The Trade Cycle and Credit Expansion: The Economic Consequences of Cheap Money

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From a memorandum, dated April 24, 1946, prepared in English by Professor Mises for a committee of businessmen for whom he served as a consultant

1. Introductory Remarks

The author of this paper is fully aware of its insufficiency. Yet, there is no means of dealing with the problem of the trade cycle in a more satisfactory way if one does not write a treatise embracing all aspects of the capitalist market economy. The author fully agrees with the dictum of Böhm-Bawerk: "A theory of the trade cycle, if it is not to be mere botching, can only be written as the last chapter or the last chapter but one of a treatise dealing with all economic problems."

It is only with these reservations that the present writer presents this rough sketch to the members of the Committee.

2. The Unpopularity of Interest

One of the characteristic features of this age of wars and destruction is the general attack launched by all governments and pressure groups against the rights of creditors. The first act of the Bolshevik Government was to abolish loans and payment of interest altogether. The most popular of the slogans that swept the Nazis into power was Brechung der Zinsknechtschaft, abolition of interest-slavery. The debtor countries are intent upon expropriating the claims of foreign creditors by various devices, the most efficient of which is foreign exchange control. Their economic nationalism aims at brushing away an alleged return to colonialism. They pretend to wage a new war of independence against the foreign exploiters as they venture to call those who provided them with the capital required for the improvement of their economic conditions. As the foremost creditor nation today is the United States, this struggle is virtually directed against the American people. Only the old usages of diplomatic reticence make it advisable for the economic nationalists to name the devil they are fighting not the Yankees, but "Wall Street."

"Wall Street" is no less the target at which the monetary authorities of this country are directing their blows when embarking upon an "easy money" policy. It is generally assumed that measures designed to lower the rate of interest, below the height at which the unhampered market would fix it, are extremely beneficial to the immense majority at the expense of a small minority of capitalists and hardboiled moneylenders. It is tacitly implied that the creditors are the idle rich while the debtors are the industrious poor, However, this belief is atavistic and utterly misjudges contemporary conditions.

In the days of Solon, Athens' wise legislator, in the time of ancient Rome's agrarian laws, in the Middle Ages and even for some centuries later, one was by and large right in identifying the creditors with the rich and the debtors with the poor. It is quite different in our age of bonds and debentures, of savings banks, of life insurance and social security. The proprietory classes are the owners of big plants and farms, of common stock, of urban real estate and, as such, they are very often debtors. The people of more modest income are bondholders, owners of saving deposits and insurance policies and benefi ciaries of social security. As such, they are creditors. Their interests are impaired by endeavors to lower the rate of interest and the national currency's purchasing power.

It is true that the masses do not think of themselves as creditors and thus sympathize with the anti-creditor policies. However, this ignorance does not alter the fact that the immense majority of the nation are to be classified as creditors and that these people, in approving of an "easy money" policy, unwittingly hurt their own material interests. It merely explodes the Marxian fable that a social class never errs in recognizing its particular class interests and always acts in accordance with these interests.

The modern champions of the "easy money" policy take pride in calling themselves unorthodox and slander their adversaries as orthodox, old-fashioned and reactionary. One of the most eloquent spokesmen of what is called functional finance, Professor Abba Lerner, pretends that in judging fiscal measures he and his friends resort to what "is known as the method of science as opposed to scholasticism." The truth is that Lord Keynes, Professor Alvin H. Hansen and Professor Lerner, in their passionate denunciation of interest, are guided by the essence of Medieval Scholasticism's economic doctrine, the disapprobation of interest. While emphatically asserting that a return to the nineteenth century's economic policies is out of the question, they are zealously advocating a revival of the methods of the Dark Ages and of the orthodoxy of old canons.

3. The Two Classes of Credit

There is no difference between the ultimate objectives of the anti-interest policies of canon law and the policies recommended by modern interest-baiting. But the methods applied are different. Medieval orthodoxy was intent first upon prohibiting by decree interest altogether and later upon limiting the height of interest rates by the so-called usury laws. Modern self-styled unorthodoxy aims at lowering or even abolishing interest by means of credit expansion.

Every serious discussion of the problem of credit expansion must start from the distinction between two classes of credit: commodity credit and circulation credit.

Commodity credit is the transfer of savings from the hands of the original saver into those of the entrepreneurs who plan to use these funds in production. The original saver has saved money by not consuming what he could have consumed by spending it for consumption. He transfers purchasing power to the debtor and thus enables the latter to buy these non-consumed commodities for use in further production. Thus the amount of commodity credit is strictly limited by the amount of saving, i.e., abstention from consumption. Additional credit can only be granted to the extent that additional savings have been accumulated. The whole process does not affect the purchasing power of the monetary unit.

Circulation credit is credit granted out of funds especially created for this purpose by the banks. In order to grant a loan, the bank prints banknotes or credits the debtor on a deposit account. It is creation of credit out of nothing. It is tantamount to the creation of fiat money, to undisguised, manifest inflation. It increases the amount of money substitutes, of things which are taken and spent by the public in the same way in which they deal with money proper. It increases the buying power of the debtors. The debtors enter the market of factors of production with an additional demand, which would not have existed except for the creation of such banknotes and deposits. This additional demand brings about a general tendency toward a rise in commodity prices and wage rates.

While the quantity of commodity credit is rigidly fixed by the amount of capital accumulated by previous saving, the quantity of circulation credit depends on the conduct of the bank's business. Commodity credit cannot be expanded, but circulation credit can. Where there is no circulation credit, a bank can only increase its lending to the extent that the savers have entrusted it with more deposits. Where there is circulation credit, a bank can expand its lending by what is, curiously enough, called "being more liberal."

Credit expansion not only brings about an inextricable tendency for commodity prices and wage rates to rise. It also affects the market rate of interest. As it represents an additional quantity of money offered for loans, it generates a tendency for interest rates to drop below the height they would have reached on a loan market not manipulated by credit expansion. It owes its popularity with quacks and cranks not only to the inflationary rise in prices and wage rates which it engenders, but no less to its short-run effect of lowering interest rates. It is today the main tool of policies aiming at cheap or easy money.

4. The Function of Prices, Wage Rates and Interest Rates

The rate of interest is a market phenomenon. In the market economy it is the structure of prices, wage rates and interest rates, as determined by the market, that directs the activities of the entrepreneurs toward those lines in which they satisfy the wants of the consumers in the best possible and cheapest way. The prices of the material factors of production, wage rates and interest rates on the one hand and the anticipated future prices of the consumers' goods on the other hand are the items that enter into the planning businessman's calculations. The result of these calculations shows the businessman whether or not a definite project will pay. If the market data underlying his calculations are falsified by the interference of the government, the result must be misleading. Deluded by an arithmetical operation with illusory figures, the entrepreneurs embark upon the realization of projects that are at variance with the most urgent desires of consumers. The disagreement of the consumers becomes manifest when the products of capital malinvestment reach the market and cannot be sold at satisfactory prices. Then, there appears what is called "bad business."

If, on a market not hampered by government tampering with the market data, the examination of a definite project shows its unprofitability, it is proved that under the given state of affairs the consumers prefer the execution of other projects. The fact that a definite business venture is not profitable means that the consumers, in buying its products, are not ready to reimburse entrepreneurs for the prices of the complementary factors of production required, while on the other hand, in buying other products, they are ready to reimburse entrepreneurs for the prices of the same factors. Thus the sovereign consumers express their wishes and force business to adjust its activities to the satisfaction of those wants which they consider the most urgent. The consumers thus bring about a tendency for profitable industries to expand and for unprofitable ones to shrink.

It is permissible to say that what proximately prevents the execution of certain projects is the state of prices, wage rates and interest rates. It is a serious blunder to believe that if only these items were lower, production activities could be expanded. What limits the size of production is the scarcity of the factors of production. Prices, wage rates and interest rates are only indices expressive of the degree of this scarcity. They are pointers, as it were. Through these market phenomena, society sends out a warning to the entrepreneurs planning a definite project: Don't touch this factor of production; it is earmarked for the satisfaction of another, more urgent need.

The expansionists, as the champions of inflation style themselves today, see in the rate of interest nothing but an obstacle to the expansion of production. If they were consistent, they would have to look in the same way at the prices of the material factors of production and at wage rates. A government decree cutting down wage rates to 50% of those on the unhampered labor market would likewise give to certain projects, which do not appear profitable in a calculation based on the actual market data, the appearance of profitability. There is no more sense in the assertion that the height of interest rates prevents a further expansion of production than in the assertion that the height of wage rates brings about these effects. The fact that the expansionists apply this kind of fallacious argumentation only to interest rates and not also to the prices of primary commodities and to the prices of labor is the proof that they are guided by emotions and passions and not by cool reasoning. They are driven by resentment. They envy what they believe is the rich man's take. They are unaware of the fact that in attacking interest they are attacking the broad masses of savers, bondholders and beneficiaries of insurance policies.

5. The Effects of Politically Lowered Interest Rates

The expansionists are quite right in asserting that credit expansion succeeds in bringing about booming business. They are mistaken only in ignoring the fact that such an artificial prosperity cannot last and must inextricably lead to a slump, a general depression.

If the market rate of interest is reduced by credit expansion, many projects which were previously deemed unprofitable get the appearance of profitability. The entrepreneur who embarks upon their execution must, however, very soon discover that his calculation was based on erroneous assumptions. He has reckoned with those prices of the factors of production which corresponded to market conditions as they were on the eve of the credit expansion. But now, as a result of credit expansion, these prices have risen. The project no longer appears so promising as before. The businessman's funds are not sufficient for the purchase of the required factors of production. He would be forced to discontinue the pursuit of his plans if the credit expansion were not to continue. However, as the banks do not stop expanding credit and providing business with "easy money," the entrepreneurs see no cause to worry. They borrow more and more. Prices and wage rates boom. Everybody feels happy and is convinced that now finally mankind has overcome forever the gloomy state of scarcity and reached everlasting prosperity.

In fact, all this amazing wealth is fragile, a castle built on the sands of illusion. It cannot last. There is no means to substitute banknotes and deposits for non-existing capital goods. Lord Keynes, in a poetical mood, asserted that credit expansion has performed "the miracle . . . of turning a stone into bread."[1] But this miracle, on closer examination, appears no less questionable than the tricks of Indian fakirs.

There are only two alternatives.

One, the expanding banks may stubbornly cling to their expansionist policies and never stop providing the money business needs in order to go on in spite of the inflationary rise in production costs. They are intent upon satisfying the ever increasing demand for credit. The more credit business de mands, the more it gets. Prices and wage rates skyrocket. The quantity of banknotes and deposits increases beyond all measure. Finally, the public becomes aware of what is happening. People realize that there will be no end to the issue of more and more money substitutes – that prices will consequently rise at an accelerated pace. They comprehend that under such a state of affairs it is detrimental to keep cash. In order to prevent being victimized by the progressing drop in money's purchasing power, they rush to buy commodities, no matter what their prices may be and whether or not they need them. They prefer everything else to money. They arrange what in 1923 in Germany, when the Reich set the classical example for the policy of endless credit expansion, was called die Flucht in die Sachwerte, the flight into real values. The whole currency system breaks down. Its unit's purchasing power dwindles to zero. People resort to barter or to the use of another type of foreign or domestic money. The crisis emerges.

[1] Paper of the British Experts, April 8, 1943.

The other alternative is that the banks or the monetary authorities become aware of the dangers involved in endless credit expansion before the common man does. They stop, of' their own accord, any further addition to the quantity of banknotes and deposits. They no longer satisfy the business applications for additional credits. Then the panic breaks out. Interest rates jump to an excessive level, because many firms badly need money in order to avoid bankruptcy. Prices drop suddenly, as distressed firms try to obtain cash by throwing inventories on the market dirt cheap. Production activities shrink, workers are discharged.

Thus, credit expansion unavoidably results in the economic crisis. In either of the two alternatives, the artificial boom is doomed. In the long run, it must collapse. The short-run effect, the period of prosperity, may last sometimes several years. While it lasts, the authorities, the expanding banks and their public relations agencies arrogantly defy the warnings of the economists and pride themselves on the manifest success of their policies. But when the bitter end comes, they wash their hands of it.

The artificial prosperity cannot last because the lowering of the rate of interest, purely technical as it was and not corresponding to the real state of the market data, has misled entrepreneurial calculations. It has created the illusion that certain projects offer the chances of profitability when, in fact, the available supply of factors of production was not sufficient for their execution. Deluded by false reckoning, businessmen have expanded their activities beyond the limits drawn by the state of society's wealth. They have underrated the degree of the scarcity of factors of production and overtaxed their capacity to produce. In short: they have squandered scarce capital goods by malinvestment.

The whole entrepreneurial class is, as it were, in the position of a master builder whose task it is to construct a building out of a limited supply of building materials. If this man overestimates the quantity of the available supply, he drafts a plan for the execution of which the means at his disposal are not sufficient. He overbuilds the groundwork and the foundations and discovers only later, in the progress of the construction, that he lacks the material needed for the completion of the structure. This belated discovery does not create our master builder's plight. It merely discloses errors commit ted in the past. It brushes away illusions and forces him to face stark reality.

There is need to stress this point, because the public, always in search of a scapegoat, is as a rule ready to blame the monetary authorities and the banks for the outbreak of the crisis. They are guilty, it is asserted, because in stopping the further expansion of credit, they have produced a deflationary pressure on trade. Now, the monetary authorities and the banks were certainly responsible for the orgies of credit expansion and the resulting boom; although public opinion, which always approves such inflationary ventures whole heart edly, should not forget that the fault rests not alone with others. The crisis is not an outgrowth of the abandonment of the expansionist policy. It is the inextricable and unavoidable aftermath of this policy. The question is only whether one should continue expansionism until the final collapse of the whole monetary and credit system or whether one should stop at an earlier date. The sooner one stops, the less grievous are the damages inflicted and the losses suffered.

Public opinion is utterly wrong in its appraisal of the phases of the trade cycle. The artificial boom is not prosperity, but the deceptive appearance of good business. Its illusions lead people astray and cause malinvestment and the consumption of unreal apparent gains which amount to virtual consumption of capital. The depression is the necessary process of readjusting the structure of business activities to the real state of the market data, i.e., the supply of capital goods and the valuations of the public. The depression is thus the first step on the return to normal conditions, the beginning of recovery and the foundation of real prosperity based on the solid production of goods and not on the sands of credit expansion.

Additional credit is sound in the market economy only to the extent that it is evoked by an increase in the public's savings and the resulting increase in the amount of commodity credit. Then, it is the public's conduct that provides the means needed for additional investment. If the public does not provide these means, they cannot be conjured up by the magic of banking tricks. The rate of interest, as it is determined on a loan market not manipulated by an "easy money" policy, is expressive of the people's readiness to withhold from current consumption a part of the income really earned and to devote it to a further expansion of business. It provides the businessman reliable guidance in determining how far he may go in expanding investment, what projects are in compliance with the true size of saving and capital accumulation and what are not. The policy of artificially lowering the rate of interest below its potential market height seduces the entrepreneurs to embark upon certain projects of which the public does not approve. In the market economy, each member of society has his share in determining the amount of additional investment. There is no means of fooling the public all of the time by tampering with the rate of interest. Sooner or later, the public's disapproval of a policy of over-expansion takes effect. Then the airy structure of the artificial prosperity collapses.

Interest is not a product of the machinations of rugged exploiters. The discount of future goods as against present goods is an eternal category of human action and cannot be abolished by bureaucratic measures. As long as there are people who prefer one apple available today to two apples available in twenty-five years, there will be interest. It does not matter whether society is organized on the basis of private ownership of the means of production, viz., capitalism, or on the basis of public ownership, viz., socialism or communism. For the conduct of affairs by a totalitarian government, interest, the different valuation of present and of future goods, plays the same role it plays under capitalism.

Of course, in a socialist economy, the people are deprived of any means to make their own value judgments prevail and only the government's value judgments count. A dictator does not bother whether or not the masses approve of his decision of how much to devote for current consumption and how much for additional investment. If the dictator invests more and thus curtails the means available for current consumption, the people must eat less and hold their tongues. No crisis emerges, because the subjects have no opportunity to utter their dissatisfaction. But in the market economy, with its economic democracy, the consumers are supreme. Their buying or abstention from buying creates entrepreneurial profit or loss. It is the ultimate yardstick of business activities.

6. The Inevitable Ending

It is essential to realize that what makes the economic crisis emerge is the public's disapproval of the expansionist ventures made possible by the manipulation of the rate of interest. The collapse of the house of cards is a manifestation of the democratic process of the market.

It is vain to object that the public favors the policy of cheap money. The masses are misled by the assertions of the pseudo-experts that cheap money can make them prosperous at no expense whatever. They do not realize that investment can be expanded only to the extent that more capital is accumulated by savings. They are deceived by the fairy tales of monetary cranks from John Law down to Major C. H. Douglas. Yet, what counts in reality is not fairy tales, but people's conduct. If men are not prepared to save more by cutting down their current consumption, the means for a substantial expansion of investment are lacking. These means cannot be provided by printing banknotes or by loans on the bank books.

In discussing the situation as it developed under the expansionist pressure on trade created by years of cheap interest rates policy, one must be fully aware of the fact that the termination of this policy will make visible the havoc it has spread. The incorrigible inflationists will cry out against alleged deflation and will advertise again their patent medicine, inflation, rebaptising it re-deflation. What generates the evils is the expansionist policy. Its termination only makes the evils visible. This termination must at any rate come sooner or later, and the later it comes, the more severe are the damages which the artificial boom has caused. As things are now, after a long period of artificially low interest rates, the question is not how to avoid the hardships of the process of recovery altogether, but how to reduce them to a minimum. If one does not terminate the expansionist policy in time by a return to balanced budgets, by abstaining from government borrowing from the commercial banks and by letting the market determine the height of interest rates, one chooses the German way of 1923.

Ch20 Interest, Credit Expansion and the Trade Cycle. Ch21 Work and Wages. Ch22 The Nonhuman Original Factors of Production.Â On the other hand the growing of wheat is the cheapest way for the Canadian farmer to acquire watches.â€ (p. 395) For Mises a price is a ratio arrived at on the market by the competitive bids of consumers for money on the one hand and some particular good or service on the other. A government may issue decrees, but â€œA government can no more determine prices than a goose can lay henâ€™s eggs.â€ (p. 397).Â The Difference Between Credit Expansion and Simple Inflation. 8 The Monetary of Circulation Credit Theory of the Trade Cycle . . . 571. PDF | Credit expansion has been associated with faster economic growth and with a higher occurrence of financial crises - a pair of results which seem | Find, read and cite all the research you need on ResearchGate.Â At the same time, one should always bear in mind the consequences of excessive increases in household debt for financial and macroeconomic stability in the medium to long run. As studies have shown, in contrast to business loans, household loans are not associated with GDP growth in the long run and excessive growth of them is more likely related to subsequent banking crises (BÃ¼yÃ¼kkarabacak and Valev, 2010, Beck et al., 2012, Angeles, 2015, Mian et al., 2017. THE TRADE CYCLE AND CREDIT EXPANSION: THE ECONOMIC CONSEQUENCES OF CHEAP MONEY * By Ludwig von Mises 1. Introductory Remarks The author of this paper is fully aware of its insufficiency. Yet, there is no means of dealing with the problem of the trade cycle in a more satisfactory way if one does not write a treatise embracing all aspects of the capitalist market economy. The author fully agrees with the dictum of BÃ¶hm-Bawerk: â€œA theory of the trade cycle, if it is not to be mere botching, can only be written as the last chapter or the last chapter but one of a treatise dealing with all economic problems.â€ It is only with these reservations that the present writer presents this rough sketch to the members of the Committee.