Money, Bank Credit, *and* Economic Cycles

Jesús Huerta de Soto

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Third Edition

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Jesús Huerta de Soto

Translated by Melinda A. Stroup

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Preface to the Third English Edition

The three years since the publication of the previous English edition of *Money, Bank Credit, and Economic Cycles* have seen a continuation of the economic recession process set in motion after the 2007 financial crisis. This process has consisted of the inevitable microeconomic readjustment and realignment of a real productive structure which the credit expansion of the prior "speculative bubble" years had rendered unsustainable. Though governments' fiscal and monetary policies have on many occasions been erratic and counterproductive, in the end, enormous growth in public deficits has brought on a sovereign public debt crisis in international markets. This crisis has been so severe that one by one, the different governments have been forced to take measures, even if timid ones, in the right direction, measures to reduce public spending, interventionism, and regulation of the economy, and to liberalize factor markets and make them more flexible, especially the labor market.

With this in mind, we must consider the situation of those countries, like Spain, which for the first time in their history have had to face a profound economic crisis without the ability to implement monetary policy on their own, as they now belong to the European Monetary Union. For these countries, the euro has played a role similar to that once played by the gold standard: it has put an end to monetary nationalism and to the possibility of reacting to a crisis by expanding the money supply, depreciating or devaluing the currency, and postponing indefinitely the necessary structural, austerity

reforms in the public sector and economic liberalization. Oddly enough, for the first time, European politicians have had no choice but to finally tell citizens the truth about the seriousness of the situation, and to undertake reforms which until now seemed utterly impossible politically. Moreover, even if only for this reason, at least those members of the monetary union which until now have tended to follow less austere and more irresponsible economic policies should be particularly grateful to the euro.[1]

In this economic and political context, the analysis this book contains of the causes of the crisis and the reforms which must be applied to the current banking and financial system to prevent the predictable reemergence of these causes in the future could not be more timely or important. As a case in point, we have the presentation before the British Parliament by two Tory MPs of a bill designed to bring about the culmination of Peel's Bank Charter Act of July 19, 1844 (which, curiously, is still in effect) by extending the requirement of a 100-percent reserve to demand deposits and their equivalents. This action is in perfect keeping with one of the three prescriptions found in this book (the other two being the elimination of central banks and a return to the classical gold standard), the author of which they expressly cited in their presentation before the House of Commons.[2] In any case, the very fact that this reform proposal is being discussed on a political level is, in and of itself, extremely significant, and it raises the hope that we may now be moving in the right direction.

[1]Without a doubt, Germany has a different perspective, since its traditional monetary austerity is in danger of becoming destabilized by the euro. See Philipp Bagus, *The Tragedy of the Euro* (Auburn, Ala.: Ludwig von Mises Institute, 2011).

[2]See the *Financial Services (Regulation of Deposits and Lending) Bill* presented before the British Parliament on September 15, 2010 by the Tory MPs for Clacton and Wycombe, Douglas Carswell and Steve Baker. Their presentation speech appears in the official record of parliamentary debates, *Hansard*, for the above date (vol. 515, no. 46, pp. 904–05).

Another source of hope, and also satisfaction, for the author of these lines, is the growing number of foreign language translations of this book which have appeared in the short time since the last edition was published in 2009. To be specific, during this period, the book has come out in Polish, Czech, Romanian, Dutch, French, German, and Italian. In short, at the time of this writing, the book has been translated into thirteen different languages and published in ten different countries.[3]

At any rate, whether or not these signs are in the future confirmed and our efforts crowned with success, our inalienable responsibility as university students and economic theorists is to focus all our efforts on research and the quest for scientific truth, and thus to pass on to future generations a body of knowledge and principles which permits them to further, without limits or hindrance, the advancement of humanity and civilization.

Jesús Huerta de Soto
Madrid
April 21, 2011

[3]The author wishes to express his sincere gratitude to the translators and publishers of the following editions: Polish (translation by Grzegorz Luczkiewicz, published in Warsaw by the Instytut Ludwiga von Misesa in 2009); Czech and Slovak (translation by M. Froněk, A. Tuma, D. Vořechovský, J. Havel, and M. Janda, published in Prague by ASPI-Wolters Kluwer in 2009); Romanian (translation by Diana Costea and Tudor Smirna, published in Iaşi by the Universitatea "Alexandru Ioan Cuza" in 2010); Dutch and Flemish (translation by Tuur Demeester and Koen Swinkels, published in Leuven and the Hague by ACCO in 2011); French (translation by Professor Rosine Létinier, published in Paris by L'Harmattan in 2011); German (translation by Professor Philipp Bagus, published by Lucius & Lucius in 2011); and Italian (translation by Giancarlo Ianulardo, published by Rubbettino in 2011). The Chinese, Portuguese, Japanese, and Arabic translations have been completed and, God willing, will soon be published. Finally, Serbian, Hungarian, Greek, Turkish, Swedish, Finnish, Bulgarian, Hindi and Korean translations are currently under preparation.

PREFACE TO THE SECOND ENGLISH EDITION

I am happy to present the second English edition of *Money, Bank Credit, and Economic Cycles*. Its appearance is particularly timely, given that the severe financial crisis and resulting worldwide economic recession I have been forecasting, since the first edition of this book came out ten years ago, are now unleashing their fury.

The policy of artificial credit expansion central banks have permitted and orchestrated over the last fifteen years could not have ended in any other way. The expansionary cycle which has now come to a close began gathering momentum when the American economy emerged from its last recession (fleeting and repressed though it was) in 2001 and the Federal Reserve reembarked on the major artificial expansion of credit and investment initiated in 1992. This credit expansion was not backed by a parallel increase in voluntary household saving. For several years, the money supply in the form of bank notes and deposits has grown at an average rate of over 10 percent per year (which means that every seven years the total volume of money circulating in the world could have been doubled). The media of exchange originating from this severe fiduciary inflation have been placed on the market by the banking system as newly-created loans granted at very low (and even negative in real terms) interest rates. The above fueled a speculative bubble in the

shape of a substantial rise in the prices of capital goods, real-estate assets and the securities which represent them, and are exchanged on the stock market, where indexes soared.

Curiously, like in the "roaring" years prior to the Great Depression of 1929, the shock of monetary growth has not significantly influenced the prices of the subset of consumer goods and services (approximately only one third of all goods). The last decade, like the 1920s, has seen a remarkable increase in productivity as a result of the introduction on a massive scale of new technologies and significant entrepreneurial innovations which, were it not for the injection of money and credit, would have given rise to a healthy and sustained reduction in the unit price of consumer goods and services. Moreover, the full incorporation of the economies of China and India into the globalized market has boosted the real productivity of consumer goods and services even further. The absence of a healthy "deflation" in the prices of consumer goods in a stage of such considerable growth in productivity as that of recent years provides the main evidence that the monetary shock has seriously disturbed the economic process. I analyze this phenomenon in detail in chapter 6, section 9.

As I explain in the book, artificial credit expansion and the (fiduciary) inflation of media of exchange offer no short cut to stable and sustained economic development, no way of avoiding the necessary sacrifice and discipline behind all high rates of voluntary saving. (In fact, particularly in the United States, voluntary saving has not only failed to increase in recent years, but at times has even fallen to a negative rate.) Indeed, the artificial expansion of credit and money is never more than a short-term solution, and that at best. In fact, today there is no doubt about the recessionary quality the monetary shock always has in the long run: newly-created loans (of money citizens have not first saved) immediately provide entrepreneurs with purchasing power they use in overly ambitious investment projects (in recent years, especially in the building sector and real estate development). In other words, entrepreneurs act as if citizens had increased their saving, when they have not actually done so. Widespread discoordination in the economic

system results: the financial bubble ("irrational exuberance") exerts a harmful effect on the real economy, and sooner or later the process reverses in the form of an economic recession, which marks the beginning of the painful and necessary readjustment. This readjustment invariably requires the reconversion of every real productive structure inflation has distorted. The specific triggers of the end of the euphoric monetary "binge" and the beginning of the recessionary "hangover" are many, and they can vary from one cycle to another. In the current circumstances, the most obvious triggers have been the rise in the price of raw materials, particularly oil, the subprime mortgage crisis in the United States, and finally, the failure of important banking institutions when it became clear in the market that the value of their liabilities exceeded that of their assets (mortgage loans granted).

At present, numerous self-interested voices are demanding further reductions in interest rates and new injections of money which permit those who desire it to complete their investment projects without suffering losses. Nevertheless, this escape forward would only temporarily postpone problems at the cost of making them far more serious later. The crisis has hit because the profits of capital-goods companies (especially in the building sector and in real-estate development) have disappeared due to the entrepreneurial errors provoked by cheap credit, and because the prices of consumer goods have begun to perform relatively less poorly than those of capital goods. At this point, a painful, inevitable readjustment begins, and in addition to a decrease in production and an increase in unemployment, we are now still seeing a harmful rise in the prices of consumer goods (stagflation).

The most rigorous economic analysis and the coolest, most balanced interpretation of recent economic and financial events support the conclusion that central banks (which are true financial central-planning agencies) cannot possibly succeed in finding the most advantageous monetary policy at every moment. This is exactly what became clear in the case of the failed attempts to plan the former Soviet economy from above. To put it another way, the theorem of the economic impossibility of socialism, which the Austrian economists

Ludwig von Mises and Friedrich A. Hayek discovered, is fully applicable to central banks in general, and to the Federal Reserve—(at one time) Alan Greenspan and (currently) Ben Bernanke—in particular. According to this theorem, it is impossible to organize society, in terms of economics, based on coercive commands issued by a planning agency, since such a body can never obtain the information it needs to infuse its commands with a coordinating nature. Indeed, nothing is more dangerous than to indulge in the "fatal conceit"—to use Hayek's useful expression—of believing oneself omniscient or at least wise and powerful enough to be able to keep the most suitable monetary policy fine tuned at all times. Hence, rather than soften the most violent ups and downs of the economic cycle, the Federal Reserve and, to some lesser extent, the European Central Bank, have most likely been their main architects and the culprits in their worsening. Therefore, the dilemma facing Ben Bernanke and his Federal Reserve Board, as well as the other central banks (beginning with the European Central Bank), is not at all comfortable. For years they have shirked their monetary responsibility, and now they find themselves in a blind alley. They can either allow the recessionary process to begin now, and with it the healthy and painful readjustment, or they can escape forward toward a "hair of the dog" cure. With the latter, the chances of even more severe stagflation in the not-too-distant future increase exponentially. (This was precisely the error committed following the stock market crash of 1987, an error which led to the inflation at the end of the 1980s and concluded with the sharp recession of 1990–1992.) Furthermore, the reintroduction of a cheap-credit policy at this stage could only hinder the necessary liquidation of unprofitable investments and company reconversion. It could even wind up prolonging the recession indefinitely, as has occurred in Japan in recent years: though all possible interventions have been tried, the Japanese economy has ceased to respond to any monetarist stimulus involving credit expansion or Keynesian methods. It is in this context of "financial schizophrenia" that we must interpret the latest "shots in the dark" fired by the monetary authorities (who have two totally contradictory responsibilities: both to control

inflation and to inject all the liquidity necessary into the financial system to prevent its collapse). Thus, one day the Federal Reserve rescues Bear Stearns (and later AIG, Fannie Mae, and Freddie Mac or Citigroup), and the next it allows Lehman Brothers to fail, under the amply justified pretext of "teaching a lesson" and refusing to fuel moral hazard. Then, in light of the way events were unfolding, a 700-billion-dollar plan to purchase the euphemistically named "toxic" or "illiquid" (i.e., worthless) assets from the banking system was approved. If the plan is financed by taxes (and not more inflation), it will mean a heavy tax burden on households, precisely when they are least able to bear it. Finally, in view of doubts about whether such a plan could have any effect, the choice was made to inject public money directly into banks, and even to "guarantee" the total amount of their deposits, decreasing interest rates to almost zero percent.

In comparison, the economies of the European Union are in a somewhat less poor state (if we do not consider the expansionary effect of the policy of deliberately depreciating the dollar, and the relatively greater European rigidities, particularly in the labor market, which tend to make recessions in Europe longer and more painful). The expansionary policy of the European Central Bank, though not free of grave errors, has been somewhat less irresponsible than that of the Federal Reserve. Furthermore, fulfillment of the convergence criteria involved at the time a healthy and significant rehabilitation of the chief European economies. Only the countries on the periphery, like Ireland and particularly Spain, were immersed in considerable credit expansion from the time they initiated their processes of convergence. The case of Spain is paradigmatic. The Spanish economy underwent an economic boom which, in part, was due to real causes (liberalizing structural reforms which originated with José María Aznar's administration in 1996). Nevertheless, the boom was also largely fueled by an artificial expansion of money and credit, which grew at a rate nearly three times that of the corresponding rates in France and Germany. Spanish economic agents essentially interpreted the decrease in interest rates which resulted from the convergence process in the easy-money terms traditional in Spain: a greater availability of easy money and mass

requests for loans from Spanish banks (mainly to finance real-estate speculation), loans which these banks have granted by creating the money *ex nihilo* while European central bankers looked on unperturbed. When faced with the rise in prices, the European Central Bank has remained faithful to its mandate and has tried to maintain interest rates as long as possible, despite the difficulties of those members of the Monetary Union which, like Spain, are now discovering that much of their investment in real estate was in error and are heading for a lengthy and painful reorganization of their real economy.

Under these circumstances, the most appropriate policy would be to liberalize the economy at all levels (especially in the labor market) to permit the rapid reallocation of productive factors (particularly labor) to profitable sectors. Likewise, it is essential to reduce public spending and taxes, in order to increase the available income of heavily-indebted economic agents who need to repay their loans as soon as possible. Economic agents in general and companies in particular can only rehabilitate their finances by cutting costs (especially labor costs) and paying off loans. Essential to this aim are a very flexible labor market and a much more austere public sector. These factors are fundamental if the market is to reveal as quickly as possible the real value of the investment goods produced in error and thus lay the foundation for a healthy, sustained economic recovery in a future which, for the good of all, I hope is not long in coming.

We must not forget that a central feature of the recent period of artificial expansion was a gradual corruption, on the American continent as well as in Europe, of the traditional principles of accounting as practiced globally for centuries. To be specific, acceptance of the International Accounting Standards (IAS) and their incorporation into law in different countries (in Spain via the new General Accounting Plan, in effect as of January 1, 2008) have meant the abandonment of the traditional principle of prudence and its replacement by

the principle of fair value in the assessment of the value of balance sheet assets, particularly financial assets. In this abandonment of the traditional principle of prudence, a highly influential role has been played by brokerages, investment banks (which are now on their way to extinction), and in general, all parties interested in "inflating" book values in order to bring them closer to supposedly more "objective" stock-market values, which in the past rose continually in an economic process of financial euphoria. In fact, during the years of the "speculative bubble," this process was characterized by a feedback loop: rising stock-market values were immediately entered into the books, and then such accounting entries were sought as justification for further artificial increases in the prices of financial assets listed on the stock market.

In this wild race to abandon traditional accounting principles and replace them with others more "in line with the times," it became common to evaluate companies based on unorthodox suppositions and purely subjective criteria which in the new standards replace the only truly objective criterion (that of historical cost). Now, the collapse of financial markets and economic agents' widespread loss of faith in banks and their accounting practices have revealed the serious error involved in yielding to the IAS and their abandonment of traditional accounting principles based on prudence, the error of indulging in the vices of creative, fair-value accounting.

It is in this context that we must view the recent measures taken in the United States and the European Union to "soften" (i.e., to partially reverse) the impact of fair-value accounting for financial institutions. This is a step in the right direction, but it falls short and is taken for the wrong reasons. Indeed, those in charge at financial institutions are attempting to "shut the barn door when the horse is bolting"; that is, when the dramatic fall in the value of "toxic" or "illiquid" assets has endangered the solvency of their institutions. However, these people were delighted with the new IAS during the preceding years of "irrational exuberance," in which increasing and excessive values in the stock and financial markets graced their balance sheets with staggering figures corresponding to

their own profits and net worth, figures which in turn encouraged them to run risks (or better, uncertainties) with practically no thought of danger. Hence, we see that the IAS act in a pro-cyclic manner by heightening volatility and erroneously biasing business management: in times of prosperity, they create a false "wealth effect" which prompts people to take disproportionate risks; when, from one day to the next, the errors committed come to light, the loss in the value of assets immediately decapitalizes companies, which are obliged to sell assets and attempt to recapitalize at the worst moment, i.e., when assets are worth the least and financial markets dry up. Clearly, accounting principles which, like those of the IAS, have proven so disturbing must be abandoned as soon as possible, and all of the accounting reforms recently enacted, specifically the Spanish one, which came into effect January 1, 2008, must be reversed. This is so not only because these reforms mean a dead end in a period of financial crisis and recession, but especially because it is vital that in periods of prosperity we stick to the principle of prudence in valuation, a principle which has shaped all accounting systems from the time of Luca Pacioli at the beginning of the fifteenth century to the adoption of the false idol of the IAS.

In short, the greatest error of the accounting reform recently introduced worldwide is that it scraps centuries of accounting experience and business management when it replaces the prudence principle, as the highest ranking among all traditional accounting principles, with the "fair value" principle, which is simply the introduction of the volatile market value for an entire set of assets, particularly financial assets. This Copernican turn is extremely harmful and threatens the very foundations of the market economy for several reasons. First, to violate the traditional principle of prudence and require that accounting entries reflect market values is to provoke, depending upon the conditions of the economic cycle, an inflation of book values with surpluses which have not materialized and which, in many cases, may never materialize. The artificial "wealth effect" this can produce, especially during the boom phase of each economic cycle, leads to the allocation of paper (or merely temporary) profits, the

acceptance of disproportionate risks, and in short, the commission of systematic entrepreneurial errors and the consumption of the nation's capital, to the detriment of its healthy productive structure and its capacity for long-term growth. Second, I must emphasize that the purpose of accounting is not to reflect supposed "real" values (which in any case are subjective and which are only objectively determined and vary daily in the corresponding markets) under the pretext of attaining a (poorly understood) "accounting transparency." Instead, the purpose of accounting is to permit the prudent management of each company and to prevent capital consumption,[1] by applying strict standards of accounting conservatism (based on the prudence principle and the recording of either historical cost or market value, whichever is less), standards which ensure at all times that distributable profits come from a safe surplus which can be distributed without in any way endangering the future viability and capitalization of the company. Third, we must bear in mind that in the market there are no equilibrium prices a third party can objectively determine. Quite the opposite is true; market values arise from subjective assessments and fluctuate sharply, and hence their use in accounting eliminates much of the clarity, certainty, and information balance sheets contained in the past. Today, balance sheets have become largely unintelligible and useless to economic agents. Furthermore, the volatility inherent in market values, particularly over the economic cycle, robs accounting based on the "new principles" of much of its potential as a guide for action for company managers and leads them to systematically commit major errors in management, errors which have been on the verge of provoking the severest financial crisis to ravage the world since 1929.

[1]See especially F. A. Hayek, "The Maintenance of Capital," *Economica* 2 (August 1934), reprinted in *Profits, Interest and Investment and Other Essays on the Theory of Industrial Fluctuations* (Clifton, N.J.: Augustus M. Kelley, 1979; first edition London: George Routledge & Sons, 1939). See especially section 9, "Capital Accounting and Monetary Policy," pp. 130–32.

In chapter 9 of this book (pages 789–803), I design a process of transition toward the only world financial order which, being fully compatible with the free-enterprise system, can eliminate the financial crises and economic recessions which cyclically affect the world's economies. The proposal the book contains for international financial reform has acquired extreme relevance at the present time (November 2008), in which the disconcerted governments of Europe and America have organized a world conference to reform the international monetary system in order to avoid in the future such severe financial and banking crises as the one that currently grips the entire western world. As is explained in detail over the nine chapters of this book, any future reform will fail as miserably as past reforms unless it strikes at the very root of the present problems and rests on the following principles: (1) the reestablishment of a 100-percent reserve requirement on all bank demand deposits and equivalents; (2) the elimination of central banks as lenders of last resort (which will be unnecessary if the preceding principle is applied, and harmful if they continue to act as financial central-planning agencies); and (3) the privatization of the current, monopolistic, and fiduciary state-issued money and its replacement with a classic pure gold standard. This radical, definitive reform would essentially mark the culmination of the 1989 fall of the Berlin Wall and real socialism, since the reform would mean the application of the same principles of liberalization and private property to the only sphere, that of finance and banking, which has until now remained mired in central planning (by "central" banks), extreme interventionism (the fixing of interest rates, the tangled web of government regulations), and state monopoly (legal tender laws which require the acceptance of the current, state-issued fiduciary money), circumstances with very negative and dramatic consequences, as we have seen.

I should point out that the transition process designed in the last chapter of this book could also permit from the outset the bailing out of the current banking system, thus preventing

its rapid collapse, and with it the sudden monetary squeeze which would be inevitable if, in an environment of widespread broken trust among depositors, a significant volume of bank deposits were to disappear. This short-term goal, which at present, western governments are desperately striving for with the most varied plans (the massive purchases of "toxic" bank assets, the *ad hominem* guarantee of all deposits, or simply the partial or total nationalization of the private banking system), could be reached much faster and more effectively, and in a manner much less harmful to the market economy, if the first step in the proposed reform (pages 791–98) were immediately taken: to back the total amount of current bank deposits (demand deposits and equivalents) with cash, bills to be turned over to banks, which from then on would maintain a 100-percent reserve with respect to deposits. As illustrated in chart IX-2 of chapter 9, which shows the consolidated balance sheet for the banking system following this step, the issuance of these banknotes would in no way be inflationary (since the new money would be "sterilized," so to speak, by its purpose as backing to satisfy any sudden deposit withdrawals). Furthermore, this step would free up all banking assets ("toxic" or not) which currently appear as backing for demand deposits (and equivalents) on the balance sheets of private banks. On the assumption that the transition to the new financial system would take place under "normal" circumstances, and not in the midst of a financial crisis as acute as the current one, I proposed in chapter 9 that the "freed" assets be transferred to a set of mutual funds created *ad hoc* and managed by the banking system, and that the shares in these funds be exchanged for outstanding treasury bonds and for the implicit liabilities connected with the public social-security system (pp. 796–97). Nevertheless, in the current climate of severe financial and economic crisis, we have another alternative: apart from canceling "toxic" assets with these funds, we could devote a portion of the rest, if desired, to enabling savers (not depositors, since their deposits would already be backed 100 percent) to recover a large part of the value lost in their investments (particularly in loans to commercial banks, investment banks, and holding companies). These measures would

immediately restore confidence and would leave a significant remainder to be exchanged, once and for all and at no cost, for a sizeable portion of the national debt, our initial aim.[2] In any case, an important warning must be given: naturally, and I must never tire of repeating it, the solution proposed is only valid in the context of an irrevocable decision to reestablish a free-banking system subject to a 100-percent reserve requirement on demand deposits. Any of the reforms noted above, if adopted in the absence of a prior, firm conviction and decision to change the international financial and banking system as indicated, would be simply disastrous: a private banking system which continued to operate with a fractional reserve (orchestrated by the corresponding central banks), would generate, in a cascading effect, and based on the cash created to back deposits, an inflationary expansion like none other in history, one which would eventually finish off our entire economic system.

The above considerations are crucially important and reveal how very relevant this treatise has now become in light of the critical state of the international financial system (though I would definitely have preferred to write the preface to this new edition under very different economic circumstances). Nevertheless, while it is tragic that we have arrived at the current situation, it is even more tragic, if possible, that there exists a widespread lack of understanding regarding the causes of the phenomena that plague us, and especially an atmosphere of confusion and uncertainty prevalent among experts, analysts, and most economic theorists. In this area at least, I can hope the successive editions of this book which are

[2]On this matter, see also my "Hayek Memorial Lecture" delivered at the London School of Economics and Political Science on October 28, 2010; published with the title "Economic Recessions, Banking Reform and the Future of Capitalism," *Economic Affairs*, June 2011, pp. 76–84.

being published all over the world[3] may contribute to the theoretical training of readers, to the intellectual rearmament of new generations, and eventually, to the sorely needed institutional redesign of the entire monetary and financial system of current market economies. If this hope is fulfilled, I will not only view the effort made as worthwhile, but will also deem it a great honor to have contributed, even in a very small way, to movement in the right direction.

Jesús Huerta de Soto
Madrid
November 13, 2008

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[3]Since the appearance of the first English-language edition, the third and fourth Spanish editions have been published in 2006 and 2009. Moreover, Tatjana Danilova and Grigory Sapov have completed a Russian translation, which has been published as *Dengi, Bankovskiy Kredit i Ekonomicheskie Tsikly* (Moscow: Sotsium Publishing House, 2008). Three thousand copies have been printed initially, and I had the satisfaction of presenting the book October 30, 2008 at the Higher School of Economics at Moscow State University. In addition, Professor Rosine Létinier has produced the French translation, which is now pending publication. Grzegorz Luczkiewicz has completed the Polish translation, and translation into the following languages is at an advanced stage: German, Czech, Italian, Romanian, Dutch, Chinese, Japanese, and Arabic. God willing, may they soon be published.

Preface to the First English-Language Edition

It is a genuine pleasure for me to see this handsomely-printed English edition of my book, *Dinero, Crédito Bancario y Ciclos Económicos*, which first appeared in Spain in 1998. This translation incorporates the small number of corrections included in the second Spanish edition of January 2002, and it is the result of the great effort of Melinda A. Stroup, who wrote the first English manuscript of the entire book.

This English version was thoroughly examined by Dr. Jörg Guido Hülsmann, whose comments on several important points improved the manuscript significantly. I would also like to acknowledge the work of my research assistant, Dr. Gabriel Calzada, who searched for various English editions of rare books unavailable in Spain and looked up certain quotations and references. Last, I personally inspected the final version in its entirety to ensure the accuracy of its content.

I am grateful to the Ludwig von Mises Institute, and especially to its president, Lewellyn H. Rockwell, Jr., for bringing the project to its culmination with such high standards.

Jesús Huerta de Soto
Señorío de Sarría
May 2005

Note: The author welcomes any comments on this English-language edition and requests they be sent to huertadesoto@dimasoft.es.

Preface to the Third Spanish Edition

In this, the third edition of *Dinero, Crédito Bancario y Ciclos Económicos*, an attempt has been made to preserve as far as possible the contents, structure, and page numbering of the two previous editions. However, changes have been necessary in certain cases, as I have taken this new opportunity to raise some additional arguments and points, both in the main text and in several footnotes. Also, the bibliography has been updated with the new editions and Spanish translations which have appeared in the four years since the previous edition, and with a few new books and articles which have a particular bearing on the topics covered in the book.[1] Finally, the editor of the English version, *Money, Bank Credit, and Economic Cycles*,[2] Judith Thommesen, very patiently and painstakingly

[1]One such book is Roger W. Garrison's *Time and Money: The Macroeconomics of Capital Structure*, published by Routledge in London and New York in 2001, three years after the appearance of the first Spanish edition of *Money, Bank Credit, and Economic Cycles*. Garrison's text can be viewed as complementary to this one. His book is especially noteworthy, because in it he develops the Austrian analysis of capital and economic cycles in the context of the different paradigms of modern macroeconomics, and the approach and language he uses to do so are fully consistent with those used by the mainstream in our discipline. Hence, Garrison's book will undoubtedly help build awareness among economists in general of the need to consider the Austrian perspective and its comparative advantages. However, I do feel that Garrison's explanations are too mechanistic

verified hundreds of quotations in English and other languages against their original sources. A significant number of small misprints had been detected and have now been rectified, and thus her efforts have helped to make this third edition even more polished. I am deeply grateful to her, as well as to Dr. Gabriel Calzada, Associate Professor at the Universidad Rey Juan Carlos, for his assistance in reviewing and correcting certain bibliographic references.

In the interval since the publication of the previous edition, economic trends have been marked by the high fiduciary inflation and the sharp increase in public deficits necessary to finance the war in Iraq and to meet the rising costs which the "welfare state," plagued by severe and insoluble problems, generates in most western countries. The money supply and the interest rate have been subject to further manipulation. In fact, the United States Federal Reserve lowered the rate to a historical minimum of 1 percent, thus preventing the necessary correction of the investment errors committed prior to the 2001 recession. The above circumstances have triggered a new speculative bubble in real estate markets, along with a dramatic rise in the price of the energy products and raw materials which are the object of almost unlimited demand on a worldwide scale, due to new investment projects undertaken mainly in the Asiatic basin, and particularly in China. Thus, we seem to be approaching the typical turning-point phase of

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and that he falls short of providing sufficient justification for his analysis from the juridical-institutional standpoint. Nonetheless, I thought it advisable to promote the book's translation into Spanish by a team of professors and disciples from my department at the Universidad Rey Juan Carlos. Dr. Miguel Ángel Alonso Neira led the team, and the translation has already been published in Spain under the title *Tiempo y dinero: la macroeconomía en la estructura del capital* (Madrid: Unión Editorial, 2005). Finally, we should recommend also the encyclopedic work of Ludwig van den Hauwe, *Foundations of Business Cycle Research* (Saarbrücken, Germany: VDM Verlag Dr. Müller, 2009).

[2]The English edition was beautifully published in 2006 as *Money, Bank Credit, and Economic Cycles* under the auspices of the Ludwig von Mises Institute in Auburn, Alabama, thanks to the support of the Institute's president, Llewellyn H. Rockwell.

the cycle, the phase which precedes every economic recession. Moreover, the very recent 180-degree turn in the monetary policy of the Federal Reserve, which has jacked up interest rates to 4 percent in only a few months, confirms the trend even further.

It is my hope that this new edition will help readers and scholars to better understand the economic phenomena of the world that surrounds them. May it also serve to convince specialists and framers of current economic policy that we must abandon social engineering in the monetary and financial sphere as soon as possible. The attainment of these goals will mean the complete fulfilment of one of my primary objectives.

Jesús Huerta de Soto
Formentor
August 28, 2005

PREFACE TO THE SECOND SPANISH EDITION

Following the success of the first edition of *Dinero, Crédito Bancario y Ciclos Económicos*, which sold out rapidly, I am pleased to present the second edition to Spanish-speaking readers. To avoid confusion and facilitate the work of scholars and researchers, the contents, structure, and page numbering of the first edition have been maintained in the second, though the book has been thoroughly examined and all misprints detected have been eliminated.

In the wake of a decade marked by great credit expansion and the development of a large financial bubble, the course of economic events in the world from 1999 through 2001 was characterized by the collapse of stock-market values and the emergence of a recession which now simultaneously grips the United States, Europe, and Japan. These circumstances have left the analysis presented in this book even more clearly and fully illustrated than when it was first published, at the end of 1998. While governments and central banks have reacted to the terrorist attack on New York's World Trade Center by manipulating interest rates, reducing them to historically low levels (1 percent in the United States, 0.15 percent in Japan and 2 percent in Europe), the massive expansion of fiduciary media injected into the system will not only prolong and hinder the necessary streamlining of the real productive structure, but may also lead to

dangerous stagflation. In light of these worrisome economic conditions, which have repeated themselves since the emergence of the current banking system, I fervently hope the analysis this book contains will help the reader to understand and interpret the phenomena which surround him and will exert a positive influence on public opinion, my university colleagues and economic-policy authorities in government and central banks.

Various reviews of this book's first edition have appeared, and I am grateful to the eminent authors of them for their many positive comments.[1] A common denominator among all has been to urge the translation of this book into English, a task now complete. It is my hope that, God willing, the first English edition of this book will soon be published in the United States and will thus become available to some of the most influential academic and political circles.

Finally, since 1998 this manual has been employed successfully as a textbook during the semester devoted to the theory of money, banking, and business cycles in courses on Political Economy and in Introduction to Economics, first at the law school of Madrid's Universidad Complutense and later at the school of law and social sciences of the Universidad Rey Juan Carlos, also in Madrid. This educational experience has been based on an institutional and decidedly multidisciplinary approach to economic theory, and I believe this method can be easily and successfully applied to any other course connected with banking theory (Economic Policy, Macroeconomics, Monetary and Financial Theory, etc.). This experience would not have been possible without the keen interest and enthusiasm hundreds of students have expressed each academic year as they studied and discussed the teachings contained in the present volume. This book, to

[1] I am particularly grateful to Leland Yeager (*Review of Austrian Economics* 14 no. 4 [2001]: 255); Jörg Guido Hülsmann (*Quarterly Journal of Austrian Economics* 3, no. 2 [2000]: 85–88); and Ludwig van den Hauwe (*New Perspectives on Political Economy* 2, no. 2 [2006]: 135–41) for their remarks.

which they have dedicated their efforts, is chiefly aimed at them, and I thank all of them. May they continue to cultivate their critical spirit and intellectual curiosity as they progress to higher and increasingly enriching stages in their formative journey.[2]

Jesús Huerta de Soto
Madrid
December 6, 2001

[2]Comments on this second edition are welcome and may be sent to huertadesoto@dimasoft.es.

Introduction

The economic analysis of juridical institutions has come to the fore in recent years and promises to become one of the most fruitful spheres of economics. Much of the work completed thus far has been strongly influenced by traditional neoclassical assumptions, namely by the concept of strict maximization in contexts of equilibrium. Still, economic analyses of law reveal the shortcomings of the traditional approach and do so perhaps better than any other branch of economics. In fact, juridical institutions are so intimately involved in daily life that it is notoriously difficult to apply the traditional assumptions of economic analysis to them. I have already attempted elsewhere to expose the dangers the neoclassical perspective brings to the analysis of juridical institutions.[1] Economic analyses of law are certainly necessary, but they call for a less restrictive methodology than has generally been used to date, one more suited to this particular field of research. The subjectivist view is a more fitting approach. Developed by the Austrian School, it is based on their concept of creative human action or entrepreneurial activity and implies a dynamic analysis of the general processes of social interaction. This perspective promises to make great contributions to the future development of the economic analysis of juridical institutions.

In addition, most studies of juridical institutions carried out so far have had exclusively *microeconomic* implications because, among other reasons, theorists have simply borrowed the traditional analytical tools of neoclassical microeconomics

[1]See Jesús Huerta de Soto, "The Ongoing Methodenstreit of the Austrian School," *Journal des Économistes et des Études Humaines* 8, no. 1 (March 1998): 75–113.

and applied them to the analysis of law. This has been the case, for example, with respect to the economic analysis of contracts and civil liability, bankruptcy law, the family, and even criminal law and justice. Very few economic analyses of law have had mainly *macroeconomic* implications, and this reflects the harmful decades-long separation between these two sides of economics. However, this need not be the case. It is necessary to recognize economics as a unified whole, where macroeconomic elements are firmly rooted in their microeconomic foundations. In addition, I will attempt to demonstrate that the economic analysis of some juridical institutions yields critical implications and conclusions that are essentially macroeconomic. Or, in other words, even when the basic analysis is microeconomic, the conclusions drawn and primary outcomes resulting from it are macroeconomic. By closing the profound artificial gap between micro and macroeconomics, we arrive at a unified theoretical treatment of legal issues in the economic analysis of law.

This is my primary goal as I undertake an economic analysis of the monetary *irregular-deposit* contract, in its different facets. Furthermore, I intend my examination to cast light on one of the most obscure and complex spheres of economics: the theory of money, bank credit, and economic cycles. Now that the issue of socialism has been resolved,[2] at least from a theoretical standpoint, and it has been empirically illustrated to be impracticable, the main theoretical challenge facing economists at the dawn of the twenty-first century lies most likely in the field of money, credit, and financial institutions. The highly abstract nature of social relationships involving money in its various forms makes these relationships remarkably difficult to understand and the corresponding theoretical treatment of them particularly complex. In addition, in the financial and monetary spheres of western countries, a series of institutions has been developed and imposed; namely central banks, bank legislation, a monopoly on the issue of currency,

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[2]Jesús Huerta de Soto, *Socialismo, cálculo económico y función empresarial* (Madrid: Unión Editorial, 1992; 4th ed., 2010). English edition, *Socialism, Economic Calculation and Entrepreneurship* (Cheltenham, U.K. and Northampton, Mass., U.S.A.: Edward Elgar, 2010).

and foreign exchange controls. These institutions thoroughly regulate every country's financial sector, rendering it much more similar to the socialist system of central planning than is appropriate to a true market economy. Hence, as I will attempt to demonstrate, the arguments which establish the impracticability of socialist economic calculation are fully applicable to the financial sphere. Supporters of the Austrian School of economics originally developed these arguments when they showed it was impossible to organize society in a coordinated fashion via dictatorial commands. If my thesis is correct, the impracticability of socialism will also be established in the financial sector. Furthermore, the inevitable discoordination to which all state intervention gives rise will be vividly revealed in the cyclical phases of boom and recession which traditionally affect the mixed economies of the developed world.

Any theoretical study today which attempts to identify the causes, stages, remedies for, and chances of preventing economic cycles is guaranteed to be front-page material. As a matter of fact, as I write these lines (November 1997), a serious financial and banking crisis grips Asian markets and threatens to spread to Latin America and the rest of the western world. This crisis comes in the wake of the period of apparent economic prosperity which in turn followed the severe financial crises and economic recessions that shook the world at the beginning of the nineties and particularly the end of the seventies. Furthermore, in the eyes of ordinary people, politicians, and the majority of economic theorists themselves, an understanding has not yet been reached as to the true causes of these phenomena, the successive and recurrent appearances of which are constantly used by politicians, philosophers, and interventionist theorists alike as a pretext for rejecting a market economy and justifying an increasing level of dictatorial state intervention in the economy and society.

For this reason, from the point of view of classical liberal doctrine, it is of great theoretical interest to scientifically analyze the origin of economic cycles, and in particular, to determine the ideal model for the financial system of a truly free society. Libertarian theorists themselves still disagree in this

area, and there are great differences of opinion as to whether it is necessary to maintain the central bank or whether it would be better to exchange it for a system of free banking, and in the latter case, as to what concrete rules economic agents participating in a completely free financial system should have to follow. The central bank originally appeared as the result of a series of dictatorial government interventions, though these were mainly urged by various agents of the financial sector (specifically by private banks themselves), who on many occasions have considered it necessary to demand state support to guarantee the stability of their business activities during stages of economic crisis. Does this mean the central bank is an inevitable evolutionary outcome of a free-market economy? Or rather, that the way private bankers have characteristically done business, which at a certain point became corrupt from a legal point of view, has brought about financial practices unsustainable without backing from a lender of last resort? These and other issues are of utmost theoretical interest and should be the object of the most careful analysis. In short, my main objective is to develop a research plan to determine which financial and banking system is appropriate for a free society.

I intend this research to be multidisciplinary. It will have to rest not only on the study of juridical science and the history of law, but also on economic theory and specifically on the theory of money, capital, and economic cycles. Furthermore, my analysis will shed new light on some historical economic events related to the financial realm, and will better illustrate the evolution of certain trends in the history of economic thought itself, as well as the development of various accounting and banking techniques. A proper understanding of finance requires the integration of various disciplines and branches of knowledge, and we will consider these from the three perspectives I deem necessary to correctly comprehend any social phenomenon: historical-evolutionary, theoretical, and ethical.[3]

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[3]I have presented the theory of the three-tiered approach to studying social issues in Jesús Huerta de Soto, "Conjectural History and Beyond," *Humane Studies Review* 6, no. 2 (Winter, 1988–1989): 10.

This book comprises nine chapters. In the first I describe the legal essence of the monetary irregular-deposit contract, paying special attention to the main characteristics distinguishing it from a loan contract, or mutuum. In addition, Chapter 1 deals with the different legal logic inherent in these two institutions, their mutual incompatibility at a fundamental level, and how the unique ways each is regulated embody traditional, universal legal principles identified and developed from the time of Roman classical law.

Chapter 2 is a historical study of economic events. There I examine ways in which the traditional legal principle governing the irregular-deposit contract has been corrupted over time, mainly due to the temptation felt by the first bankers to use their depositors' money to their own benefit. The intervention of the political establishment has also played an important role in this process. Always eager to secure new financial resources, political authorities have turned to bankers entrusted with others' deposits and have attempted to exploit these funds, granting the bankers all sorts of privileges, chiefly authorization to use their depositors' money for their own benefit (of course on condition that a significant part of such funds be loaned to the politicians themselves). This chapter offers three different examples (classical Greece and Rome, the resurgence of banking in medieval Italian cities, and the revival of banking in modern times) to illustrate the process by which the traditional legal principles governing the monetary irregular-deposit bank contract have become corrupted and to outline the resulting economic effects.

In chapter 3 I adopt a legal viewpoint to consider different theoretical attempts to come up with a new contractual framework in which to classify the monetary bank-deposit contract. Such attempts are aimed at justifying banks' lending of demand-deposit funds to third parties. I intend to show that these attempts at justification are riddled with an insoluble logical contradiction and therefore doomed to failure. I will also explain how the effects of privileged banking practices (see chapter 2) expose profound contradictions and weaknesses in the formulation of a new legal, theoretical basis for the monetary irregular-deposit contract. The attempt to establish such a

foundation dates back to the Middle Ages and has continued until practically the present day. We will take a detailed look at different efforts to formulate an unorthodox legal principle capable of governing present-day monetary bank deposits in a logical, coherent manner. I conclude that such attempts could not possibly have been successful, because current banking practices are based precisely on the violation of traditional principles inherent in property rights, which cannot be violated without serious harmful effects on the processes of social interaction.

Chapters 4, 5, 6, and 7 comprise the heart of my economic analysis of the bank-deposit contract as it has developed over time; that is, using a fractional-reserve ratio in violation of traditional legal principles. I will explain why Hayek's insightful rule rings true in the banking field as well. This rule states that whenever a traditional legal principle is violated, sooner or later there are serious harmful effects on society. From a theoretical viewpoint, I will analyze the effects the current banking practice of disregarding traditional legal principles in the monetary-deposit contract has on the creation of money, intra- and intertemporal market coordination, entrepreneurship, and economic cycles. My conclusion is that the successive stages of boom, crisis, and economic recession recurring in the market result from the violation of the traditional legal principle on which the monetary bank-deposit contract should be based. They stem from the privilege bankers have come to enjoy and have been granted in the past by governments for reasons of mutual interest. We will study the theory of economic cycles in depth and critically analyze the alternative explanations offered by the monetarist and Keynesian schools for this type of phenomena.

Chapter 8 focuses on the central bank as a lender of last resort. The creation of this institution resulted inevitably from certain events. When the principles which should govern the irregular-deposit contract are violated, such acute and inescapable effects appear that private bankers soon realized they needed to turn to the government for an institution to act on their behalf as lender of last resort and provide support during stages of crisis, which experience demonstrated to be a

recurrent phenomenon. I will endeavor to show that the central bank did not emerge spontaneously as the result of market institutions, but was forcibly imposed by the government and responds to the demands of powerful pressure groups. I will also examine the current financial system, which is based on a central bank, and apply to it the analytical economic theory of the impracticability of socialism. Indeed, the current financial system rests on a monopoly one government agency holds on the chief decisions regarding the type and quantity of money and credit to be created and injected into the economic system. Thus it constitutes a financial market system of "central planning" and therefore involves a high level of intervention and is to a great extent "socialist." Sooner or later the system will inevitably run up against the impossibility of socialist economic calculation, the theorem of which maintains it is impossible to coordinate any sphere of society, especially the financial sphere, via dictatorial mandates, given that the governing body (in this case the central bank) is incapable of obtaining the necessary and relevant information required to do so. The chapter concludes with a review of the recent central-banking/free-banking controversy. We will see that most current free-banking theorists have failed to realize that their plan loses much of its potential and theoretical weight if not accompanied by a call to return to traditional legal principles; that is, to banking with a 100-percent reserve requirement. Freedom must go hand-in-hand with responsibility and strict observance of traditional legal principles.

The ninth and last chapter presents an ideal, coherent model for a financial system which respects traditional legal principles and is thus based on the adoption of a 100-percent reserve requirement in banking. Also considered are the different arguments made against my proposal. I criticize them and explain how the transition from the current system to the proposed ideal system could be carried out with a minimum of tension. A summary of main conclusions wraps up the book, along with some additional considerations on the advantages of the proposed financial system. The principles studied here are also applied to certain urgent practical issues, such as the construction of a new European monetary system

and of a modern financial system in the former socialist economies.

A summarized version of this book's essential thesis was first presented in a paper before the Mont Pèlerin Society in Rio de Janeiro in September 1993 and received the support of James M. Buchanan, to whom I am very grateful. A written, Spanish version has been partially published in the "Introducción Crítica" of the first Spanish edition of Vera C. Smith's book, *The Rationale of Central Banking and the Free Banking Alternative*.[4] It was later published in French as an article entitled "Banque centrale ou banque libre: le débat théorique sur les réserves fractionnaires."[5]

I express my gratitude to my colleague at the law school of Madrid's Universidad Complutense, Professor Mercedes López Amor, for her help in the search for sources and a bibliography regarding the treatment under Roman law of the irregular deposit of money. Also, my former professor, Pablo Martín Aceña, from the University of Alcalá de Henares (Madrid), offered direction in my study of the evolution of banking throughout the Middle Ages. Luis Reig, Rafael Manzanares, José Antonio de Aguirre, José Luis Feito, Richard Adamiak of Chicago, the late Professor Murray N. Rothbard,

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[4]Vera C. Smith, *Fundamentos de la banca central y de la libertad bancaria* (Madrid: Unión Editorial/Ediciones Aosta, 1993), pp. 27–42. (*The Rationale of Central Banking and the Free Banking Alternative* [Indianapolis: Liberty Press, 1990].)

[5]Jesús Huerta de Soto, "Banque centrale ou banque libre: le débat théorique sur les réserves fractionnaires," in the *Journal des Économistes et des Études Humaines* 5, no. 2/3 (June-September 1994): 379–91. This paper later appeared in Spanish with the title "La teoría del banco central y de la banca libre" in my book, *Estudios de economía política*, chap. 11, pp. 129–43. Two other versions of this article were also later published: one in English, entitled "A Critical Analysis of Central Banks and Fractional Reserve Free Banking from the Austrian School Perspective," in *The Review of Austrian Economics* 8, no. 2 (1995): 117–30; the other in Romanian, thanks to Octavian Vasilescu, "Băncile centrale şi sistemul de free-banking cu rezerve fracţionare: o analiză critică din perspectiva Şcolii Austriece," *Polis: Revista de ştiinţe politice* 4, n.º 1 (Bucarest, 1997): 145–57.

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