THE THEORY OF MONEY AND CREDIT

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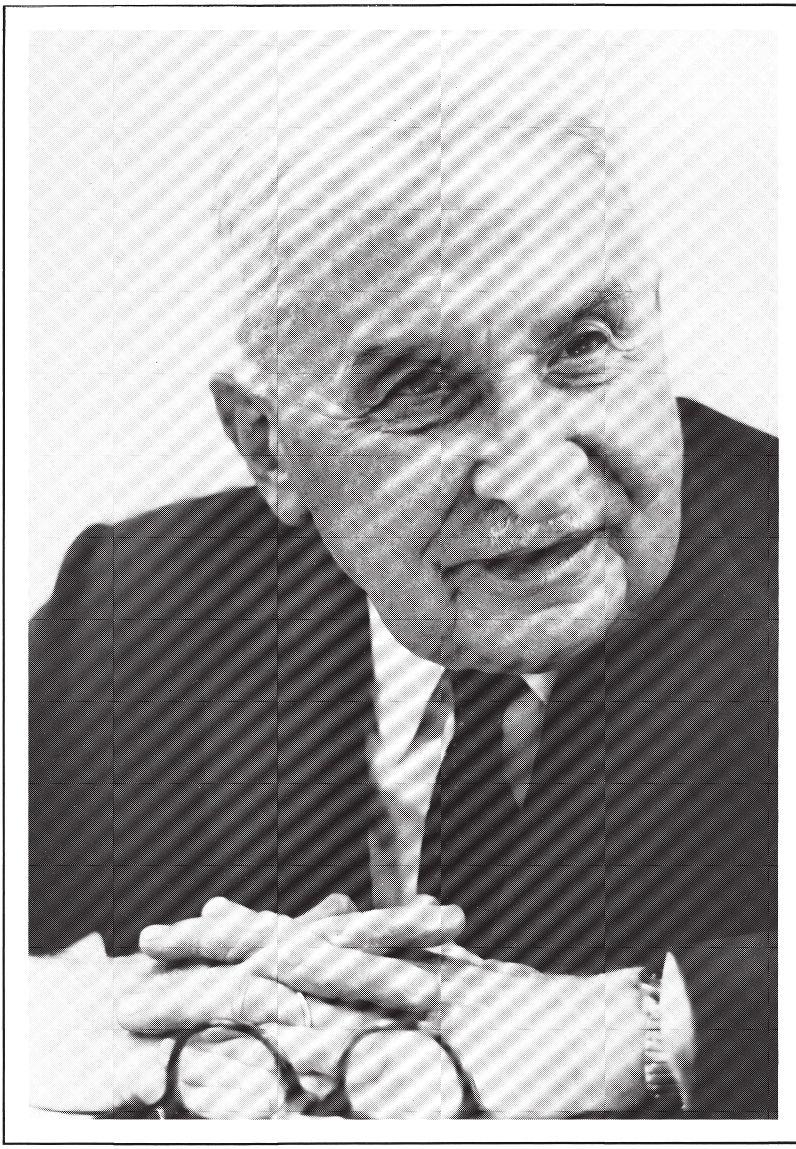

LUDWIG VON MISES

THE THEORY OF MONEY AND CREDIT

by LUDWIG VON MISES

Translated from the German by H. E. Batson

Liberty Fund

Indianapolis

This book is published by Liberty Fund, Inc., a foundation established to encourage study of the ideal of a society of free and responsible individuals.

The cuneiform inscription that serves as the design motif for our endpapers is the earliest-known written appearance of the word “freedom” (*amagi*), or “liberty.” It is taken from a clay document written about 2300 B.C. in the Sumerian city-state of Lagash.

This edition of *The Theory of Money and Credit* follows the text, with stylistic changes and footnote corrections, of the translation from the German by H. E. Batson, published in 1934 by Jonathan Cape Ltd., of London, and in 1953 by Yale University Press. The foreword by Murray N. Rothbard was written for this edition, published in 1981 by Liberty Fund, Inc.

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FOREWORD
By Murray N. Rothbard

Ludwig von Mises' *The Theory of Money and Credit* is, quite simply, one of the outstanding contributions to economic thought in the twentieth century. It came as the culmination and fulfillment of the "Austrian School" of economics, and yet, in so doing, founded a new school of thought of its own.

The Austrian School came as a burst of light in the world of economics in the 1870s and 1880s, serving to overthrow the classical, or Ricardian, system which had arrived at a dead end. This overthrow has often been termed the "marginal revolution," but this is a highly inadequate label for the new mode of economic thinking. The essence of the new Austrian paradigm was analyzing *the individual* and his actions and choices as the fundamental building block of the economy. Classical economics thought in terms of broad classes, and hence could not provide satisfactory explanations for value, price, or earnings in the market economy. The Austrians began with the actions of the individual. Economic value, for example, consisted of the *valuations* made by choosing individuals, and prices resulted from market interactions based on these valuations.

The Austrian School was launched by Carl Menger, professor of economics at the University of Vienna, with the publication of his

Principles of Economics (Grundsätze der Volkswirtschaftslehre) in 1871.[1] It was further developed and systematized by Menger's student and successor at Vienna, Eugen von Böhm-Bawerk, in writings from the 1880s on, especially in various editions of his multivolume *Capital and interest*.[2] Between them, and building on their fundamental analysis of individual valuation, action, and choice, Menger and Böhm-Bawerk explained all the aspects of what is today called "micro-economics": utility, price, exchange, production, wages, interest, and capital.

Ludwig von Mises was a "third-generation" Austrian, a brilliant student in Böhm-Bawerk's famous graduate seminar at the University of Vienna in the first decade of the twentieth century. Mises' great achievement in *The Theory of Money and Credit* (published in 1912) was to take the Austrian method and apply it to the one glaring and vital *lacuna* in Austrian theory: the broad "macro" area of money and general prices.

For monetary theory was still languishing in the Ricardian mold. Whereas general "micro" theory was founded in analysis of individual action, and constructed market phenomena from these building blocks of individual choice, monetary theory was still "holistic," dealing in aggregates far removed from real choice. Hence, the total separation of the micro and macro spheres. While all other economic phenomena were explained as emerging from individual action, the supply of money was taken as a given external to the market, and supply was thought to impinge mechanistically on an abstraction called "the price level." Gone was the analysis of individual choice that illuminated the "micro" area. The two spheres were analyzed totally separately, and on very different foundations. This book performed the mighty feat of integrating monetary with micro theory, of building monetary theory upon the individualistic foundations of general economic analysis.

Eugen von Böhm-Bawerk died soon after the publication of *The Theory of Money and Credit,* and the orthodox Böhm-Bawerkians,

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[1] The English translation of Menger's *Grundsätze* only first appeared in 1950. See Carl Menger, *Principles of Economics* (New York: New York University Press, 1981).

[2] The first complete English translation of the third/fourth German edition, by George D. Hunke and Hans F. Sennholz, was published by Libertarian Press, South Holland, Ill., in 1959; it includes: Volume I, *History and Critique of Interest Theories;* Volume II, *Positive Theory of Capital;* and Volume III, *Further Essays on Capital and Interest.*

locked in their old paradigm, refused to accept Mises' new breakthrough in the theory of money and business cycles. Mises therefore had to set about the arduous task of founding his own neo-Austrian, or Misesian, school of thought. He was handicapped by the fact that his post at the University of Vienna was not salaried; yet, all during the 1920s, many brilliant students flocked to his *Privatseminar.*

In the English-speaking world, acceptance of Misesian ideas was gravely hampered by the simple but significant fact that few economists read any language other than English. Mises' *The Theory of Money and Credit* was not translated into English until 1934, and the result was two decades of neglect of the Misesian insights. Cash balance analysis was developed in the late 1920s in England by Sir Dennis H. Robertson, but his approach was holistic and aggregative, and not built out of individual action. The purchasing power parity theory came to England and the United States only through the flawed and diluted form propounded by the Swedish economist Gustav Cassel. And neglect of the Čuhel-Mises theory of ordinal marginal utility allowed Western economists, led by Hicks and Allen in the mid-1930s, to throw out marginal utility altogether in favor of the fallacious "indifference curve" approach, now familiar in micro textbooks.

Mises' integration of micro and macro theory, his developed theory of money and the regression theorem, as well as his sophisticated analysis of inflation, were all totally neglected by later economists. The idea of integrating macro theory on micro foundations is further away from current economic practice than ever before.

Only Mises' business cycle theory penetrated the English-speaking world, and this feat was accomplished by personal rather than literary means. Mises' outstanding follower, Friedrich A. von Hayek, immigrated to London in 1931 to assume a teaching post at the London School of Economics. Hayek, who had concentrated on developing Mises' insights into a systematic business cycle theory, managed quickly to convert the best of the younger generation of English economists, and one of the brightest of the group, Lionel Robbins, was responsible for the English translation of *The Theory of Money and Credit.* For a few glorious years in the early 1930s, such youthful luminaries of English economics as Robbins, Nicholas Kaldor, John R. Hicks, Abba P. Lerner, and Frederic Benham fell under the strong influence of Hayek. In the meanwhile, Austrian followers of Mises' business cycle theory—notably Fritz Machlup and Gottfried von Haberler—began to be translated or published in the United States. Also in the United States, young Alvin H. Hansen was becoming the leading proponent of the Mises-Hayek cycle theory.

Mises' business cycle theory was being adopted precisely as a cogent explanation of the Great Depression, a depression which Mises anticipated in the late 1920s. But just as it was being spread through England and the United States, the Keynesian revolution swept the economic world, converting even those who knew better. The conversion process won, not by patiently rebutting Misesian or other views, but simply by ignoring them, and leading the economic world into old and unsound inflationist views dressed up in superficially impressive new jargon. By the end of the 1930s only Hayek, and none of the other students of himself or Mises, had remained true to the Misesian view of business cycles. Mises' *The Theory of Money and Credit,* in its English version, barely had time to be read before the Keynesian revolution of 1936 rendered pre-Keynesian thought, particularly on business cycles, psychologically inaccessible to the next generation of economists.

Mises added part four to the 1953 English-language edition of *The Theory of Money and Credit.* But Keynesian economics was riding high, and the world of economics was scarcely ready to resume attention to the Misesian insights. Now, however, and particularly since his death in 1973, Misesian economics has experienced a remarkable resurgence, especially in the United States. There are conferences, symposia, books, articles, and dissertations abounding in Austrian and Misesian economics. With the Keynesian system in total disarray, reeling from chronic and accelerating inflation punctuated by periods of inflationary recession, economists are more receptive to Misesian cycle theory than they have been in four decades. Let us hope that this new edition will stimulate economists to reexamine the other sparkling insights in this grievously neglected masterpiece, and that Mises' integration of money and banking with micro theory will serve as the basis for future advances in monetary thought.

PREFACE TO THE NEW EDITION

Forty years have passed since the first German-language edition of this volume was published. In the course of these four decades the world has gone through many disasters and catastrophes. The policies that brought about these unfortunate events have also affected the nations' currency systems. Sound money gave way to progressively depreciating fiat money. All countries are today vexed by inflation and threatened by the gloomy prospect of a complete breakdown of their currencies.

There is need to realize the fact that the present state of the world and especially the present state of monetary affairs are the necessary consequences of the application of the doctrines that have got hold of the minds of our contemporaries. The great inflations of our age are not acts of God. They are man-made or, to say it bluntly, government-made. They are the offshoots of doctrines that ascribe to governments the magic power of creating wealth out of nothing and of making people happy by raising the "national income."

One of the main tasks of economics is to explode the basic inflationary fallacy that confused the thinking of authors and statesmen from the days of John Law down to those of Lord Keynes. There cannot be any question of monetary reconstruction and economic recovery as long as such fables as that of the blessing of "expansionism" form an integral part of official doctrine and guide the economic policies of the nations.

None of the arguments that economics advances against the inflationist and expansionist doctrine is likely to impress demagogues. For the demagogue does not bother about the remoter consequences of his policies. He chooses inflation and credit expansion although he knows that the boom they create is short-lived and must inevitably end in a slump. He may even boast of his neglect of the long-run effects. In the long run, he repeats, we are all dead; it is only the short run that counts.

But the question is, how long will the short run last? It seems that statesmen and politicians have considerably overrated the duration of the short run. The correct diagnosis of the present state of affairs is this: We have outlived the short run and have now to face the long-run consequences that political parties have refused to take into account. Events turned out precisely as sound economics, decried as orthodox by the neo-inflationist school, had prognosticated.

In this situation an optimist may hope that the nations will be prepared to learn what they blithely disregarded only a short time ago. It is this optimistic expectation that prompted the publishers to republish this book and the author to add to it as an epilogue an essay on monetary reconstruction (part four).

LUDWIG VON MISES

New York
June 1952

INTRODUCTION

Of all branches of economic science, that part which relates to money and credit has probably the longest history and the most extensive literature. The elementary truths of the Quantity Theory were established at a time when speculation on other types of economic problems had hardly yet begun. By the middle of the nineteenth century when, in the general theory of value, a satisfactory statical system had not yet been established, the pamphlet literature of money and banking was tackling, often with marked success, many of the subtler problems of economic dynamics. At the present day, with all our differences, there is no part of economic theory which we feel to be more efficient to lend practical aid to the statesman and to the man of affairs, than the theory of money and credit.

Yet for all this there is no part of the subject where the established results of analysis and experience have been so little systematized and brought into relation with the main categories of theoretical economics. Special monographs exist by the hundred. The pamphlet literature is so extensive as to surpass the power of any one man completely to assimilate it. Yet in English, at any rate, there has been so little attempt at synthesis of this kind that, when Keynes came to write his *Treatise on Money,* he was compelled to lament the absence, not only of an established tradition of arrangement, but even of a single example of a systematic treatment of the subject on a scale and of a quality comparable with that of the standard discussions of the central problems of pure equilibrium theory.

In these circumstances it is hoped that the present publication will meet a very real need among English-speaking students. For the work of which it is a translation, the *Theorie des Geldes und der Umlaufsmittel* of Professor von Mises of Vienna, does meet just this deficiency. It deals systematically with the chief propositions of the theory of money and credit, and it brings them into relation both with the main body of analytical economics and with the chief problems of contemporary policy to which they are relevant. Commencing with a rigid analysis of the nature and function of money, it leads by a highly ingenious series of approximations, from a discussion of the value of money under simple conditions in which there is only one kind of money and no banking system, through an analysis of the phenomena of parallel currency and foreign exchanges, to an extensive treatment of the problems of modern banking and the effects of credit creation on the capital structure and the stability of business. In continental circles it has long been regarded as the standard textbook on the subject. It is hoped that it will fill a similar role in English-speaking countries. I know few works which convey a more profound impression of the logical unity and the power of modern economic analysis.

It would be a great mistake, however, to suppose that systematization of the subject constituted the only, or indeed the chief, merit of this work. So many of the propositions which it first introduced have now found their way into the common currency of modern monetary theory that the English reader, coming to it for the first time more than twenty years after its first publication, may be inclined to overlook its merits as an original contribution to knowledge—a contribution from which much of what is most important and vital in contemporary discussions takes its rise. Who in 1912 had heard of forced saving, of disparities between the equilibrium and the money rates of interest and of the cycle of fluctuations in the relations between the prices of producers' goods and consumers' goods which is the result of the instability of credit? They are all here, not as *obiter dicta* on what are essentially side issues, as is occasionally the case in the earlier literature, but as central parts of a fully articulated theoretical system—a system which the author has had the somewhat melancholy satisfaction of seeing abundantly verified by the march of subsequent events, first in the great inflations of the immediately postwar period and later in the events which gave rise to the depression from which the world is now suffering. Nor should we overlook its contributions to the more abstract parts of the theory of the value of money. Professor von Mises shares with Marshall and one or two others the merit of having assimilated the treatment of this theory to the general categories of the pure theory of value: and his emphasis in the course of this assimilation on the relation between uncertainty and the size of the cash holding and the dependence of certain monetary phenomena on the absence of foresight, anticipates much that has proved most fruitful in more recent speculation in these matters. In spite of a tendency observable in some quarters to revert to more mechanical forms of the quantity theory, in particular to proceed by way of a multiplication of purely tautological formulae, it seems fairly clear that further progress in the explanation of the more elusive monetary phenomena is likely to take place along this path.

The present translation is based upon the text of the second German edition, published in 1924. Certain passages of no great interest to English readers have been omitted and a chapter dealing with more or less purely German controversies has been placed in an appendix. The comments on policy, however, in part three, chapter twenty, have been left as they appeared in 1924.[1] But the author, who has most generously lent asistance at every stage of the translation, has written a special introduction in which he outlines his views on the problems which have emerged since that date. A note in the appendix gives the German equivalents to the technical terms

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[1] Except for one minor change of tense. In the second edition, the author prefaced the first major division of the last chapter of part three with a note to the effect that this section was to be read as referring to the time about 1912, when it was originally written. In the present edition, in order to prevent certain misunderstandings that seemed possible even if this note had been reprinted in its proper place on p. 406, certain practices and circumstances (especially in sections 4 to 8) have been described in the *past* tense. (Cf. pp. 406 n. z, 416 n., and also 429 n.)