



Compounding Wealth

Property, Exchange and Capital Investment

An Austrian Perspective

18-June-2009

Chris Tormey

cctormey@optonline.net

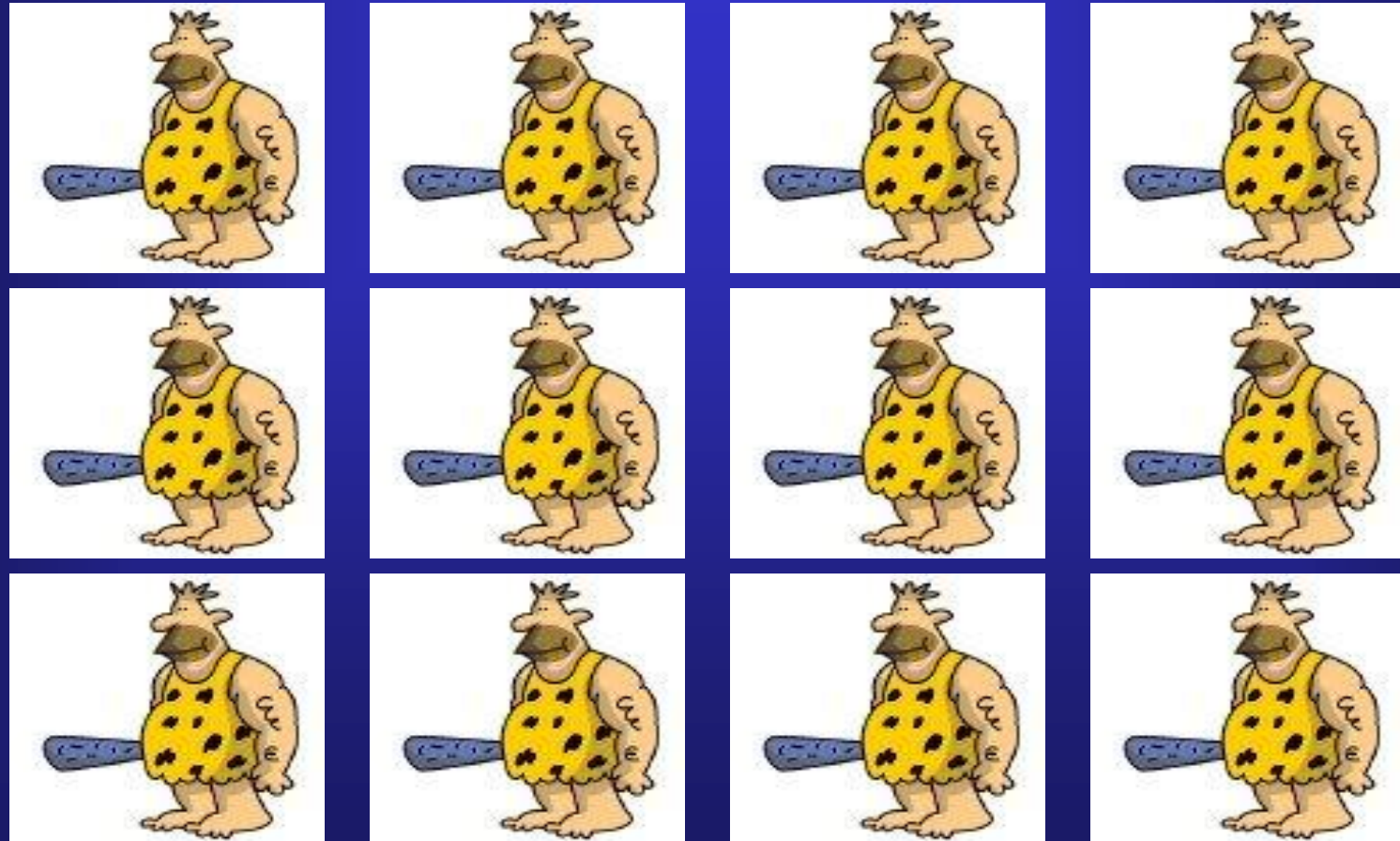
A long time ago,
12 cavemen went to work...



...to kill one of these each day
(12,000 calories)



After each hunt, the 12 caveman
would tear off the meat...



...then they would eat and relax
(consuming 1,000 calories each).

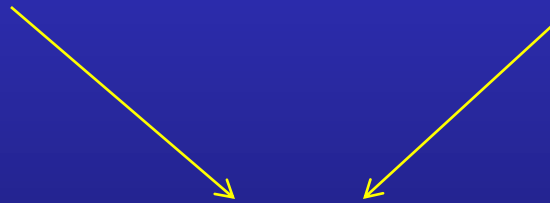
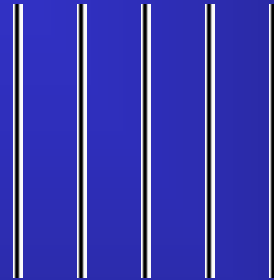


One day, a caveman has an idea!

The others decide to feed him and 5 helpers in order to develop it

- This creates great risk. Only 6 cavemen are hunting, but twelve are still eating.
- Consumption reduced--now 500 calories a day.
- They could starve before the idea is completed.
- The idea might not work.
- At a minimum, risk of lost time and calories.

Creating the first spear



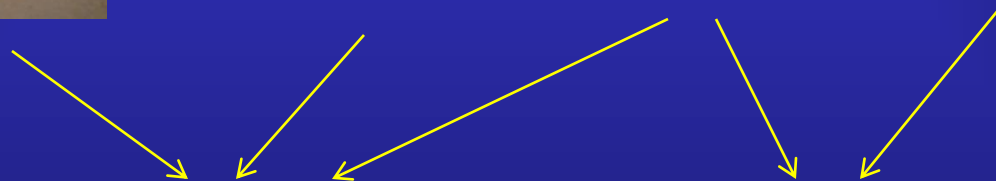
Using spears doubles tiger kill
with only 3 men, 8x productivity



At a nearby tribe, another caveman gets an idea!

- For this effort, all 12 cavemen give up their relaxation time after eating.
- They sacrifice leisure for the “disutility” of work.
- If the idea does not work, time will be lost and “cave fun” will be sacrificed.

Creating soup bowls and spoons



Cooking soup doubles calories
per tiger, increases leisure time.



Employing “division of labor” and developing “tacit knowledge”

- A “classical” economic thought; Adam Smith (1776).
- Division of labor multiplies productivity and builds cooperative relations between people.
- The cavemen are getting wealthier.

One day cavemen from each tribe meet and show off their inventions



Each is VERY interested in the other's "higher order" good

- "Spear man" realizes soup bowls and spoons will double his food supply (24,000 calories per tiger)!
- Plus, tiger soup is really tasty.
- "Soup man" realizes spears increase kill-rate of tigers by 8 times!
- Plus, tiger-mauling incidents are much lower using spears instead of clubs.

“Gains from trade” is also a Classical School concept

- David Ricardo (1817) praised the value of free trade.
- Every nation gains by specialization.
- Concept of “comparative advantage”.
- Trade creates value by expanding the division of labor and raising global productivity.

But trade creates even more value than explained by Ricardo!

- An amazing discovery was made in the late 1800s.
- Three economists, unknown to each other, developed a new insight about trade.
- This new insight was called “marginal utility”.

What is trade worth to the Spear Tribe?

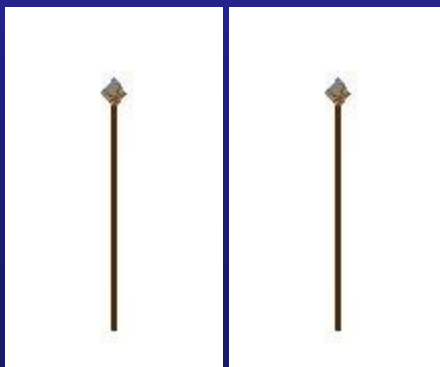
- “Spear Assembly Team” is very productive.
- Large inventory of “idle” spears on hand.
- Spears have low “marginal utility” to Spear Tribe.
- Soup would double caloric intake and increase dining pleasure.
- Soup has high “marginal utility” to Spear Tribe.

What is trade worth to the Soup Tribe?

- “Bowl and Spoon Team” is very productive .
- Large inventory of unused bowls and spoons.
- Bowls and spoons have low “marginal utility” to the Soup Tribe.
- Spears would improve safety and increase tiger kill-rate by a factor of 8!
- Spears have high “marginal utility” to Soup Tribe.

They make the trade!

Wealth compounds: “lower utility” exchanged for
“higher utility” in each tribe



Fathers of Marginal Utility Theory

Carl Menger (1840 -1921)
“Principles of Economics”
(1871)



William Stanley
Jevons
(non Austrian)



Leon Walras
(non Austrian)



Austrian “Marginal Utility” unique

- All schools: division of labor increases wealth and leisure.
- All schools: trade compounds wealth, “comparative advantage” plus “marginal utility” of excess goods.
- Austrians: trade does not take place at “equal value” for each side; “Value” is not mathematical or even measurable in units; Value is in the “eye of the beholder” and the value scale is ordinal.
- No mathematical equations are possible in the “Austrian” world of ordinal values.

Creating “higher order” goods and trading can be risky business

1. Tribes could run out of food before finishing production of spears, soup bowls or spoons.
2. Inventions might not work (low increase in tiger-kill or no extra caloric soup intake).
3. Tribes might just kill each other, obtaining bowls or spears but with no knowledge of how to create new ones.

The Theory of Capital and Interest

- Time preference and “originary interest”.
- Savings gets production going.
- Lower consumption when needed helps too.
- Creating “higher order goods” is the trick to progress.
- Projects risk running out of resources if they miscalculate.

Father of the Austrian Theory of Capital and Interest

Eugen von Bohm-Bawerk (1851-1914)
“Theory of Capital and Interest”
(1884)



Profit and Loss

Price achieved for a product versus the factors of production employed

- Entrepreneurs appraise.
- Capitalists fund.
- To avoid Capital Loss, final price (at volume) must be greater than materials and labor purchased plus cost of capital (market interest rate).
- Capital loss probability is high if market interest rates are lower than the ordinary rate.
- Boom/Bust.

Nobel Prize Winner; Economics (1974); Business Cycle Theory

F. A. Hayek (1899 -1992)
“Prices and Production”
(1931)



Property Rights.

- Respect for Property Rights is the necessary condition for trade.
- Alternative to trade is war, theft and/or slavery.
- Killing or stealing yields possessions, but encourages revenge, eliminates labor and quells entrepreneurial spirit.
- Enslaving is intuitively lower value-creating system compared to free-market system.

Combining Ethics and Economics

Murray Rothbard (1926 -1995)
“Man, Economy, & State” (1962)
“For a New Liberty” (1973)



Beyond “direct exchange” of spears and bowls...

- How does a shoemaker trade with a baker ?
- How does a consumer or businessman know whether to exchange now or wait?
- How do entrepreneurs and capitalists know if a new idea might be worth their time and sacrifice?

...and what about those spoons?

- Bowls and spears often needed replacement.
- Spoons never broke.
- And they were made of a nice, shiny, metal!
- As a “consumption” good, spoons had a very high marginal utility (didn’t need much inventory).
- Could they be used.....for “Indirect Exchange”?

Money: Indirect Exchange

- Money is needed to balance out or completely replace “direct” (goods for goods) exchange.
- Historically, money has always evolved from something of “consumption” value.
- Money is the numerator by which all other goods and services are denominated.
- Money is the device for appraising opportunities in the market for buying, selling, borrowing or investing.
- Any amount of money is “just right” for purposes of understanding relative trading values between goods.

Requirements for “Good Money”

- Universally recognized in trade / exchange.
- Easily divisible.
- High value to weight/volume (transportable).
- Does not degrade over time.
- Easy to store.
- Uniform quality.
- Easy to authenticate.
- Difficult to counterfeit.
- Ratio of new production / total supply relatively low.

Candidates for Money

- Animal skins, sea shells, cows, tobacco...and...
- Gold and silver have all the qualities of “good money” and have been used by markets for 5000+ years.
- Government paper and electronic money (fiat money) have many “good money” features. However:
 - (a) governments make decisions rather than markets,
 - (b) no natural limits on supply of new money.
- Fiat money is popular with governments because they can create it instead of borrowing it or taking it.
- Paper money makes inflation easy and inflation is wealth destructive.

Champion of the Austrian School

Ludwig von Mises (1881 -1973)

“The Theory of Money and Credit” (1912)

“Human Action” (1939, translated 1949)



The men who developed the Austrian School of Economics.

Murray Rothbard (1926 -1995)



F. A. Hayek (1899 -1992)



Ludwig von Mises (1881 -1973)



Eugen von Bohm-Bawerk
(1851 -1914)



Carl Menger (1840 -1921)



2009: What if an Austrian Economist was in charge of government?

- Repeal the Federal Reserve and Income Tax Acts (1913).
- Shut down the FDIC. Eliminate liquidity insurance on banks, money market funds, PPIP, etc.
- Downsize government every day in every way.
- Allow consumers and businesses to deliver / rebuild the economy's real pool of savings.
- Privatize postal system and most government businesses.
- Link the USD to gold (at prevailing prices).
- Discourage fractional reserve banking .
- Let banks and companies that are failing.....fail.

2009: Where do the current actions lead (without Austrian solutions)?

- Zombie banks, insolvent but liquid enough to pay their management (often handsomely) and employees.
- Personal bankruptcies in large segment of population.
- Double-digit contraction of GDP.
- US Dollar rally and asset selloff into deep and extended economic depression.
- Nationalization of major (30 to 50) US companies.
- Fed monetization of all US denominated debt.
- Another credit-induced or fiat money boom.
- Hyperinflation - “crack up boom”.

Leading Austrian thinkers today



Lew Rockwell



Robert Higgs



Gene Callahan



Joseph Salerno



Robert Murphy



Marc Faber



Jorg Guido Hulsman



Peter Schiff



Ron Paul



Thomas Woods



Hans Herman Hoppe



Roger Garrison



Walter Block



James Grant



Frank Shostak