PREFACIOS DE *DINERO, CRÉDITO BANCARIO Y CICLOS ECONÓMICOS* HASTA LA 8ª EDICIÓN

JESÚS HUERTA DE SOTO

Con ocasión del 25 aniversario de la obra *Dinero, Crédito Bancario y Ciclos Económicos* del Prof. Huerta de Soto se reproducen a continuación los prefacios de las ediciones en español del libro, que son ocho hasta la fecha, traducidos al inglés.

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 (1.75 percent in the United States, 0.15 percent in Japan and 3.25 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,[1] and I am grateful to the eminent authors of them for their many positive comments. 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, over the past three academic years, 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 as they studied and discussed the teachings contained in the present volume. This book, to 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

[1] I am particularly grateful to Leland Yeager (*The Review of Austrian Economics*, 14:4, 2001, p. 255) and Jörg Guido Hülsmann (*The Quarterly Journal of Austrian Economics*, summer 2000, vol. 3, no. 2, pp. 85-88) for their remarks.

curiosity as they progress to higher and increasingly enriching stages in their formative journey.[2]

Madrid, December 6, 2001
JESÚS HUERTA DE SOTO

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.[3] Finally, the editor of the English version, *Money, Bank Credit, and*

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

[3] 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. I do feel that Garrison's explanations are too mechanistic 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).

Economic Cycles,[4] Judith Thommesen, very patiently and painstakingly 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, Adjunct 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 in the typical turning-point phase of 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

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

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 FOURTH SPANISH EDITION

I am happy to present to Spanish-speaking readers the fourth edition of *Dinero, Crédito Bancario y Ciclos Económicos*. Its appearance is particularly timely, given that the severe financial crisis and resulting worldwide economic recession I have been forecasting since the first edition came out ten years ago are now unleashing their fury.

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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 many years, the money supply in the form of banknotes and deposits (M3) has grown at an average rate of over ten percent per year (which means that every seven years the total volume of money circulating in the world has 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 seeing a very 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 and (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 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, 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.

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. The countries on the periphery especially, 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 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.

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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, fortunately, 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 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 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,[5] by applying strict standards of accounting conservatism (based on the prudence principle and

[5] 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* (New Jersey: Augustus M. Kelley, 1979; first edition London: George

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.

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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

Routledge & Sons, 1939). See especially section 9, "Capital Accounting and Monetary Policy," pp. 130-132.

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 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 negative 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 (page 792) 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 bills 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. 796-797). 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. 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.

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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 fourth 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 being published all over the world[6] 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.

Madrid, November 13, 2008
Feast of San Diego de Alcalá
Jesús Huerta de Soto

PREFACE TO THE FIFTH SPANISH EDITION

The two years since the publication of the previous edition of *Dinero, crédito bancario y ciclos económicos* have seen a continuation

[6] Since the appearance of the previous edition, the first English-langage edition, of almost 4,000 copies, published in the United States in 2006, has sold out, and a second edition is currently in the preparation phase. Moreover, Tatjana Danilova and Grigory Sapov have completed a Russian translation, which has been published as *Denugi, Bankovskii Kredit i Ekonomicheski Tzikli* (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 Letinier 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.

of the economic recession process set in motion with 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.[7]

In this economic and political context, the analysis this book contains of the causes of the crisis and the reforms which must be

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[7] 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 Alabama: Ludwig von Mises Institute, 2011).

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.[8] 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.

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.[9]

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[8] 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. 904-905).

[9] 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. Fronék, A. Túma, D. Vořechovsky, 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). Finally, the Chinese, Portuguese, Japanese, and Arabic translations have been completed and, God willing, will soon be published.

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.

El Aprisco, Señorío de Sarría
April 21, 2011
Holy Thursday
JESÚS HUERTA DE SOTO

PREFACE TO THE SIXTH SPANISH EDITION

I am pleased to present this sixth Spanish edition of *Money, Bank Credit, and Economic Cycles*. This new edition has been thoroughly revised and includes, among other minor modifications and insertions, references to the most relevant literature published on the subject since the previous edition appeared in 2011. In this respect, we should note the growing number of economists, even in the "neoclassical mainstream,"[10] who are ultimately recognizing the full theoretical validity of the Austrian approach as an explanatory paradigm for the economic and financial crisis which began to grip the world in 2008 and the consequences of which are still far from being definitively overcome. In any case, I have made sure that the improvements and bibliographic comments added do not significantly affect the pagination of the work, so that new references scholars and specialists make to it will be consistent with earlier editions.

Since the appearance of the most recent edition four years ago, economic events have unfolded entirely in line with the analysis contained in this book. Perhaps the main changes have been the massive quantitative easing program launched by the US Federal

[10] The most relevant literature is cited, for instance, in footnote 118 of chapter 6, p. 505.

Reserve and the yielding of the European Central Bank, in an environment of anti-deflationist paranoia,[11] to the pressures of the Federal Reserve. The ECB was joined in giving in by all of those interested in ending the policies of austerity and discipline that have so benefited the countries which, like Spain, were among the most affected by the crisis. In fact, the introduction in March of 2015 of the European program of purchasing public and private, corporate financial debt at the rate of eighty billion euros a month blocks the necessary reforms (particularly in France and Italy), threatens to Japanize the economy of the European Union, and above all, jeopardizes the future of the euro as the common currency of European countries.[12] Finally, we must touch upon the bursting of the speculative bubble which has affected China in recent years and which, regardless of the more or less desperate political and economic measures that may be taken, will make the necessary restructuring of the Chinese economy unavoidable in order to detect and abandon the many unsound investments made during the years of artificial credit expansion and to permit the market, free from harmful interference and regulations, to uncover the sustainable projects aimed at satisfying, properly and in a timely manner, the true desires of consumers.

Finally, it also gives me great pleasure to note that the Austrian analysis is awakening greater interest worldwide, and one of the most surprising signs of this is the number of completed and

[11] See "Anti-Deflationist Paranoia," in *Banking and Monetary Policy from the Perspective of Austrian Economics*, ed. Annette Godart-van der Kroon and Patrik Vonlanthen (Cham, Switzerland: Springer, 2018), pp. 195-206. Deflation rooted in an increase in productivity pushes up real wages, encourages saving, and fosters investment sustainable in the long term, and all in an environment that curbs the lack of discipline and the financial irresponsibility of authorities, unions, and interest groups.

[12] See my article, "The Japanization of the European Union," Mises Wire, December 11, 2019. The program of purchasing European government and private bonds on a massive scale removes any incentive for the governments involved to carry out the needed economic austerity and liberalization reforms they have yet to adopt. On top of that, the program causes addiction, hinders the necessary restructuring and the sustainable growth which was already beginning to emerge in Europe, and therefore sets the stage for a new speculative bubble fueled by excess liquidity and virtually zero or even negative real interest rates. This bubble will create all sorts of perverse incentives that will lead to widespread malinvestment and encourage all kinds of speculative projects devoid of long-term sustainability.

published translations of this book. In all, the book has already appeared in seventeen different languages (including six editions in Spanish, four in English, as well as editions in German, French, Italian, Portuguese, Arabic, Japanese, Chinese, Russian, Polish, Czech, Hungarian, Romanian, Dutch, Turkish, and Brazilian Portuguese). Further translations (into Hindi, Korean, Swedish, Greek, Finnish, Bulgarian, and Serbian) have been completed and are pending publication. This is a publishing phenomenon for a work of the Austrian School. Nevertheless, the book's success is due, more than to the author's merit, to the great scientific tradition he has inherited, and especially, to the undeniable fact that the noble Austrian approach has managed to answer the theoretical, historical, and ethical conundrums we face.

Madrid, Saturday, October 3, 2015
Feast Day of Saint Francis Borgia
Jesús Huerta de Soto

PREFACE TO THE SEVENTH SPANISH EDITION

Nearly twenty-two years after the first publication of *Dinero, crédito bancario, y ciclos económicos*, we present this seventh, completely revised edition to academics and researchers, as well as to university students and the general public. To facilitate scholars' ever-increasing citing of quotations and references from this book, we have managed to maintain the page numbering, despite the various improvements and modifications (including new bibliographic citations) which, though not very numerous, we have thought it useful to include.

Since the last edition appeared in 2016, the evolution of economic events has continued to be dominated by ultra-lax monetary policies orchestrated by the different central banks and, particularly, the European Central Bank. Beginning in the summer of 2019, in the midst of strong clashes in its Governing Council, the ECB ultimately not only reinforced its policy of negative interest rates, but also reintroduced its program of purchasing sovereign bonds and corporate debt on the pretext that a high level of uncertainty still remained latent. All of these monetary decisions have very adversely impacted Eurozone economies. In fact, not only have all of the essential, pending structural reforms been halted, but the growing government interventionism has led to a clear process of economic and social lethargy, which we have examined in detail in our article "The Japanization of the European Union."[13]

To make matters worse, the severe COVID-19 pandemic has spread from China to the rest of the world beginning in the first trimester of 2020, and the different governments have reacted by paralyzing most economic activities by decree and coercively confining their populations for a period of several months. It is obvious that, though at the time of writing there is much talk of the need to "rebuild" our economies, there is actually no need to rebuild anything. Our companies, facilities, factories, and capital equipment are there and remain intact, waiting only to be implemented again by a class of dynamic and innovative entrepreneurs who, in an environment of liberty, low taxes, and renewed confidence, can again devote all of their effort and ingenuity to detecting and satisfying the short, medium, and long-term needs of the entire population. Though it is still too early to know exactly how the next economic recovery will unfold, there is no indication of a significant change in the social rate of time preference which could compel, as explained in this book, widespread changes in the productive structure of capital goods. And except for a few specific sectors that are more vulnerable to possible changes – which could persist – in social customs, such as tourism, transportation, the hospitality industry, and entertainment, it is quite possible that it will not be necessary to undertake more painful and long-term restructuring, such as that typical of the stages in the cycle which follow an expansion of credit and which we also study in detail in this book. Therefore, without a doubt, the most serious risk at this time is that an attempt may be made to alleviate the post-pandemic situation via new doses of monetary expansion, government

[13] Jesús Huerta de Soto, "La japonización de la Unión Europea," *Procesos de Mercado* 16 (fall 2019): 317-342; "The Japanization of the European Union," Mises Wire, Dec. 11, 2019, https://mises.org/wire/japanization-european-union.

spending, and economic interventionism that will make the recovery more painful and prolonged, if they do not halt it completely. Once the natural increase in uncertainty and the demand for money which characterize the present moment are overcome, such measures could even trigger a severe, cumulative process of stagflation unseen in the world since the 1970s.

In any case, our greatest hope is that the analytical tools and the teachings contained in this book will be useful in helping readers to better understand the economic events taking place around them and the harmful effects of the policies that are being adopted supposedly to meet the challenges that await us.

Formentor, Saturday, July 25, 2020
Feast of the Apostle Saint James, Patron of Spain
JESÚS HUERTA DE SOTO

PREFACE TO THE EIGHTH SPANISH EDITION OF *DINERO, CRÉDITO BANCARIO, Y CICLOS ECONÓMICOS*

It is with great happiness that I write this preface to the eighth edition of my book *Dinero, crédito bancario, y ciclos económicos*, which was first published in 1998, exactly twenty-five years ago now. The preceding, seventh edition, which appeared at the end of 2020, in the midst of the pandemic, sold out quickly, and I have again taken the opportunity to carefully examine the entire work.[14] I have refined a number of details and have updated several bibliography entries, but without changing the book's structure or page numbering, in order to facilitate the efforts of scholars who cite it and to encourage its use as a research manual.

The course of recent economic and financial events not only confirms, once again, the full relevance and explanatory power of the analysis carried out in this book, but it also reveals that the dynamic approach of the theory of capital and economic cycles, an approach unique to the Austrian School of economics, has alone

[14] I would like to express my gratitude to Ms. Betzabeth Rasse for her valuable help in this task.

managed to fully account for the complex monetary, economic, and financial phenomena which so strongly impact the real economy and, thus, our own lives.

In fact, as we predicted in the preface to the previous edition, the ultra-lax monetary policies adopted by central banks and even further promoted on the pretext of the pandemic have triggered a worldwide inflationary process unseen in over forty years. Indeed, as soon as normality returned and the understandable, high level of uncertainty stemming from the health crisis disappeared, the demand for money returned to normal as well. The market has seen the surfacing of a very large supply of money which had been created and injected into the system by central banks, but which economic agents had nevertheless hoarded and not spent.[15] As a result, the purchasing power of money has not stopped falling, and it will continue to depreciate for quite a few more months, until the necessary readjustment in the money relation has taken place. Central banks, led by the Federal Reserve and the European Central Bank, have lost all credibility. Initially, central bankers, in their sophisticated mathematical models, failed to even consider the possibility that an inflationary process might arise. Then, when it did, they defended until the last moment the notion that inflation would be an almost transitory phenomenon. Finally, when the course of events convinced them of the contrary, they had no choice but to (often grudgingly) raise nominal interest rates, which will not be truly "normalized" until they go over 4 percent – assuming these central bankers continue to pursue and eventually achieve the much-touted 2-percent inflation target they have jointly imposed on themselves.

As for the real impact of the current process of monetary normalization, and in line with the Austrian theory of the economic cycle expounded in this book, we are, without a doubt, already

[15] By way of illustration, the money injected by the Federal Reserve increased the money supply from fourteen to nineteen trillion dollars in a little over two years, while the European Central Bank injected slightly less but a very similar amount. Therefore, a period of at least around four years (of which almost two have already passed) will have to elapse with very significant inflation (between 6 and 8 percent) before prices manage to absorb the entire monetary impact.

seeing the need for significant readjustments in the productive structure. It can be rightly argued that, compared to the damage caused during the decade of irrational exuberance and credit expansion prior to the Great Recession of 2008, widespread disco-ordination and malinvestment have not been as profound in this most recent cycle (notable for the economic standstill which resulted from the lockdowns). However, there is no doubt that entrepreneurs are still to discover the need for significant restructuring and will have to tackle it. In all probability, this task will combine with the reforms that remained pending during the previous cycle, as well as the reorganization of zombie companies and projects that have been able to survive only in an environment of monetary flooding and zero and negative interest rates, which central banks have irresponsibly promoted over the last decade and which have particularly affected the following sectors: new technology, startups, environmental investment, private equity, cryptocurrencies, and, in general, investment in public or private fixed-income securities at prices which had artificially reached levels unprecedented in the history of mankind.[16]

As usual, and as is explained in detail especially in chapter 5, the necessary restructuring always begins with the financial crisis of the marginally more vulnerable credit institutions. At the time of writing, it has already put an end to, or is very severely affecting, institutions like Silicon Valley Bank, Signature Bank, FTX, First Republic Bank, and dozens more banks on the other side of the Atlantic. Meanwhile, in Europe, we have the paradigmatic case of the (until now) iconic Credit Suisse, which, at over a century old, suffered a grave banking crisis. At any rate, the definitive solution to the crisis of confidence in the banking system can be achieved only by advancing the reform we present in chapter 9 of this book. The reform is founded on the idea that demand deposits are money; or rather, they are perfect money substitutes that circulate, and their disappearance would seriously harm their innocent holders and

[16] By way of illustration, we should mention the severe British-pension-fund crisis of October 2022. Funds had invested in fixed-income products, and the Bank of England was obliged to intervene when rates rose and the prices of these products plummeted in financial markets.

must be avoided at all costs. However, it is essential to completely eliminate the possibility of guaranteed deposits being used to pyramid massive expansions of credit in the future. Therefore, we must reestablish a 100-percent reserve requirement on demand deposits and equivalents, and the assets which, until now, have appeared in accounting entries to offset these can be used to remove much of the substantial indebtedness of the different governments. Any other reforms (further increases in regulation or higher requirements for capital or liquidity ratios, etc.) are nothing more than patches doomed to repeated failure, as in the past, since they do not address the abolition of fractional reserves, which are the root cause and the only source of all of the other problems that afflict us in this area.

Hence, central bankers find themselves in an uncomfortable situation, and they have gotten themselves into it. On one hand, they must continue with a restrictive monetary policy and thus raise nominal interest rates if they wish to curb inflation. On the other hand, they can defuse banking crises only by injecting even more liquidity into the system, at the grave risk that inflation will become chronic and much-feared "stagflation" will emerge. In any case, it is critical that we steer economic policies away from populism and reintroduce the principles of a balanced budget, the reduction of public spending and taxes, and deregulation and flexibilization at all levels of the economy. The goal is to make possible and facilitate to the fullest extent the necessary and quick restructuring of the economy, based on sustainable investment projects which generate many high-quality jobs. Such projects can be discovered and advanced only by a vigorous entrepreneurial class that regains confidence in an environment of respect and support for the market economy.

I would not like to conclude this preface without mentioning the significance that has been acquired by the Austrian School of economics (in general) and the "Austrian School of Madrid" (in particular), which I have had the honor and the privilege to promote – and not only in the Spanish-speaking world – over the last forty years. The upcoming publication of the book by Professor Cristóbal Matarán,[17] who has become our "official chronicler"; the

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[17] Cristóbal Matarán, *La escuela austriaca de Madrid* (Madrid: Unión Editorial, 2023).

twentieth anniversary of our scientific journal, *Market Processes*; the six editions of the Madrid Conference on Austrian Economics, organized by the Universidad Rey Juan Carlos in cooperation with Lübeck University in Germany; and various other events and publications[18] attest to the considerable academic and research effort being devoted to the Austrian School in Spain. Nevertheless, the chief merit lies in the ever-growing number of young (and not so young) professors, researchers, doctors, disciples, and, naturally, university students who have, with great enthusiasm, been devoting all of their effort and dedication to deepening and furthering the advancement of the noble and fruitful approach of the Austrian School of economics. To all of them, I especially dedicate this new edition.

Jesús Huerta de Soto
Madrid, March 19, 2023
Feast Day of Saint Joseph

[18] See, for instance, chapter 9 of *The Austrian School of Economics in the 21st Century: Evolution and Impact*, ed. Annette Godart-van der Kroon and Joseph Salerno (Brussels: Springer, 2023), especially pp. 85-115, Krzysztof Turowski and Mateusz Machaj, "The Present State of Austrian School of Economics in Europe"; Cristóbal Matarán, "The Austrian School of Madrid," *The Review of Austrian Economics* 36, no. 1 (2023): 61-76; and William Hongsong Wang, "Jesús Huerta de Soto: The Synthesizer of the Austrian School," *Procesos de Mercado: Revista Europea de Economía Política* 14, no. 2 (2017): 173-202.