A BRIEF NOTE ON ECONOMIC RECESSIONS, BANKING REFORM AND THE FUTURE OF CAPITALISM

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In my book «Money, Bank Credit, and Economic Cycles» (1st Spanish Edition 1992, 2nd English Edition 2009) I present a detailed analysis of the Austrian Business Cycle Theory. Now I will concentrate on the financial crisis and the current worldwide economic recession as one of the most challenging problems we must now cope with and the way in which the Austrian Business Cycle Theory can help us to understand its causes and the best approach to economic recovery.

Having witnessed the intellectual and practical defeat of socialism specially during the last decades of the twentieth century, in my opinion one of the main challenges that still remains for the future of Capitalism is the urgent need to privatize money by dismantling the organ of central monetary planning: 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 and supply of money. Furthermore, the whole financial system is based on the legal privilege given by the state to private bankers to act with a fractional reserve ratio in relation with the demand deposits they receive from their clients. As a result of this

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privilege, private bankers are not true financial intermediaries, but are mainly creators of deposits materializing in credit expansions. These credit expansions are artificial and do not correspond to any previous increases in the voluntary savings of the citizens. In this way the current fractional reserve banking system, tends to worsen and amplify the systemic intertemporal distortions and investment misallocations that the macroeconomic planners working for central banks induce in the production structure of the whole real economy. These distortions manifest themselves in the stages of financial bubbles, economic boom, overall malinvestment and afterwards in the stages of financial crisis, deep economic recession and unemployment.

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. For many years, the money supply in the form of banknotes and deposits 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 extremely 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 «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 economic process.

Economic theory teaches us that unfortunately, 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, but in some past years 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 the entire real productive structure, which 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 debts (deposits received) 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, an inevitable, painful readjustment begins, characterized by a drop in production and an increase in unemployment.

The most rigorous economic analysis and the coolest, most balanced interpretation of recent economic and financial events lead inexorably to 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 a 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 follow its path, and with it the healthy and painful readjustment, or they can escape forward toward a «renewed inflationist» cure. With the latter, the chances of even more severe recession (even inflationary recession) 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 occurred in the Japanese economy, which, after all possible interventions were tried, 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 «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 AIG, Bear Stearns, 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 have launched multi-billion-dollar plans to purchase illiquid (i.e. worthless) assets from the banking system, or even to buy banks shares, nationalizing totally or partially the private banking system. If those plans are 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.

In comparison, the economies of the European Union are in a somewhat less poor state (if we do not consider the relatively greater European rigidities, particularly in the labor market, which tend to make recessions in Europe longer and more painful). The expansionary policy of the European Central Bank, though not free of grave errors, has been somewhat less irresponsible than that of the Federal Reserve. Furthermore, fulfillment of the convergence criteria involved at the time a healthy and significant rehabilitation of the chief European economies. Only some countries on the periphery, like Ireland and especially 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). 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 tried to remain faithful to its mandate and at least for some months decided to maintain interest rates despite the difficulties of those members of the Monetary Union which, like Spain, were already discovering that much of their investment in real estate was in error and now 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, we hope is not too distant.

Now, let us make some comments on the influence of the new accounting rules on the current economic and financial crisis. Very often we hear and read in the media that the financial crisis and the stock market crash are the result of the lack of confidence produced by the accountancy and management scandals. But the so called «creative accounting» of the bubble years and the subsequent scandals are not the cause of our current problems, but just the opposite: they are one of the most typical byproducts of the feverish market pressures on business during a long period of «irrational exuberance». Accounting is the language of business and its traditional century old foundations based on the principle of very prudent valuation of assets (namely the lower of cost or market) cannot be substituted by new principles based on the very volatile so called «fair market value» and the artificial inflation of balance sheets in bubble markets without destroying the whole capitalist system.

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 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 this abandonment of the traditional principle of prudence, a highly influential role has been played by brokerages, investment

banks (which are now on their way to extinction), and in general, all parties interested in «inflating» book values in order to bring them closer to supposedly more «objective» stock-market values, which in the past rose continually in an economic process of financial euphoria.

In fact, during the years of the «speculative bubble,» this process was characterized by a feedback loop: rising stock-market values were immediately entered into the books, and then such accounting entries were sought as justification for further artificial increases in the prices of financial assets listed on the stock market.

We see that 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 all of 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 to the adoption of the false idol of the International Accounting Rules.

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 (as Hayek already established as early as 1934 in his article «The Maintenance of Capital»). 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 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.

If we want to get rid of real socialism in the monetary and credit sector, I mean get rid of central banks, and if we want to create a truly free and stable financial and monetary system in this new 21st century, it will be necessary to take three steps: 1) the reestablishment of a 100-percent reserve requirement on all bank demand deposits and equivalents; 2) the elimination of central banks as lenders of last resort (which will be unnecessary if the preceding principle is applied, and harmful if they continue to act as financial central-planning agencies); and 3) the privatization of the current, monopolistic, and fiduciary state-issued money and its replacement with a classic 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 (for instance, the fixing of interest rates, the tangled web of government regulations), and state monopoly (through legal tender laws which require the acceptance of the current, state-issued fiduciary money).

All these considerations are crucially important in light of the critical state of the international financial system. Nevertheless, while it is tragic that we have arrived at the current situation, it is even more tragic, if possible, the widespread lack of understanding regarding the causes of the phenomena that plague us, and especially the atmosphere of confusion and uncertainty prevalent among experts, analysts, and most economic theorists. In this area at least, I can hope the different editions of my book which are being published all over the world may contribute to the theoretical training of readers, to the intellectual rearmament of new generations, and eventually, to the so much 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 move in the right direction.