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Economic Recessions, Banking Reform and the Future of Capitalism

By

Jesús Huerta de Soto
Professor of Political Economy
Universidad Rey Juan Carlos (Spain)

Thank you very much for your nice introduction.

It is a great honor for me to have been invited by the London School of Economics to deliver this Hayek Lecture. To begin, I would like to thank the school and especially Professor Timothy Besley for inviting me, Professor Philip Booth and the Institute of Economic Affairs for allowing me to also use this as an opportunity to introduce my most recent book entitled "Socialism, Economic Calculation and Entrepreneurship," and finally Toby Baxendale for making this whole event possible.

Today I will concentrate on the recent financial crisis and the current worldwide economic recession, which I consider to be the most challenging problem we as economists must now face.

The Fatal Error of Peel's Bank Act

I would like to start off by stressing the following important idea: all the financial and economic problems we are struggling with today are the result, in one way or another, of something that happened precisely in this country on July 19, 1844... What happened on that fateful day that has conditioned up to the present time the financial and economic evolution of the whole world? On that date, Peel's Bank Act was enacted after years of debate between Banking and Currency School Theorists on the true causes of the artificial economic booms and the subsequent financial crises that had been affecting England especially since the beginning of the Industrial Revolution.

The Bank Charter Act of 1844 successfully incorporated the sound monetary theoretical insights of the Currency School. This school was able to correctly diagnose that the origin of the boom and bust cycles lay in the artificial credit expansions orchestrated by private banks and financed not by the prior or genuine savings of citizens, but through the issue of huge doses of fiduciary media (in those days mainly paper banknotes, or certificates of demand deposits issued by banks for a much greater amount than the gold originally deposited in their vaults). So, the requirement by Peel's Bank Act of a 100 percent reserve on the banknotes issued was not only in full accordance with the most elementary general principles of Roman Law regarding the need to prevent the forgery or the over-issue of deposit certificates, but also was a first and positive step in the right direction to avoid endlessly recurring cycles of booms and depressions.

However Peel's bank Act, not withstanding the good intentions behind it, and its sound theoretical foundations, was a huge failure. Why? Because it stopped short of extending the 100 percent reserve requirement to demand deposits also (Mises 1980, 446-448). Unfortunately, by Peel's day, some ideas originally hit upon by the Scholastics of the Spanish Golden Century had been entirely forgotten. The Scholastics had discovered at least three hundred years earlier that demand deposits (which they called in Latin "chirographis pecuniarium," or money created only by the entries in banks' accounting books) were part of the money supply (Huerta de Soto 2009, 606). They had also realized that from a legal standpoint, neglecting to maintain a 100 percent reserve on demand deposits is a mortal sin and a crime not of forgery, as is the case with the over-issue of banknotes, but of misappropriation.

This error of Peel's Bank Act, or rather, of most economists of that period, who were ignorant of something already discovered much earlier by the Spanish Scholastics, proved to be a fatal error: after 1844 bankers did continue to keep fractional reserves, not on banknotes of course, because it was forbidden by the Bank Charter Act, but on demand deposits. In other words, banks redirected their activity from the business of over-issuing banknotes to that of issuing demand deposits not backed by a 100 percent reserve, which from an economic point of view is exactly the same business. So, artificial credit expansions and economic booms did continue, financial crises and economic recessions were not avoided, and despite all the hopes and good intentions originally put into Peel's Bank

Act, this piece of legislation soon lost all of its credibility and popular support. Not only that, but the failure of the Bank Act conditioned the evolution of financial matters up to the present time and fully explains the wrong institutional design that afflicts the financial and monetary system of the so-called free market economies, and the dreadful economic consequences we are currently suffering.

When we consider the failure of Peel's Bank Act, the evolution of events up to now makes perfect sense: bubbles did continue to form, financial crises and economic recessions were not avoided, bank bailouts were regularly demanded, the lender of last resort or central bank was created precisely to bail out banks and to permit the creation of the necessary liquidity in moments of crisis, gold was abandoned and legal tender laws and a purely fiduciary system were introduced all over the world. So as we can see, the outcome of this historical process sheds light on the wrong institutional design and financial mess that incredibly is still affecting the world at the beginning of the second decade of the 21st century!

The healthy process of capital accumulation based on true savings

Now it is important that we quickly review the specifics of the economic processes through which artificial credit expansions created by a fractional-reserve banking system under the direction of a Central Bank entirely distort the real productive structure, and thus generate bubbles, induce unwise investments and finally trigger a financial crisis and a deep economic recession. But before that, and in honor of Hayek, we must remember the fundamental rudiments of capital theory which up to the present time and at least since the Keynesian revolution, have been almost entirely absent from the syllabus of most university courses on economic theory. In other words, we are first going to explain the specific entrepreneurial, spontaneous and microeconomic processes that in an unhampered free market tend to correctly invest all funds previously saved by economic agents. This is important, because only this knowledge will permit us to understand the huge differences with respect to what happens if investment is financed not by true savings, but by the mere creation out of thin air of new demand deposits which only materialize in the entries of banks' accounting books. What we are going to explain now is nothing more and nothing less than why the so-called "paradox of saving" is entirely wrong from the standpoint of economic theory (Hayek 1975, 199-263). Unfortunately this is something very few students of economic theory know even when they finish their studies and leave the university. Nevertheless this knowledge applies without any doubt to one of the most important spontaneous market processes that every economist should be highly familiar with.

In order to understand what will follow, we must visualize the real productive structure of the market as a temporal process composed of many very complex temporal stages in which most labor, capital goods and productive resources are not devoted to producing consumer goods maturing this year, but consumer goods and services that will mature, and eventually be demanded by consumers, two, three, four, or even many more years from now… For instance, a period of several years elapses between the time engineers begin to imagine and design a new car, and the time the iron ore has already been mined and converted into steel, the different parts of the car have been produced, everything has been assembled in the auto factory, and the new cars are distributed, marketed and sold. This period comprises a very complex set of successive temporal productive stages. So, what happens if the subjective time preference of economic agents suddenly decreases and as a result the current consumption of this year decreases, for example, by ten percent? If this increase in savings happens, three key spontaneous microeconomic processes are triggered and tend to guarantee the correct investment of the newly saved consumer goods.

The *first effect* is the new disparity in profits between the different productive stages: immediate sales in current consumer goods industries will fall and profits will decrease and stagnate compared with the profits in other sectors further away in time from current consumption. I am referring to industries which produce consumer goods maturing two, three, five or more years from now, their profitability not being affected by the negative evolution of short term current consumption. Entrepreneurial profits are the key signal that moves entrepreneurs in their investment decisions, and the relatively superior profit behavior of capital goods industries which help to produce consumer goods that will mature in the long term tells entrepreneurs all around the productive structure that they must redirect their efforts and investments from the less profitable industries closer to consumption to the more profitable capital goods industries situated further away in time from consumption.

The *second effect* of the new increase in savings is the decrease in the interest rate and the way it influences the market price of capital goods situated further away in time from consumption: as the interest rate is used to discount the present value of the expected future returns of each capital good, a decrease in the interest rate increases the market price of capital goods, and this increase in price is greater the longer the capital good takes to reach maturity as a consumer good. This significant increase in the market prices of capital goods compared with the relatively lower prices of the less demanded consumer goods (due to the increase in savings) is a second very powerful microeconomic effect that signals all around the market that entrepreneurs must redirect their efforts and invest less in consumer goods industries and more in capital goods industries further from consumption.

Finally, *and third*, we should mention what Hayek called *The Ricardo Effect* (Hayek 1948, 220-254; 1978, 165-178), which refers to the impact on real wages of any increase in savings: whenever savings increase, sales and market prices of immediate consumer goods relatively stagnate or even decrease. If factor incomes remain the same, this means higher real wages, and the corresponding reaction of entrepreneurs, who will try in the margin to substitute the now relatively cheaper capital goods for labor.

What the Ricardo Effect explains is that it is perfectly possible to earn profits even when sales (of consumer goods) go down, if costs decrease even more via the replacement of labor, which has become more expensive, with machines and computers, for instance. Who produces these machines, computers, and capital goods that are newly demanded? Precisely the workers who have been dismissed by the stagnating consumer goods industries and who have relocated to the more distant capital goods industries, where there is new demand for them to produce the newly demanded capital goods. This third effect, the Ricardo Effect, along with the other two mentioned above, promotes a longer productive process with more stages, which are further away from current consumption. And this new, more capital-intensive productive structure is fully sustainable, since it is fully backed by prior, genuine real savings. Furthermore, it can also significantly increase, in the future, the final production of consumer goods and the real income of all economic agents. These three combined effects all work in the same direction; they are the most elementary teachings of capital theory; and they explain the secular tendency of the unhampered free market to correctly invest new savings and constantly promote capital accumulation and the corresponding sustainable increase in economic welfare and development.

The unsustainable nature of the Bubbles induced by artificial credit expansions created by the fractional-reserve banking industry.

We are now in a position to fully understand, by contrast with the above process of healthy capital accumulation, what happens if investments are financed not by prior genuine savings but by a process of artificial credit expansion, orchestrated by fractional-reserve banks and directed by the lender of last resort or Central Bank.

Unilateral credit expansion means that new loans are provided by banks and recorded on the asset side of their balance sheets, against new demand deposits that are created out of thin air as collateral for the new loans, and are automatically recorded on the liability side of banks' balance sheets. So new money, or I should say new "virtual money" because it only "materializes" in bank accounting book entries, is constantly created through this process of artificial credit expansion. And in fact roughly only around ten percent of the money supply of most important economies is in the form of cash (paper bills and coins), while the remaining 90 percent of the money supply is this kind of virtual money that only exists as written entries in banks' accounting books. (This is precisely what the Spanish Scholastics termed, over 400 years ago, "chirographis pecuniarum" or virtual money that only exists in writing in an accounting book.)

It is easy to understand why credit expansions are so tempting and popular and the way in which they entirely corrupt the behavior of economic agents and deeply demoralize society at all levels. To begin with, entrepreneurs are usually very happy with expansions of credit, because they make it seem as if any investment project, no matter how crazy it would appear in other situations, could easily get financing at very low interest rates. The money created through credit expansions is used by entrepreneurs to demand factors of production, which they employ mainly in capital goods industries more distant from consumption. As the process has not been triggered by an increase in savings, no productive resources are liberated from consumer industries, and the prices of commodities, factors of production, capital goods and the securities that represent them in stock markets tend to grow substantially and create a market bubble. Everyone is happy, especially because it appears it would be possible to increase one's wealth very easily without any sacrifice in the form of prior saving and honest hard individual work. The so-called "virtuous circle of the new economy" in which recessions seemed to have been avoided forever, cheats all economic agents: investors are very happy looking at stock market quotes that grow day after day; consumer goods industries are able to sell everything they carry to the market at ever increasing prices; restaurants are always full with long waiting lists just to get a table; workers and their unions see how desperately entrepreneurs demand their services in an environment of full employment, wage increases and immigration; political leaders benefit from what appears to be an exceptionally good economic and social climate that they invariably sell to the electorate as the direct result of their leadership and good economic policies; state budget bureaucrats are astonished to find that every year public income increases at double digit figures, particularly the proceeds from Value Added tax, which, though in the end is paid by the final consumer, is advanced by the entrepreneurs of the early stages newly created and artificially financed by credit expansion.

But we may now ask ourselves: how long can this party last? How long can there continue to be a huge discoordination between the behavior of consumers (who do not wish to increase their savings) and that of investors (who continually increase their investments financed by banks' artificial creation of virtual money and not by citizens' prior genuine savings)? How long can this illusion that everybody can get whatever he wants without any sacrifice last?

The unhampered market is a very dynamically efficient process (Huerta de Soto 2010a, 1-30). Sooner or later it inevitably discovers (and tries to correct) the huge errors committed. Six spontaneous microeconomic reactions always occur to halt and revert the negative effects of the bubble years financed by artificial bank credit expansion.

The spontaneous reaction of the market against the effects of credit expansions: first the financial crisis and second the deep economic recession.

In my book on *Money, Bank Credit and Economic Cycles* (Huerta de Soto 2009, 361-384) I study in detail the six spontaneous and inevitable microeconomic causes of the reversal of the artificial boom that the aggression of bank credit expansion invariably triggers in the market. Let us summarize these six factors briefly:

1st The rise in the price of the original means of production (mainly labor, natural resources, and commodities). This rise appears when these resources have not been liberated from consumer goods industries (because savings have not increased) and the entrepreneurs of the different stages in the production process compete with each other in demanding the original means of production with the newly created loans they have received from the banking system.

2nd The subsequent rise in the price of consumer goods at an even quicker pace than that of the rise in the price of the factors of production. This happens when time preference remains stable and the new money created by banks reaches the pockets of the consumers in an environment in which entrepreneurs are frantically trying to produce more for distant consumption and less for immediate consumption of all kinds of goods. This also explains the 3rd factor which is

3rd The substantial relative increase in the accounting profits of companies closest to final consumption, especially compared with the profits of capital goods industries which begin to stagnate when their costs rise more rapidly than their turn over.

4th "The Ricardo Effect" which exerts an impact which is exactly opposite to the one it exerted when there was an increase in voluntary saving. Now the relative rise in the prices of consumer goods (or of consumer industries' turnover in an environment of increased productivity) with respect to the increase in original-factor income begins to drive down real wages, motivating entrepreneurs to substitute cheaper labor for machinery, which lessens the demand for capital goods and further reduces the profits of companies operating in the stages furthest from consumption.

5th The increase in the loan rate of interest even exceeding pre-credit expansion levels. This happens when the pace of credit expansion stops accelerating, something that sooner or later always occurs. Interest rates significantly increase due to the higher purchasing power and risk premiums demanded by the lenders. Furthermore, entrepreneurs involved in malinvestments start a "fight to the death" to obtain additional financing to try to complete their investment projects (Hayek 1937).

These five factors provoke the following sixth combined effect:

6th Companies which operate in the stages relatively more distant from consumption begin to discover they are incurring heavy accounting losses. These accounting losses, when compared with the relative profits generated in the stages closest to consumption, finally reveal beyond a doubt that serious entrepreneurial errors have been committed and that there is an urgent need to correct them by paralyzing and liquidating the investment projects mistakenly launched during the boom years.

The financial crisis begins the moment the market, which as I have said is very dynamically efficient (Huerta de Soto 2010a, 1-30), discovers that the true market value of the loans granted by banks during the boom is only a fraction of what was originally thought. In other words, the market discovers that the value of bank assets is much lower than previously thought and, as bank liabilities (which are the deposits created during the boom) remain constant, the market discovers the banks are in fact bankrupt, and were it not for the desperate action of the lender of last resort in bailing out the banks, the whole financial and monetary system would collapse. In any case, it is important to understand that the financial and banking crisis *is not* the cause of the economic recession but one of its most important first symptoms.

Economic recessions begin when the market discovers that many investment projects launched during the boom years are not profitable. And then consumers demand liquidation of these malinvestments (which, it is now discovered, were planned to mature in a too-distant future considering the true wishes of consumers). The recession marks the beginning of the painful readjustment of the productive structure, which consists of withdrawing productive resources from the stages furthest from consumption and transferring them back to those closest to it.

Both the financial crisis and the economic recession are always unavoidable once credit expansion has begun, because the market sooner or later discovers that investment projects financed by banks during the boom period were too ambitious due to a lack of the real saved resources that would be needed to complete them. In other words, bank credit expansion during the boom period encourages entrepreneurs to act as if savings had increased when in fact this is not the case. A generalized error of economic calculation has been committed and sooner or later it will be discovered and corrected spontaneously by the market. In fact all the Hayekian theory of economic cycles is a particular case of the theorem of the impossibility of economic calculation under socialism discovered by Ludwig von Mises, which is also fully applicable to the current wrongly designed and heavily regulated banking system.

The specific features of the 2008 Financial Crisis and the current economic recession.

The expansionary cycle which has now come to a close was set in motion when the American economy emerged from its last recession in 2001 and the Federal Reserve embarked again on a major artificial expansion of credit and investment, an expansion unbacked by a parallel increase in voluntary household saving. In fact, for several years the money supply in the form of banknotes and deposits has been growing 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 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 extremely low (and even negative in real terms) interest rates. This 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 enough, like in the “roaring” years prior to the Great Depression of 1929, the shock of monetary growth has not significantly influenced the unit prices of the subset of consumer goods and services (which are only approximately one third of the total number of goods that are exchanged in the market). 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 “money and credit injection,” would have given rise to a healthy and sustained reduction in the unit price of the goods and services all citizens consume. Moreover, the full incorporation of the economies of China and India into the globalized market has gradually raised 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 whole economic process. And let us remember the “Antideflationist Hysteria" of those who, even during the years of the bubble, used the slightest symptoms of this healthy deflation, to justify even greater doses of credit expansion.

As we have already seen, artificial credit expansion and the (fiduciary) inflation of media of exchange offer no shortcut to stable and sustained economic development, no way of avoiding the necessary sacrifice and discipline behind all high rates of voluntary saving. (In fact, before the crisis and particularly in the United States, voluntary saving not only failed to increase, but even fell to a negative rate for several years.)

The specific factors that trigger 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 this crisis, the most obvious triggers were first, the rise in the price of commodities and raw materials, particularly oil, second, 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 debts exceeded that of their assets (mainly mortgage loans erroneously granted).

If we consider the level of past credit expansion and the quality and volume of malinvestment produced by it, we could say that very probably in this cycle the economies of the European Monetary Union are in comparison in a somewhat less poor state (if we do not consider the relatively greater Continental 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 for the monetary union involved at the time a healthy and significant rehabilitation of the chief European economies. Only some countries on the periphery, like Ireland and 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 (like the liberalizing structural reforms which originated with José María Aznar's administration). 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 Spanish banks granted by creating the money ex nihilo while European central bankers looked on unperturbed. Once the crisis hit Spain the readjustment was quick and efficient: In less than a year more than 150,000 companies -mainly related with the building sector- have disappeared, almost five million workers who were employed in the wrong sectors have been dismissed, and nowadays we can conclude that although still very weak, the economic body of Spain has been already healed. We will later come back to the subject of what economic policy is most appropriate to the current circumstances. But before that, let us make some comments on the influence of the new accounting rules on the current economic and financial crisis.

The negative influence of the new accounting rules.

We must not forget that a central feature of the long past 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 most countries 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 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.

It is easy to realize that the new accounting rules 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, when assets are worth the least and financial markets dry up. Clearly, accounting principles which have proven so disturbing must be abandoned as soon as possible, and the accounting reforms recently enacted, 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 till the adoption of the false idol of the International Accounting Rules.

It must be emphasized 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, as Hayek already established as early as 1934 in his article "The Maintenance of Capital" (Hayek 1934). This requires the application of strict standards of accounting conservatism (based on the prudence principle and the recording of either historical cost or market value, whichever is lower), 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 each company.

Who is responsible for the current situation?

Of course the spontaneous order of the unhampered market is *not* responsible for the current situation. And one of the most typical consequences of every past crisis and of course of this current one, is how many people are blaming the market and firmly believing that the recession is a “market failure” that requires more government intervention. The market is a process that spontaneously reacts in the way we have seen against the monetary aggression of the bubble years, which consisted of a huge credit expansion that was not only allowed but even orchestrated and directed by *Central Banks, which are the institutions truly responsible for all the economic sufferings from the crisis and recession that are affecting the world*. And paradoxically central banks have been able to present themselves to the general public not only as indignant victims of the list of ad hoc scapegoats they have been able to put together (stupid private bankers, greedy managers receiving exorbitant bonuses, etc.), but also as the only institutions which, by bailing out the banking system as a last resort, have avoided a much greater tragedy.

In any case, it is crystal clear that the world monetary and banking system has chronically suffered from wrong institutional design at least since Peel’s Bank Act of 1844. There is no free market in the monetary and banking system but just the opposite: private money has been nationalized, legal tender rules introduced, a huge mess of administrative regulations enacted, the interest rate manipulated and most importantly, everything is directed by a monetary central-planning agency: The Central Bank.

In other words, real socialism, represented by state money, Central Banks and financial administrative regulations, is still in force in the monetary and credit sectors of the so-called free market economies.

As a result of this fact we experience regularly in the area of money and credit all the negative consequences established by the Theorem of the Impossibility of Socialism discovered by those distinguished members of the Austrian School of Economics: Ludwig von Mises and Friedrich Hayek.

Specifically, the central planners of state money are unable to know, to follow and to control the changes in both the demand for and supply of money. Furthermore, as we have seen, the whole financial system is based on the legal privilege given by the state to private bankers, who can use a fractional-reserve ratio with respect to the demand deposits they receive from their customers. As a result of this privilege, private bankers are not true financial intermediaries, but are mainly creators of deposits materializing in credit expansions that inevitably end in crisis and recession.

The most rigorous economic analysis and the coolest, most balanced interpretation of past and recent economic and financial events lead inexorably to the conclusion that central banks (which, again, are true financial central-planning agencies) cannot possibly succeed in finding the most convenient monetary policy at every moment. This is exactly the kind of problem that became evident 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 any area of the economy and especially the financial sector, via 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. This is precisely what I analyze in Chapter 3 of my book on *Socialism, Economic Calculation and Entrepreneurship,* which has been published by Edward Elgar in association with the Institute of Economic Affairs, and which we present today (Huerta de Soto, 2010b).

Indeed, nothing is more dangerous than to indulge in the "fatal conceit" – to use Hayek's useful expression (Hayek, 1990) – 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 softening the most violent ups and downs of the economic cycle, the Federal Reserve and, to a lesser extent, the European Central Bank, have 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 up a blind alley. They can either allow the recessionary process to follow its course, and with it the healthy and painful readjustment, or they can escape forward toward a "renewed inflationist" cure. With the latter, the chances of an even more severe recession (even stagflation) in the not-too-distant future increase dramatically. (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 the artificially 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 happened in the case of the Japanese economy, which, though all possible interventions have been tried, has ceased to respond to any stimulus involving either monetarist credit expansions or Keynesian methods.

It is in this context of "financial schizophrenia" that we must interpret the "shots in the dark" fired in the last two years 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 Fed rescues Bear

Stearns, AIG, Fannie Mae, Freddie Mac or City Group, and the next it allows Lehman Brothers to fail, under the amply justified pretext of "teaching a lesson" and refusing to fuel moral hazard. Finally, in light of the way events were unfolding, the US and European governments launched multi-billion-dollar plans to purchase illiquid (that is, worthless) assets from the banking system, or to monetize the public debt, or even to buy bank shares, totally or partially nationalizing the private banking system. And considering all that we have seen, which are now the possible future scenarios?

Possible future scenarios and the most appropriate economic policy.

Theoretically, under the wrongly designed current financial system, once the crisis has hit we can think of four possible scenarios:

The first scenario is the catastrophic one in which the whole banking system based on a fractional reserve collapses. This scenario seems to have been avoided by central banks which, acting as lenders of last resort, are bailing out private banks whenever it is necessary.

The second scenario is just the opposite of the first one but equally tragic: it consist of an "inflationist cure" so intense, that a new bubble is created. This forward escape would only temporarily postpone the solution of the problems at the cost of making them far more serious later (this is precisely what happened in the crisis of 2001).

The third scenario is what I have called the “japanization” of the economy: it happens when the reintroduction of the cheap-credit policy together with all conceivable government interventions entirely blocks the spontaneous market process of liquidation of unprofitable investments and company reconversion. As a result, the recession is prolonged indefinitely and the economy does not recover and ceases to respond to any stimulus involving monetarist credit expansions or Keynesian methods.

The fourth and final scenario is currently the most probable one: It happens when the spontaneous order of the market, against all odds and despite all government interventions, is finally able to complete the microeconomic readjustment of the whole economy, and the necessary reallocation of labor and the other factors of production toward profitable lines based on sustainable new investment projects.

In any case, after a financial crisis and an economic recession have hit it is necessary to avoid any additional credit expansion (apart from the minimum monetary injection strictly necessary to avoid the collapse of the whole fractional-reserve banking system). And 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 measures 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, sustainable economic recovery.

However, once the economy recovers (and in a sense the recovery begins with the crisis and the recession themselves which mark the discovery by the market of the errors committed and the beginning of the necessary microeconomic readjustment), I am afraid that, as has happened in the past again and again, no matter how careful central banks may be in the future (can we expect them to have learned their lesson? For how long will they remember what happened?), nor how many new regulations are enacted (as in the past all of them, and now especially Basel II and III, have attacked only the symptoms but not the true causes), sooner or later new cycles of credit expansion, artificial economic boom, financial crisis and economic recession will inevitably continue affecting us until the world financial and banking systems are entirely redesigned according to the general principles of private property law that are the essential foundation of the capitalist system and that require a 100 percent reserve for any demand deposit contract.

Conclusion.

I began this lecture with Peel's Bank Act, and I will also finish with it. On June 13 and 24, 1844 Robert Peel pointed out in the House of Commons that in each one of the previous monetary crises "there was an increase in the issues of country bank paper" and that "currency without a basis (…) only creates fictitious value, and when the bubble bursts, it spreads ruin over the country and deranges all commercial transactions".

Today, 166 years later, we are still suffering from the problems that were already correctly diagnosed by Robert Peel. And in order to solve them and finally reach the only truly free and stable financial and monetary system that is compatible with a free market economy in this 21st century, it will be necessary to take the following three steps:

First, to develop and culminate the basic concept of Peel's Bank Act by also extending the prescription of a 100 percent reserve requirement to demand deposits and equivalents. Hayek states that this radical solution would prevent all future crises (Hayek 1984, 29) as no credit expansions would be possible without a prior increase in real genuine saving, making investments sustainable and fully matched with prior voluntary savings. And I would add to Hayek's statement the most important fact that 100 percent banking is the only system compatible with the general principles of the law of property rights that are indispensable for the capitalist system to work: there is no reason to treat deposits of money differently from any other deposit of a fungible good, such as wheat or oil in which nobody doubts the need to keep the 100 percent reserve requirement.

In relation to this first step of the proposed reform it is most encouraging to see how two Tory mps, Douglas Carswell and Steve Baker, were able to introduce in the British Parliament on September the 15th and under the 10 minute rule the first reading of a Bill to reform the banking system extending the prescriptions of Peel's Bank Act to demand deposits. This "Customer Choice Disclosure and Protection Bill" will be discussed in its second reading, three weeks from now, on November the 19th, and has two goals: first to fully and effectively defend citizens' right of ownership over money they have deposited in checking accounts at banks; and second, to once and for all put an end to the recurrent cycles of artificial boom, financial crisis and economic recession. Of course this first draft of the bill still needs to be completed with some important details, for instance the time period (let us say a month) under which all deposits should be considered demand deposits for storage and not for investment, and the need to clarify that any contract that guarantees full availability of its nominal value at any moment should be considered at all effects a demand deposit for storage. But the mere discussion of these matters in the British Parliament and by the public at large is, in itself, of huge importance. In any case it is exciting that a handful of mps have taken this step against the tangle of vested interests related to the current privileged fractional-reserve banking system. If they are successful in their fight against what we could call the current "financial slavery" that grips the world they will go down in history like William Wilberforce –with the abolition of the slave trade- and other outstanding British figures to which the whole world owes so much.

Second, if we wish to culminate the fall of the Berlin wall and get rid of the real socialism that still remains in the monetary and credit sector, a priority would be the elimination of Central Banks, which would be rendered unnecessary as lenders of last resort if the above 100 percent reserve reform is introduced, and harmful if they insist on continuing to act as financial central-planning agencies.

And *third*, who will issue the monetary base? Maurice Allais, the French Nobel Prize winner who passed away two weeks ago, proposed that a Public Agency print the public paper money at a rate of increase of 2 percent per year. I personally do not trust this solution as any emergency situation in the state budget would be used, as in the past, as a pretext for issuing additional doses of fiduciary media. For this reason, and this is probably my most controversial proposal, in order to put an end to any future manipulation of our money by the authorities, what is required is the full privatization of the current, monopolistic, and fiduciary state-issued paper base money, and its replacement with a classic pure gold standard.

There is an old Spanish saying: “A grandes males, grandes remedios”. In English, “great problems require radical solutions”. And though of course any step toward these three measures would significantly improve our current economic system, it must be understood that the reforms proposed and taken by governments up to now (including Basel II and III) are only nervously attacking the symptoms but not the real roots of the problem, and precisely for that reason they will again miserably fail in the future.

Meanwhile, it is encouraging to see how a growing number of scholars and private institutions like the “Cobden Centre” under the leadership of Toby Baxendale, are studying again not only the radical reforms required by a truly honest private money, but also very interesting proposals for a suitable transition to a new banking system, like the one I develop in chapter 9 of my book on *Money, Bank Credit and Economic Cycles*. By the way, in this chapter I also explain a most interesting by-product of the proposed reform, namely the possibility it offers of paying off, without any cost nor inflationary effects, most of the existing public debt which in the current circumstances is a very worrying and increasingly heavy burden in most countries.

Briefly outlined, what I propose and the Cobden Centre has developed in more detail for the specific case of the United Kingdom, is to print the paper banknotes necessary to consolidate the volume of demand deposits that the public decides to keep in the banks. In any case, the printing of this new money would not be inflationary, as it would be handed to banks and kept entirely sterilized, so to speak, as 100 percent asset collateral of bank liabilities in the form of demand deposits. In this way, the basket of bank assets (loans, investments, etc.) That are currently backing the demand deposits would be "freed", and what I propose is to include these "freed" assets in mutual funds, swapping their units at their market value for outstanding treasury bonds. In any case, an important warning must be given: naturally, and one must never tire of repeating it, the solution proposed is only valid in the context of an irrevocable decision to re-establish a free-banking system subject to a 100 percent reserve requirement on demand deposits. However, no matter how important this possibility is considered under the current circumstances, we must not forget it is only a by-product (of "secondary" importance) compared to the major reform of the banking system we have outlined.

And now to conclude, should in this 21st century a new Robert Peel be able to successfully push for all these proposed reforms, this great country of the United Kingdom would again render an invaluable service not only to itself but also to the rest of the world.

Thank you very much.

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