Financial Crisis and Recession

Daily Article by Jesus Huerta de Soto | Posted

The severe financial crisis and resulting worldwide economic recession we have been forecasting for years are finally unleashing their fury. In fact, the reckless policy of artificial credit expansion that central banks (led by the American Federal Reserve) have permitted and orchestrated over the last fifteen years could not have ended in any other way.

The expansionary cycle that has now come to a close was set in motion when the American economy emerged from its last recession in 1992 and the Federal Reserve embarked 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 (M3) has grown at an average rate of over ten percent per year (which means that every six or 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 that represent them and are exchanged on the stock market, where indexes soared.

Curiously, as 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 goods and services at the final-consumer level of the production structure (approximately only one third of all goods). The decade just past, 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 binge," 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 period 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 shortcut to stable and sustained economic development, no way of avoiding the necessary sacrifice and discipline behind all voluntary saving. (In fact, particularly in the United States, voluntary saving has not only failed to increase, but in some 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 often not even that. In fact, today there is no doubt about the recessionary consequence that 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 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 "flight into the future" 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 rise faster than those of capital goods.

At this point, an inevitable, painful readjustment begins, and in addition to a drop in production and an increase in unemployment, we are now seeing a very harmful rise in the prices of consumer goods (stagflation).

The most rigorous economic analysis and the coolest, most balanced interpretation of recent economic and financial events lead inexorably to the conclusion that central banks (which are in fact monetary 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 fiduciary responsibility, and now they find themselves in a blind alley. They can either allow the recessionary process to begin now, and with it the healthy and painful readjustment, or they can procrastinate with a "hair of the dog" cure. With the latter, the chances of even more severe stagflation in the not-too-distant future increase exponentially. (This was precisely the error committed following the stock market crash of 1987, an error that 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 latest "shots in the dark" fired by the monetary authorities (who have two totally contradictory responsibilities: both to control inflation and to inject all the liquidity necessary into the financial system to prevent its collapse). Thus, one day the Fed rescues AIG, Bear Stearns, Fannie Mae, and Freddie Mac, 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 government announced a $700 billion plan to purchase illiquid (i.e., worthless) assets from the banking system. If the plan is financed by taxes (and not more inflation), it will mean a heavy tax burden on households, precisely when they are least able to bear it.

In comparison, the economies of the European Union are in a somewhat less poor state (if we do not consider the expansionary effect of the policy of deliberately depreciating the dollar, and the relatively greater European rigidities, particularly in the labor market, which tend to make recessions in Europe longer and more painful). The expansionary policy of the European Central Bank, though not free of grave errors, has been somewhat less irresponsible than that of the Federal Reserve. Furthermore, meeting the requirements for admission to the euro currency bloc (convergence) involved a healthful and significant rehabilitation of the chief European economies. Only a few countries on the periphery, like Ireland and especially Spain, engaged 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 that was due, in part, 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 has remained faithful to its mandate and has decided not to lower interest rates despite the difficulties of those members of the Monetary Union which, like Spain, are now discovering that much of their investment in real estate was in error and are heading for a lengthy and painful reorganization of their real economy.

Under these circumstances, the most appropriate policy would be to liberalize the economy at all levels (especially in the labor market) to permit the rapid reallocation of productive factors (particularly labor) to profitable sectors. Likewise, it is essential to reduce public spending and taxes, in order to increase the available income of heavily indebted economic agents who need to repay their loans as soon as possible.

Economic agents in general and companies in particular can only rehabilitate their finances by cutting costs (especially labor costs) and paying off loans. Essential to this aim are a very flexible labor market and a much more austere public sector. These factors are fundamental if the market is to reveal as quickly as possible the real value of the investment goods produced in error and thus lay the foundation for a healthy, sustained economic recovery in a future that, for the good of all, we hope is not too distant.