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# A Comparison of Investment and Cash Building of Savings: A Rejoinder

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*ABSTRACT*: Although Austrian literature does not usually dwell on this particular aspect, there are differences between the direct investment of savings and adding to one's personal cash balance (hoarding). Following Bagus's (2016) critic of my original article, the present paper will introduce supplementary qualifications. I will argue that in the course of ordinary business activity, there is no (plausible) reason why hoarding should imply disinvestment. Furthermore, I claim that the market rate of interest is the main indicator for entrepreneurs in a developed society which uses an advanced credit system. Finally, the paper will summarize the differences between investment and cash building and put these differences in connection to economic growth in order to see whether any of the two methods offers additional benefits.

*KEYWORDS*: Austrian school, market rate of interest, structure of production, investment, economic growth, hoarding

*JEL CLASSIFICATION*: B13, B53, E14, E22, E31, E41, E43, O40

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## INTRODUCTION

In "*A Comparison of Direct Investment of Savings and Cash Building of Savings*" Philipp Bagus (2016) makes a thorough critique of my original article which attempted to analyze the intricate relation between hoarding, investment and economic growth. Interestingly enough, it appears that we generally agree regarding the *differences* between hoarding (or cash building, as Bagus [2016] prefers to call it) and investment, but we are at odds concerning the demonstration I employed in the original article, which was meant to show that investment would be more swift in promoting growth.

The original article (Pătruți, 2016) employed a Wicksellian framework that focused on the divergence between the natural rate of interest (NRI) and the market rate of interest (MRI) in order to point out the different effects of hoarding and respectively investment. This type of investigation is customary to the Austrian school, since it supplies the keystone for business cycle theory (Mises, 1998; Hayek, 2008). It is certainly not new, but it has not been applied, to my knowledge, to this specific issue in a coherent fashion.

The general claim I made was that the real movements in the structure of production could be affected by monetary frictions determined by individual hoarding. In this sense, directly investing the savings through the banking system would appear as a "preferable" alternative that could temper these short-term frictions.

In his reply to my original article, Bagus (2016) first raised a number of critical remarks regarding the two scenarios[1] I used and afterwards identified, correctly in my opinion, additional differences between the two phenomena. In the present paper I will first restate my thesis by incorporating as much as possible of the pertinent observations made by Bagus, in the belief that our differences are not as many as would originally appear. Secondly, I will attempt a rejoinder of the conclusions regarding the *differences* between hoarding and investment and *their effect on potential growth*.

[1] The two scenarios were hypothetical situations used to prove my main point in the original article (Pătruți, 2016).

## THE CRITIQUE

The main observations raised by Bagus (2016) are, to my understanding, the following: that (1) *I overstressed the importance of the MRI*, that (2) *cash building by saving does not necessarily imply a longer time period* and that (3) *cash building does not necessarily stem from saving*. I will try to address all of them in an orderly fashion.

Restating the original analysis comprising the two scenarios would be superfluous, since I believe that generally Bagus should find it acceptable. The only critique I could find was that I was somewhat "*vague*" regarding the explanation of the real adjustment process of the structure of production in the second scenario (Bagus, 2016, p. 364). If this was the case, the only reason I had for that was brevity. I fully agree that the real processes of readjustment in the structure of production are the fundamental phenomena and that monetary processes are derivatives. I fully concede to his additions in this sense to my text. However, just claiming that "These spreads between buying and selling prices are the most fundamental phenomenon. The market rate of interest is just a derivative of this phenomenon" (Bagus, 2016, p. 365) does not solve the problem. It is clear that the natural rate of interest is the fundamental phenomenon, but entrepreneurs have no knowledge of this magnitude, which is more or less a theoretical concept. The signal they can use in practice is the market rate of interest. As Hayek (2008, p. 264) puts it:

> But there is one medium through which the expected ultimate effect on relative prices should make itself felt immediately, and which, accordingly, should serve as a guide for the decisions of the individual entrepreneur: the rate of interest on the loan market.

This is the reason why I stress the importance of the market rate of interest (1), even though the pure rate of interest is the fundamental phenomenon. The belief that adjustment of relative prices in the structure of production is a slow and time consuming process is also documented by Hayek[2] (2008, p. 264):

[2] In my reading of the fragment I cited in the original article, Mises (1998, p. 542) holds the same opinion. It is true, as Bagus points out (2016, p. 368) that he refers

> As the initial changes in relative prices which are caused by a change of the relative demand for consumers' goods and producers' goods give rise to a considerable shifting of goods to other stages of production, definite price relationships will only establish themselves after the movements of goods have been completed. For reasons which I shall consider in a moment, this process may take some time and involve temporary discrepancies between supply and demand.

This additional argument should suffice, in my opinion, to show why I stress the importance of the MRI and why it would be a faster tool in promoting growth. Would it be *impossible* for entrepreneurs to anticipate/speculate the change in cash balances? Of course not. As Bagus (2016, p. 368) claims:

> Market participants can anticipate effects of cash building on prices and bid a negative price premium into the market rate of interest. Therefore, there is no necessary time lag. In the case of cash building through an increase in saving, the market rate of interest rate can fall immediately if the increase in purchasing power is correctly anticipated.

But to my understanding, this is nothing else than presuming perfect foresight on behalf of the entrepreneurs and, paraphrasing Keynes, "assuming our problems away."[3] It is in this spirit that I claimed that hoarding "necessarily" involves a time lag (2).

Regarding the last comment raised by Bagus, respectively that hoarding does not necessarily stem from saving (3), it would probably be best to start by pointing towards two premises that I employed in the original scenarios, but which I probably failed to stress enough. My original analysis refers to a society in which there is a *smooth operating credit system* (banks, stock exchange) during *normal business activities*. A smooth operating credit system is the prerequisite of a developed economy, as Strigl (1934, p. 111) colorfully explains:

> Clearly, the introduction of credit makes a significant increase in economic returns possible, because the interpersonal transfer of capital

to inflation. But one can find no reason why the price premium should always lag behind prices going up (inflation), but not behind prices going down (deflation).

[3] Bagus (2016, p. 368) himself sees this problem and shortly adds a footnote to the paragraph stating "It is another question if the price premium is *likely* to be anticipated correctly."

> will make it easier to direct capital into those usages in which its return—and consequently also the return from the other cooperating factors of production—will be greater. It is clear that only a smoothly operating credit market, or one operating with the least possible friction, will provide the prerequisite for "correctly" taking advantage of the supply of capital in the economy. Finally, it is also clear that a fully developed credit market is the prerequisite for the formation of a uniform interest rate, and that only a uniform interest rate makes the reliable calculation for the use of capital possible. Although we have said that credit is not a necessary prerequisite for an exchange economy using capital, we must qualify this here by adding that the institution of credit is certainly an adequate prerequisite for a relatively developed economy using roundabout methods of production.

Of course, I fully concede Bagus that if entrepreneurs would directly invest their savings, the MRI would be irrelevant. Credit would actually be irrelevant in that case. But such a society does not resemble our society at all. All I tried to show was that during normal business activity, in a society which uses an advanced credit market, the MRI could be a more efficient tool for entrepreneurs than waiting for the movements in relative prices to run their full course, due to an increase in the value of money.

I say ordinary business activity (and this relates to claim [3]), because the only examples that Bagus (2016, p. 363) can find in which hoarding implies *disinvestment*—i.e. it stems from investments—are *bank runs*, *looming wars*, *internal riots* and *natural disasters*.

Finally, there is only one more argument which I preferred to address last because, surprisingly, it does not have an economic nature but rather an ethical one. Bagus claims: "But who is to say what is optimal and what is not? From whose perspective is an action optimal?" I assume that I triggered this kind of reaction because if hoarding would be considered suboptimal, it would automatically result that the recommended policy program would be some sort of tax on cash holdings. Perhaps I did not stress enough that this was not my policy suggestion in the original article. I do not think that it would be useful or recommended to coerce people to put their money in the banks. I just consider that it would be advantageous for them to know that if they did (of course, considering that the banking system is healthy), they would indirectly contribute to faster economic growth.[4] Of course, if people desire economic growth, i.e. an increase in material prosperity, hoarding would not be optimal. If the "uncertainty avoidance,"[5] as Bagus puts it, caused when keeping cash around is greater than the desire for potentially faster growth, hoarding becomes the optimal solution. But considering that individuals usually want to increase the quantity of consumer goods that they own, investing through the credit system would probably bring these goods faster to their doors.

## A REJOINDER REGARDING THE DIFFERENCES BETWEEN HOARDING AND INVESTMENT

In the previous section, I included additional qualifications to my thesis in the attempt to clear away most of the problems raised by the systematic critique made by Bagus (2016). In this second part I am left with the relatively easy part of summarizing the differences between hoarding and investment, an area in which Bagus actually brought more detailed contributions than myself.

*First*, hoarding implies a (monetary) tendency of prices to fall and implicitly generates Cantillon effects, as Bagus (2016, p. 370) points out. The positive feedback loop which he mentions, i.e. the fact that deflation encourages hoarding and that hoarding generates deflation, is a compelling argument. If this were the case, negative effects such as the redistribution of wealth associated with changes in purchasing power would be unavoidable.

*Second*, there is an additional selection process regarding which entrepreneurs will benefit from the credit pool. I am indebted to Bagus (2016) for pointing out this effect. Specialized intermediaries such as banks do tend to spend time and effort in choosing good

[4] In fact, my original article was named "An Analysis on the Relationship between Hoarding, Investment and *Economic Growth*." Naturally, I would analyze how these magnitudes would affect *growth*. In his reply, Bagus (2016) eliminated the idea of growth and made the title "A Comparison of Direct Investment of Savings and Cash Building of Savings."

[5] The idea of treating money as a means of assuring oneself against uncertainty does raise some rather peculiar conclusions that I have previously discussed in a book (Pătruți, 2016) which unfortunately was not translated into English.

entrepreneurs, as opposed to the case of hoarding in which the increase in purchasing power indiscriminately benefits all entrepreneurs, good and bad.[6]

*Third* on the list is what I referred to as the "wholesaler" argument, i.e. the fact that the pooling of resources can direct huge amounts of credit to specific large scale investments which could not be available by direct investment. This is, to my mind, an argument distinct from the one above.

The fact that investment can foster a more stable structure of production than hoarding is a *fourth* difference. I was not aware of this argument, based on the theory of maturity mismatching (Bagus and Howden, 2010), in my original article. The idea is, if I understand correctly, that savers committed to long term projects give entrepreneurs an increased assurance for undertaking longer production processes. The longer the maturity of the deposit, the safer it is for businessmen to invest, because it is less likely that the saver will withdraw his money. Cash holdings, on the other hand, have zero maturity and the owner can instantly change his mind and consume the saved resources.

*Finally*, keeping in mind the additional qualifications I added to the original thesis, I still hold to the idea that investment would generate faster economic growth as compared to building up cash holdings. If the market is an evolutionary (and implicitly time-consuming) process through which entrepreneurs learn by trial and error which investment projects best serve consumer preferences, a swift adjustment of the market interest rate should help them in their endeavors, given that they do not possess full knowledge. In fact, all the above arguments produced by Bagus, i.e. the tamping down of the Cantillon effects, the additional selection process and the fact that we get a more stable structure of production, all add to the idea of optimality.[7]

[6] This is indeed a much better formulation of my original argument of the benefits of an organized market (Pătruți, 2016, p. 263).

[7] If we consider that the goal of the population is economic growth and not uncertainty avoidance or something else.

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