jonathan Tepper's essay charges that "the gold standard has recessionary bias" and that "it puts the burden of adjustment on the weak-currency country rather than on the strong". Since the distinction between a 'weak' and a 'strong' currency under a gold standard is invalid, this can only mean that the gold standard is hereby charged with putting the burden of adjustment on the financially irresponsible instead of the financially responsible country. What is wrong with that? Could it not be that, perhaps, Europe's and the world's present troubles originate from the fact that the irredeemable paper currency system has shifted the burden of adjustment to the financially responsible countries, thus providing incentives for financial irresponsibility?

It was Milton Friedman on whose advice Richard Nixon discarded the fixed exchange rate system based on gold in favor of the 'floating' exchange rate system based on the irredeemable dollar. Friedman suggested that floating is an effective adjustment-mechanism of international trade. Imbalances are automatically rectified. The currency of the deficit country depreciates while that of the surplus country appreciates. As a consequence importsof the former

become dearer and are throttled,meanwhile those of the latter become cheaper and are boosted. The process continues until balance is restored.

There is no need to deny the intellectual seductiveness of this ‘theory’.However, it has a fatal flaw without any redeeming features. It ignores the *marginal terms of trade*, that is, the ratio of additional imports to additional exports. In other words it ignores the change in additional imports that the unit of exports will buy. Note that it can be *negative*, as it always is in case of adevaluing country. For example, if the unit of export is one passenger car, then the devaluing country will have to export more cars to maintain the same level of imports.

Rather than restoring trade balance, *floating makes the imbalance worse.*It makes the terms of trade of the deficit country deteriorate.Whatever ‘benefits’ the deficit country may derive from devaluation are strictly ephemeral. They vanish as soon as the inventory of imported ingredients that go into exports runs out. Thereafter the devaluing country has to pay *more*, not less, for ingredients essential for exports. It will see its deficits grow rather than contract. In effect, the devaluing country is selling its valuable resources abroad at ‘fire sale prices’. No wonder that the alleged benefits of devaluation are entirely illusory.

History bears out theory. The US has been running a trade deficit *vis-à-vis* Japan for half a century. Since 1973, following Friedmanite precepts, the dollar’s value was beaten down 5-fold (!) against the yen. Instead of falling, the US trade deficit with Japan has increased 10-fold.

This shows that the system of floating exchange rates based on the irredeemable dollaris no valid substitute for fixed exchange rates based on gold if the goal is to achieve trade balance. Financial profligacy is independent of the monetary system under which it is practiced. It is nature-ordained that the burden of adjustment fall on the profligate country.

History will pass judgment on the prejudice of the jury of the Wolfson Economics Prize Contest 2012. The jury has failed to find a single submission worthy of mention among the 425 received that makes the connection between the sovereign debt crisis and the expulsion of gold from the international monetary system in 1971. In doing so the jury has failed to make a contribution to the solution of the crisis. Most likely it has made a contribution to its prolongation.

Note. The author’s submission to the Wolfson Economic Prize Contest 2012 entitled: *How to Ensure the Stability of the New European Currencies?* can be accessed on the website:

http://www.professorfekete.com/articles/AEFSYNOPSISWolfsonEntry.pdf.
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ANNOUNCEMENT

New Austrian School of Economics

Munich, Germany
August 2012 (exact dates will be announced soon)

Title of the course:

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For further information or in order to register for the course you can get in contact with the organizers Ludwig Karl and Wilhelm Rabenstein via mail (nasoe@kt-solutions.de) or phone (+49 – 170 – 380 39 48 , before calling please consider a possible time lag).
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