

DEFLATION: CURRENT AND HISTORICAL PERSPECTIVES.
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The book *Deflation: Current and Historical Perspectives*, dedicated to the history and economics of the phenomenon of falling prices, is composed of 11 contributions by 20 economists from two major conferences on this scarcely investigated topic that were held in April 2000 at Claremont McKenna College and in 2002 at the XIIIth International Economic History Congress in Buenos Aires.¹ The editors have organized the articles, all of which examine different historical periods of deflation, into four parts. They have also provided a scholarly introduction that aptly combines an exposition of a few theoretical elements, such as Keynes's and Fisher's analyses of the impact of continuously decreasing prices, with some general historical evidence² and an overview of the different contributions.

Part one, "Fears of Deflation and the Role of Monetary Policy," contains three contributions that deal with individuals' past reactions to situations of deflation in the days of the Great Depression, in Britain during the period 1870-1939 and in Sweden during the deflations of 1921-1923 and 1931-1933. Part two, "Deflation and Asset Prices," contains two analyses of the proper way decreasing asset prices should be integrated in the conduct of monetary policy. Part three provides three "International Perspectives on Deflation." The first examines the relation between deflation and output in Canada and the United States of America during the classical gold standard.³ The second article re-examines the policy of the strong lira in Italy's interwar period, while the third article reviews the causes and consequences of the recent deflation in Japan. The three contributions in part four are dedicated to "Stock Market Adjustments to Deflation." The comparative study of the responses of the stock exchanges in London, New York, Paris, and Berlin to the financial crises of the 1890s is followed

¹Three of the contributions have already been published as working papers by the NBER, as indicated where relevant.

²For a quick introduction to the history of deflation at the end of the nineteenth and at the beginning of the twentieth century, including a substantial amount of data, cf. Bordo et al. (2004).

³This paper by Bordo and Redish was published in March 2003 as NBER Working Paper 9520. It has already received a comprehensive discussion and very important comments by Thornton (2003) in the pages of this journal.

by an analysis of Germany's stock market during the alternating periods of inflation and deflation in the period 1913-1926. Finally, an article on the role of gold stocks as a hedge against deflationary pressures in the past and today closes this volume of 359 pages rich with empirical data.

One may rightly observe that this organization is arbitrary and does not ease the communication of the main ideas to the reader. One may also note that some of the articles do not really deal with the analysis of deflation strictly speaking. For example, what ultimately interests Martin Bohl and Pierre Siklos in "The Stock Market and the Business Circle in Periods of Deflation, (Hyper-) Inflation, and Political Turmoil: Germany, 1913-1926" is whether the present value model of asset price determination applies to periods of decreasing prices of assets as well as to periods of increasing prices. Richard Burdekin and Marc Weidenmier's "Deflationary Pressures and the Role of Gold Stocks: 1929, 1987, and Today" only establishes that in the past gold stocks did not need a climate of general inflation in order to perform well, and that in the aftermath of 1929 and of 2000 they served as a refuge but did not in the market decline in 1987. To give only one other example, Hugh Rockoff's analysis of "Deflation, Silent Runs, and Bank Holidays in the Great Contraction" examines the consequences of regional conflicts in monetary policy for the transmission of a banking crisis through inter-bank capital outflows, rather than the impact of deflation upon the economy.⁴ The wide heterogeneity of the main research topics that are dealt with, and the subsequent lack of general unity of the volume, makes reading the book quite difficult.

However, despite these weaknesses and a few more to which we shall turn in a while, the volume has two great virtues that cannot be overemphasized. First, it is explicitly admitted that deflation is not always bad and that "good" deflation is theoretically quite possible. Second, the contributions that treated the relation between deflation and economic performance, contain data that clearly show that (1) deflations in the past were not disastrous and that (2) bad consequences, in terms of decreased output and higher unemployment, resulted from factors other than decreasing prices themselves. Thus, from the outset, one can hope that this volume will contribute to demystifying the current fears about deflation among the economic profession. From the point of view of Austrian economists, such an endeavor on behalf of mainstream economists can only be welcomed.

"GOOD" VERSUS "BAD" DEFLATION

In their opening chapter the editors allow for "good" deflation, deflation being defined as a "general fall in some aggregate price level," under one very specific condition only (p. 7). A decrease in prices is good if it is driven by a positive supply shock, due to productivity or technological improvements for instance. In the jargon of the aggregate demand-aggregate supply model, they state:

Falling goods prices could be triggered by any number of factors, including not only a drop in asset prices but also positive supply shocks that

⁴This contribution was published by the NBER in March 2003 as working paper 9522.

shift the economy's aggregate supply curve to the right, thereby putting downward pressure on prices *even as output increases*. Although this allows for the possibility of "good" deflation rather than "bad" deflation, it is still true that sustained deflation is only possible when the rate of money growth falls beyond the rate of growth of output and money demand. (p. 6; emphasis added)

The rationale for this kind of deflation being good is that real wealth *is* actually increasing.

On the other hand, deflations are bad whenever they are triggered by self-fulfilling expectations of decreasing prices or by "poor policy choices" (p. 10). The rationale for this kind of deflation being bad is that it *leads to* a decrease in aggregate demand, and hence in aggregate output according to their argument. These negative consequences on production are explained on the basis of three different channels. One channel is that of the intertemporal substitution effects. Expectations of continuous deflation supposedly imply a reduction in present-day consumption, i.e., in current aggregate demand, and therefore a lower output. A second channel concerns the ability of enterprises to pay off debts when nominal prices of output and of existing assets are decreasing. The bankruptcies that ensue in this case lead, again, to higher unemployment. With the third channel, falling output prices are particularly bad if nominal wages are rigid in the economy: "Deflation may be "worse" than inflation because of firms confronting rising real wages should nominal wage rigidity prevail" (p. 1). This again brings about lower employment and output.

Note that this distinction between "good" and "bad" deflation is not a genuine one, for the distinctive criterion is not the same in both cases. The goodness of a deflation is based on its causes (a supply shock), while its badness is defined relative to its consequences (a decrease in output and employment). Thus, according to this taxonomy, nothing prevents a deflation that is initially good from becoming bad later on. This is what should actually be considered the most probable outcome in the framework adopted by the editors, for they suppose that deflation brings about self-fulfilling expectations. In final analysis, the theoretical case for good deflation that the editors make is an ephemeral concession, for any deflation is destined to eventually become bad.

Within the framework of this analysis, which takes the relation between decreasing prices and bad consequences in terms of output and employment for granted, the question that naturally emerges next is, What is the monetary policy that can prevent deflation? Michael Bordo and Olivier Jeanne's contribution "Boom-Busts in Asset Prices, Economic Instability, and Monetary Policy" deals with exactly this issue.⁵ The authors construct a small model suggesting that the optimal monetary policy does not take the form of a mechanical linear rule, such as the Taylor rule (p. 158). Rather, a monetary policy that takes into account the risk of bringing about a credit crunch, and therefore a future fall in real activity, shall be loose or tight according to the level of *market exuberance*. However, even though the model has the virtue of explicitly introducing expectations and individual reactions into the analysis, the basic hypothesis behind it still remains that a tightening of the credit market leads to a fall in real production.

⁵This paper too was published by the NBER in May 2002 as working paper 8966.

This last hypothesis, as well as the other channels that are used to depict deflation as implying bad consequences, are all unacceptable.⁶ To begin with, bankruptcies—whether caused by a higher debt-burden or by a deficient demand—lead only to a redistribution, and in no case to the destruction, of property. The reallocation of goods takes time and necessarily impoverishes some individuals while making others better off. However, there is no reason why aggregate output should decrease. We can even make the contrary case that debt-induced bankruptcies, because they transfer goods from the more indebted and hence less thrifty to the less indebted and hence more thrifty individuals, increase aggregate savings, and therefore real output in the future. Independent from this highly beneficial effect of deflation, this redistribution of wealth is not qualitatively different from the redistribution of wealth that follows any voluntary exchange on the market.

On similar grounds, the bad consequences of a decreasing aggregate demand triggered by expectations of lower future prices have to be discarded. First of all, lower and lower prices, rather than delaying purchases, may incite some individuals to buy goods that they now consider cheap enough given their own preferences. But even if we concede, for the sake of argument, that deflationary expectations lead to a lower aggregate demand, this does not imply that real activity will be reduced. It is true that in this case some exchanges will not be realized (at least until prices decrease enough), but this does not mean that the quantity of goods decreases in the present or in the future. Again, only the distribution of goods will be different among individuals, and this because of the fact that some individuals refrain themselves from buying and/or selling. To say that deflation has negative consequences because at current prices some exchanges are not realized ultimately means that any exchange has negative consequences. As a matter of fact, at any moment there are exchanges that are necessarily curtailed precisely because of the current conditions of action. It follows then that the negative consequences of decreasing prices per se have to be denied.

Forrest Capie and Geoffrey Wood's "Price Change, Financial Stability, and the British Economy, 1879-1939" does not defend such a categorical rejection of the channels through which deflation negatively impacts the economy. However, the authors show that these channels did not operate in the case of the two deflations the British economy experienced in the late nineteenth century and in the interwar years. Through an econometric estimation of expectations of change in prices, their analysis suggests that deflation was largely expected and that therefore individuals acted in such a way that no adverse effects can be discovered through the channels of Keynes's and Fisher's models: "We, therefore, conclude on this basis that deflation transmitted no adverse effects to the real economy through the channels suggested by these models" (p. 86). The conclusion that deflation is not always disruptive to the economy, but that unbalances are due to other factors within a deflationary context, can certainly be considered as quite a revolutionary finding in mainstream economics. The authors also make a very important comment, namely that if there was an adverse effect on employment, it is imputable not so much to decreasing prices per se, but to nominal rigidities: "It is true that, in the deflation of 1929 to 1932, falling

⁶For a much larger list of myths about deflation, and their systematic debunking, cf. Hülsmann (2003a).

prices *and rigid money wages* did produce unemployment. Yet, even that was relatively short-lived, and there followed a great boom from 1932 to 1937-1938” (p. 86; emphasis added).

As a matter of fact, that is the only condition under which decreasing prices can be linked to lower output and employment. If costs of production are held constant while revenues are decreasing, then some processes of production become unprofitable and are discontinued, thereby freeing capital and labor. The important consideration here, however, is that no reallocation of the unemployed resources is possible, precisely because the rigidity of some of the prices prevents it. In other words, within the analytical distinction that the volume makes between bad and good deflation, it is the bad type that should have been considered the exceptional situation because price adjustments are being hampered. Unfortunately, this is not the conclusion conveyed by *Deflation*. The theoretical case for good deflation, although explicitly admitted in the volume, appears weak and will certainly not produce the much needed appeasement of the fears about deflation.

INSTITUTIONAL FACTORS AND ECONOMIC PERFORMANCE

Klas Fregert and Lars Jonung’s “Deflation Dynamics in Sweden: Perceptions, Expectations, and Adjustment During the Deflations of 1921-1923 and 1931-1933” considers cases of deflation as rare events that can only be understood qualitatively, through a study of individuals’ expectations of and reactions to the economic events. The authors take into account three groups: economists, policy makers, and wage-setters. Their article contains a vivid sketch of the economic debates between the members of the Stockholm School and of their interaction with policy announcements and actions which are very well detailed.

The deflation of 1921-1923 in Sweden was necessary in order to return the highly depreciated krona, which had lost some 60 percent of its purchasing power, to its pre-war gold parity because of the war inflation. This policy measure was supported by economists, all of whom “stressed the good performance of the gold standard before 1914 in comparison with the paper standard during the war,” and by policy makers and by the general opinion (p. 98). The deflation process went on quite quickly and the 60-percent fall in the wholesale prices was realized by the end of 1922 (p. 97). But how did nominal wages and the general economic performance evolve?

For present-day standards, something unthinkable happened: employees accepted nominal wage reductions of about 50 percent over the period 1921-1923.⁷ The real contribution of Fregert and Jonung is to make explicit the timing of these reductions, which helps us understand why unemployment increased sharply during the adjustment process and remained throughout the 1920s at double its pre-deflation level. As

⁷One reason for the actuality of this wage flexibility, so high for modern standards, is certainly rooted in the economists’ attitude toward price rigidities. Rather than trying to build a never-ending list of explanations of rigidities, which finally contributes to their legitimization, economists at the beginning of the twentieth century never doubted flexible prices were the standard case, as the authors remind us through an aptly chosen quotation from Knut Wicksell: “The idea that the workers could not be persuaded to lower their claims, even if prices go down, is pure fancy” (p. 99).

a matter of fact, the wage decreases occurred mainly after the deflation was over: “Most of the price deflation took place in 1921, whereas wage deflation took place primarily in 1922” (p. 101). This delayed adjustment, and not deflation per se, explains why unemployment skyrocketed in 1921 to 25 per cent, before reaching its rather permanent level of 10 per cent in 1923–1924.⁸ The authors themselves attribute this higher unemployment to the insufficient wage adjustment: “It is difficult not to attribute the permanently higher unemployment rate at about 10 percent, which lasted for the rest of the 1920s, to this real wage shock.” (p. 104).

But then, the next question is why did employees not accept a quicker and larger adjustment, in which case the temporary effects on production and the permanent effects on employment could have been avoided? The authors detail the negotiations between employers and labor unions, and concluded that “Overall, the existence of collective agreements slowed down the adjustment process, as most wage reductions did not occur until 1922 when the deflation was almost over” (p. 105). But why did collective agreements play such an adverse role? The answer, although absent from Fregert and Jonung’s contribution, can easily be inferred from a declaration made by the chairman of the Sweden Trade Union Federation in 1921 that they report but do not comment upon: “If there once is a significant reduction in consumer prices, then wages may become affected, but such a decrease has not happened, and it cannot be right that workers should pay before an expected but not actual decrease in the expense of consumption has happened” (p. 100). In other words, quarrels about who should first bear the distribution effects brought about by the decreasing prices are responsible for the delayed and partial adjustment. It is unfortunate that none of the contributions to the volume even raises this most important question.

The data concerning the second deflationary episode also confirm that wage rigidities are responsible for delayed adjustments in the context of deflation, even though the authors give a different interpretation. They report the support of economists for abandonment of the gold standard in September 1931, who argued that this was the way to insulate Sweden from the ongoing world deflation (p. 113). Why these same economists that defended the gold standard ten years earlier changed their mind remains however unexplained. The authors themselves express a favorable opinion of this policy measure: “The great advantage of the paper standard was that Sweden became isolated from the ‘destructive’ deflation that was taking place in countries still on gold” (p. 118). Now, despite this new weapon against deflation, results turn out to be rather mitigated, if not worse, for “The 1930s depression was about as deep as in the 1920s, *but it lasted longer*” (p. 123; emphasis added). What can be the explanation of this failure? The data that the authors report in their Figure 4.7 clearly show that real wages increased by 10 percent from 1930 to 1933, simultaneously with increases in unemployment, before both decreased afterwards. The negotiations that are again very well detailed show that nominal wages decreased much less, that the actual reductions were half what was contractually agreed to, and that “Wages decreased very little during the crises and then only gradually began to grow” (p. 125). In other words,

⁸Although this behavior of employment is the main factor that explains the temporary decrease in Sweden’s output, one should not neglect also the fact that during the adjustment process the number of lost working days in conflicts had increased substantially (p. 104).

wage rigidities were the most plausible explanation of the adverse effects upon the Swedish economy, even though Fregert and Jonung's interpretation of the data on this second deflationary period does not follow this direction.

A similar bias toward monetary interventionism can be discovered in Michele Fra-tianni and Franco Spinelli's "The Strong Lira Policy and Deflation in Italy's Interwar Period." One of their theses is that the Italian economy performed better than the American economy because of a looser monetary policy through an inventive channel of the lender of last resort. The authors also detail the achievements and the reasons for the abandonment of Mussolini's strong lira policy and derive some insights about the suitability of fixed exchange rates for domestic stabilization programs. Despite the overt pro-inflation favoritism of their contribution, the discussion of the relation between deflation and depression is highly instructive. They retain only two causal factors for depressing real economic activity: the collapse of international trade and nominal wage rigidities (p. 236). Furthermore, the reason why depression in Italy was less severe than in the United States is rooted in the relatively more flexible nominal wages there:

There is a significant difference between Italy and the United States concerning the relationship between price deflation and output growth. During the 1927-1933 period, the two variables are highly and positively correlated for the United States and *uncorrelated for Italy*. These patterns suggest that nominal rigidities were more of a force in the United States than in Italy. (pp. 236-37; emphasis added)

In the final analysis, the authors should have concluded that the data from Italy support the finding that there is no relation whatever between deflation and depression. Then, they should have looked for institutional factors in the Italian economy that could account for the 12 percent decrease in industrial production in the 1929-1934 period.

Special attention is paid to the institutional framework and its impact upon the economy in Lance Davis, Larry Neal, and Eugene White's "Deflation, the Financial Crises of the 1890s, and Stock Exchange Responses in London, New York, Paris, and Berlin." The authors undertake a comparative study of the evolutions on these major stock exchanges with the view to establish how different political and legal arrangements alter the effects of deflation on the economy. The research project is praiseworthy, and the article synthesizes extremely interesting and curious pieces of information. Thus, it appears for example that by the 1890s the volume of business on the *Coulisse*, the unofficial stock exchange in Paris, was more than 50 percent greater than that in the official market (p. 287). The authors show how political forces and self-protective measures by stockbrokers curtailed competition on financial markets respectively in France and Great Britain. Free-market competition on the NYSE is considered as instrumental in allowing self-interested innovations to prevent financial activity from declining despite the decrease in asset prices. The lesson that the reader is invited to draw is that in the long-run the economies with more competitive financial markets behaved better than the others. This last conclusion, however, if not to be taken as self-evident, is not supported by any evidence. Even though the authors are very successful in showing that financial markets did develop even during deflation, they unfortunately fail to substantiate their claim that less political and legal interventionism was comparatively better for the real economy.

This last criticism is not unimportant. Many of the contributions to the volume contain interesting data and give vivid sketches of episodes of economic and financial history. However, they are badly in want of a solid theory that would allow the authors to arrive at a justifiable and correct interpretation of past events. Even though empirical elements that demystify deflation do exist in the collection, they are scattered, not always exploited, and will probably not have the impact on the economic profession one could hope for. The unsatisfactory usage of historical data is due to theoretical weaknesses.

DEFLATION AND THE FUNDAMENTALS OF MONETARY THEORY

What *Deflation* really suffers from is a neglect of the most basic propositions of monetary theory. The first and foremost monetary law states that the economy can adapt itself to any quantity of money, and therefore one cannot speak of an optimal quantity of money that would correspond to any particular set of circumstances. Even though this adaptation takes time and brings about a redistribution of property, no causal relation whatever can be established between changes in the quantity of money and changes in aggregate production. On the other hand, monetary prices do change in such an asymmetrical way, spatially as well as temporally, that monetary neutrality is never possible.⁹

The second most essential conclusion of monetary theory establishes the differences between monetary competition and government monopoly in the production of money. Monetary competition does not only mean that a bunch of commodity monies are competing between themselves, but that their producers have to compete with the producers of any other good in the economy in order to attract the much needed labor and capital. This implies that the quantities of the various free-market monies are ultimately determined by consumers' preferences. Under monetary competition nothing dictates that the various monies be physically used in exchanges—rather they can be represented in actual exchanges by money substitutes. Government intervention in the production of money dramatically changes these basic characteristics of the monetary framework. An increase in a monopolistically produced paper money, protected by legal tender legislation, is not subject to consumers' choice and therefore depends exclusively upon the discretion of the monetary authority. Banks are no longer required to keep one hundred percent reserves and they may engage in a fraudulent production of fiduciary media that only partially represent money. Bank credit, which does not imply a previous act of saving and is hence fundamentally different from real or commodity credit, becomes possible and plays a crucial role for the occurrence of booms and busts.

The articles in *Deflation* ignore all this economic knowledge and often present contrary ideas without even an attempt at a justification. Thus, Capie and Wood assert that “New gold discoveries in the 1890s helped alleviate the *gold shortage*, and prices began to rise again” (p. 68; emphasis added). But how could the quantity of gold money have ever been insufficient if money's utility stems from its purchasing power and prices can always adjust in order to satisfy any demand for real cash balances? Rockoff seems to have fallen prey to another common fallacy when he contends that

⁹For demonstrations of this proposition, cf. Mises (1998, pp. 416-19), Rothbard (2004, pp. 764-66), and Hülsmann (2003b).

a chart depicting gains and losses of deposits by federal reserve district in 1929–1930 “illustrates the tendency of deposits to move from the smaller, *and therefore* weaker, banking systems to larger, *and therefore* stronger, systems” (p. 45; emphases added). The author does not explain how exactly the total volume of assets of a bank implies this inverse consequence upon the likelihood of its going bankrupt. The economics of fractional reserve banking establishes that such an implication is unsustainable.

Another economic error is uttered by such a keen scholar of the gold standard as Michael Bordo who is convinced, together with Olivier Jeanne, that “Restricting monetary policy implies immediate costs in terms of lower output and inflation” (p. 131). The authors must be considering this “implication” for a trivial truth, otherwise they would have cared to sketch a justification of it. The quest for such an explanation would have revealed that the positive relation between output and quantity of money, though not impossible, is certainly not inevitable. This same false belief of the existence of a Phillips curve is what ultimately accounts for the *insulation* virtues that two of the contributions ascribe to depreciation and inflation.¹⁰ Fregert and Jonung are persuaded that “The policy measure that most significantly influenced the rapid expansion of the Swedish economy during the 1930s compared with countries that remained on gold was the depreciation of the krona” (p. 114). Commenting upon the same historical episode, Michael Hutchison in his otherwise well-documented and complete “Deflation and Stagnation in Japan: Collapse of the Monetary Transmission Mechanism and Echo From the 1930s” supposes that the abandonment of the gold standard was causally connected to the recovery of the economy: “Sweden was similarly adversely affected by maintaining the gold standard, and recovery was enhanced when it was abandoned” (p. 262). Another fallacious implication that we cannot omit mentioning here is the relation that Bordo and Redish see between growth and instability, with a certain Marxist flavor: “the United States was much more developed than Canada and, *hence*, was *more* exposed to the business cycle” (p. 192; emphasis added).

This is not an exhaustive list of the erroneous theoretical elements on which most of the contributions are resting. We only intend to show here that the scattered bits of economics in *Deflation* are unsatisfactory and that the volume essentially lacks a sound theoretical framework. One understands now why the collection is encapsulated in the simplistic and contradictory distinction between “good” and “bad” deflation as presented in the first section above, neglecting Salerno’s recent contribution to a sophisticated and coherent taxonomy of deflations (Salerno 2003). Salerno’s taxonomy makes it clear that one cannot fully understand deflations unless a distinction is made between a market-driven deflation and an intervention-imposed deflation. Ultimately then, it is the absence of an analysis of the nature and consequences of government intervention in the production of money that is the greatest weakness of *Deflation*. Even though the empirical content of the volume is quite significant, as portrayed mainly in the second section above, we doubt that the book will manage to

¹⁰The *insulation* thesis assumes that an appropriate domestic monetary management can protect an economy against an external shock, to such an extent as to make domestic economic activity insulated, i.e., independent, from economic conditions in other countries. For a recent presentation of the insulation thesis, and a systematic and convincing exposition of the error it contains, cf. Glavan (2005).

make economists think differently about deflation given its theoretical flaws. The editors' warning in the Preface that "the study of deflation is, in many ways, in its infancy" could not have been more accurate.

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