Deflation: When Austrians Become Interventionists

Philipp Bagus

Austrian economists are famous for the laissez-faire conclusions they derive from their theoretical analyses, in particular in the case of money. For instance, they champion free banking and free money. Yet, most of them fear deflation[1] in at least some situations and call for government intervention to prevent it. Even more mainstream economists fear deflation and want to prevent it (Keynes 1963, p. 177; Samuelson 1980, p. 258; Bernanke 2002).

This paper examines what Austrian economists think about deflation and offers a critique of their views. This seems to be of particular importance because Austrians differ in their opinions about deflation, quite in contrast to most other subjects, especially inflation. Even Rothbard and Mises diverge in their perspectives on deflation.

I will begin with an analysis of Rothbard. With a few exceptions, his understanding of deflation serves as a standard to critique other Austrian perspectives. Then I will contrast his view with Mises's, analyze Sennholz's attitude toward deflation, and continue with Huerta de Soto, who is in some sense influenced by Hayek. A critique of Hayek's perspective will follow, with the analysis ending in a discussion of Reisman's opinion on the subject.

The Austrian Economist on Deflation

Rothbard

Rothbard takes a more favorable position toward deflation than most Austrian economists and, of course, than the mainstream economists. In his analysis of deflation and price deflation Rothbard refutes three common arguments: First, falling prices would depress business. Second, a deflation induced increase in real debt would hamper production. Third, credit contraction would worsen and aggravate the depression. His refutation of these fallacies will be discussed and used later to help criticize some errors about deflation other Austrian economists hold.

Demolishing the prevailing view that falling prices would have a depressing effect on business, Rothbard asserts that

> [w]hat matters for business is not the general behavior of prices, but the price differentials between selling prices and costs (the "natural rate of

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Philipp Bagus is an economics student at the University of Münster. He would like to thank Guido Hülsmann for his great help.

[1]Austrian economists define deflation as a contraction of the money supply. Mainstream economists, in contrast, define deflation as a general fall in prices.

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> interest"). If wage rates, for example, fall more rapidly than product prices, this stimulates business activity and employment. (Rothbard 2000, p. 17)

Rothbard also addresses the question of the anticipation of the price drop.

He stresses that the anticipation of falling prices "lead to an immediate fall in factor prices," since entrepreneurs would simply bid down the prices of the factors of production to the anticipated levels. Rothbard adds that "partial anticipation speeds up the adjustment of the PPM [purchasing power of money] to the changed conditions" (1993, p. 697) and points out that an unanticipated price drop may not change the real rate of return due to the increase in purchasing power of the revenues. The only nominally lower revenues might be sufficient to replace the factors of production (p. 696).

Yet, Rothbard cites another argument that deflation can actually stimulate business. He states that "a sharp deflation would also help to break up the powerful aggregations of monopoly unionism" (1991, p. 67). Rothbard's prediction about unionism seems doubtful, however, because even in times of rapidly falling prices, a union would not need to dissolve. They simply could adjust their demands for a wage to reflect the downward change in prices.

Addressing the second argument against price deflation—that bankruptcies would result from an increase in real debts—Rothbard argues that a creditor of a firm is just a different type of owner:

> It has often been maintained that a failing price level injures business firms because it aggravates the burden of fixed monetary debt. However, the creditors of a firm are just as much its owners as are the equity shareholders. The equity shareholders have less equity in the business to the extent of its debts. Bond holders (long-term creditors) are just different types of owners, very much as preferred and common stock holders exercise their ownership rights differently. Creditors save money and invest it in an enterprise, just as do stockholders. Therefore, no change in price level by itself helps or hampers a business; creditor-owners and debtor-owners may simply divide their gains (or losses) in different proportions. These are mere intra-owner controversies. (2000, p. 51)

Regarding the third argument—that a credit contraction during a depression would worsen the crisis—he stresses that credit contraction actually "will have the beneficial effect of speeding up the depression-adjustment process" (Rothbard 1993, p. 864):

> For bank credit expansion, we have seen, distorts the free market by lowering price differentials (the "natural rate of interest" or going rate of profit) on the market. Credit contraction, on the other hand, distorts the free market in the reverse direction. Deflationary credit contraction's first effect is to lower the money supply in the hands of business, particularly in the higher stages of production. This reduces the demand for factors in the higher stages, lowers factor prices and incomes, and increases price differentials and the interest rate. It *spurs* the shift of factors, in short, from the higher to the lower stages. But this means that credit contraction, when it follows upon credit expansion, speeds the market's adjustment process. Credit contraction returns the economy to free-market proportions much sooner than otherwise. (Rothbard 2000, p. 18)

Moreover, he sees another beneficial effect of a credit contraction during a depression. In a depression some of the erroneously undertaken investment projects have to be liquidated, because there are not enough savings available to sustain them.

Rothbard shows that due to a credit contraction "time preferences themselves" may decline because the falling price level leads to book losses and understatement of profits, which may induce businessmen to increase their savings (Rothbard 2000, p. 18). In the case of an increase in savings therefore, fewer adjustments are necessary.

For Rothbard, deflation, in most cases, is not an unfavorable situation, as his theoretical analysis shows. The only unfavorable deflation is compulsory monetary contraction by the government.[2] Ironically, he points out, this deflation which is "unhelpful and destructive generally receives favorable press" (Rothbard 1995a, pp. 234–40).[3]

In his analysis of deflation Rothbard takes leave from other Austrian economists. This disagreement can be pinpointed with their judgment of Great Britain's return to the prewar gold parity after the Napoleonic wars and again after World War I. In imitation of Ricardo, other Austrians condemn Great Britain's move.[4] Rothbard (1995b, p. 209), in contrast, judges that Ricardo had a "deflation phobia" and states that there is "no evidence whatever that the Bank of England deliberately contracted the money supply to pave the way for a return to gold at the prewar level" (Rothbard 1995, p. 203). The postwar depression, in his opinion, was a readjustment to the distortions brought about by the credit expansion during the war (Rothbard 1995, p. 205).

While Rothbard is less hysterical about deflation than others, he does not totally embrace it as a remedy against a previous credit expansion. Rather, he states, "the proper course for the government is to stop any inflationary credit expansion from getting under way" (2000, p. 24).[5] Whereas, he does not directly say that government should take a remedial step by inducing a credit contraction whenever a credit expansion has occurred,[6] he does, implicitly call for this contraction by stating:

> And if, as we contend, banks are inherently bankrupt [as they are after any credit expansion] and "runs" simply reveal that bankruptcy, it is beneficial for the economy for the banking system to be reformed, once and for all, by a thorough purge of the fractional-reserve banking system. Such a purge would bring home forcefully to the public the dangers of fractional-reserve banking, and, more than any academic theorizing, insure against such banking evils in the future. (Rothbard 2000, p. 21)[7]

Strangely enough, Rothbard does not apply his theoretical insights about the "beneficial effect[s]" (2000, p. 18) of deflation and about the fallacies concerning

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[2]See also on this "coercive deflation" Salerno (2003).

[3]Rothbard mentions the cases of Brazil in 1990 where the access to most bank accounts was blocked and the Soviet Union where notes were withdrawn and rendered worthless.

[4]See Hayek (1979, p. 5): "Great Britain returned to the gold standard unfortunately and unwisely at the former parity." See Huerta de Soto (2004, pp. 445–46); Mises (1953, p. 778); and Sennholz (1955, p. 15).

[5]See also Rothbard (2000, p. 28): " For it [government] has the power to reduce bank reserves at will, and thereby force the banks to cease inflating, or even to contract if necessary." Unfortunately that policy is not practical since he does not give a rule when contraction would be necessary. To make it not arbitrary he would have to say that a contraction is necessary whenever credit was expanded.

[6]"If the money supply is already inflated it is *at least* its responsibility [the government's] not to inflate *further*. Whether money should be deflated back to the gold level is a more difficult question which we need not discuss here" (Rothbard 2000, p. 148; first emphasis added).

[7]See also Rothbard (2000, p. 163): "The proper monetary policy, even after a depression is underway, is to deflate or at least to restrain from further inflation." It is not clear if that means that every credit expansion should be deflated right away. See in addition page 329.

deflation in his plans for monetary reform. Yet, in 1962 he states that deflation, at least potentially, could play a role in a monetary reform:

> [W]e have essentially two alternative, polar routes toward 100 percent gold: either to force a deflation of the supply of dollars down to the currently valued gold stock, or to "raise the price of gold" (to lower the definition of the dollar's weight) to make the total stock of gold dollars 100 percent equal to the total supply of dollars in the society. Or we can choose some combination of the two routes. (Rothbard 1991, p. 66)

Continuing on, he states, that

> we have built deflation into an absurd ogre, and have overlooked the healthy consequences of a deflationary purgation of the malinvestments of the boom, as well as the overdue aid that fixed income groups, hit by decades of inflationary erosion, would at last obtain from a considerable fall in prices. (Rothbard 1991, p. 67)

Despite these "healthy consequences" he does not want to commit himself to this alternative way to get back to a sound monetary system and stresses that more studies in this field are necessary.

In 1983, in the *Mystery of Banking* he commits himself to the nondeflationary course and discards the plan that would involve deflation: "The old definition of the dollar as 1/35 gold ounce is outdated and irrelevant to the current world; it has been violated too many times by government to be taken seriously now" (Rothbard 1983, pp. 263–64). In contrast he has decided for the following plan: "In short, the new dollar price of gold (or the weight of the dollar), is to be defined so that there will be enough gold dollars to redeem every Federal Reserve note and demand deposit, one for one" (Rothbard 1983, p. 264). Then fractional reserve banking would be outlawed. A similar plan he expounds in the *Case Against the Fed* with the difference, that an outlawry of fractional reserve banking is not included.[8] He proudly declares that this plan (giving banks a 100 percent reserve of gold) to return to sound money would not "entail any deflation or contraction of the money supply" (Rothbard 1983, p. 265).

He acknowledges the argument that the banks should be held responsible for their fraud but stresses that with his plan "we have the advantage of starting from Point Zero, of letting bygones be bygones, and of insuring against wracking deflation that would lead to a severe recession and numerous bankruptcies" (Rothbard 1983, p. 268). Yet, since this way of getting to Point Zero would be the result of another government intervention, is that really "Point Zero?"[9] Would not the actual "Point Zero" rather be the collapse of the unsound banking system induced by abstaining from any further intervention into the banking system, especially the permission of privileges like the fractional reserve banking?

In contrast to his statement that there would be "no taxpayer bailout,"[10] his plan would entail another bailout of the banks. In fact, his plan would actually entail a great redistribution of wealth from the depositors to the banks, because in the absence of the bailout, the depositors would take over the assets of the banks. This amnesty

[8]Rothbard (1994, p. 148): "The gold stock of the Fed should be revalued upward so that gold can pay off all the Fed's liabilities—largely Federal Reserve Notes and Federal Reserve deposits, at 100 cents to the dollar."

[9]He himself argues against privileges for the banks. See Rothbard (2000, p. 21).

[10]See another outline of his plan in Rothbard (1994, p. 150).

and bailing out of the fractional reserve banks by "letting bygones be bygones" contradicts his theory of ethics (Rothbard 1998).

Let me apply Rothbardian ethics to the case of fractional reserve banking. Rothbard himself does part of this exercise (Rothbard 1991, pp. 47–49). However, his analysis is not complete, especially when it comes to the question of punishment. He points out that fractional reserve banking is fraudulent since banks issue more money titles than they have money and promise to redeem the money substitutes on demand.[11] Fraud is "implicit theft" (Rothbard 1990, p. 51) and theft is a violation of property rights, which is a crime (Rothbard 1998, p. 60). Justice demands that the

> criminal must pay *double* the extent of theft: once, for restitution of the amount stolen, and once again for loss of what he had deprived another. . . . [F]or proportionate punishment to be levied we would also have to add *more* than double so as to compensate the victim in some way for the uncertain and fearful aspects of his particular ordeal. (Rothbard 1998, pp. 88–89)

If the banks and bank equity owners[12] would not be able to pay for that compensation, they would be forced into bankruptcy and their assets would be turned over to their customers. The bank owners would have to work for the rest of the compensation (p. 86).[13]

Another cause for punishment of the banks could be made by pointing out their relationship to the state, which is—at any rate from Rothbard's point of view—"a coercive criminal organization" (Rothbard 1998, p. 172). Fractional reserve banking and its entailed inflation help to finance the criminal activities of the state directly and indirectly. Therefore, fractional reserve banks are guilty not only of defrauding customers but also of operating in a symbiosis with a criminal organization.

Moreover it is necessary to add that in Rothbardian ethics there is nothing like a statute of limitations. Justice is not a question of time.[14] There is no arbitrary limitation of claim, which absolves a crime or a "bygone" and makes a punishment impossible. Yet, Rothbard's plan to bail out the banks is not only a prevention of justice but it entails an additional injustice, since he proposes to give to the banks gold that is the just property of other people. That is theft. It must be noted that the application of Rothbard's theory of ethics must bring about deflation by ending all fiduciary media.

Strangely enough, Rothbard does not apply his theory of ethics to his plan of monetary reform. In contrast he proposed a plan that contradicts his ethical theory and is—according to it—dead unjust.

With Rothbard's theory of ethics in mind, it is amazing that he terms the bankruptcies that would bring about a liberating deflation as "a short-lived holocaust" (1983, p. 268).[15] Surely, there would be a great redistribution of wealth with a loss for the banks, firms and households that relied on the ongoing intervention and credit expansion. The malinvestments would be liquidated and some of the sound

[11]See Rothbard (1990, pp. 50–51): "If fraud is to be proscribed in a free society, then fractional reserve banking would have to meet the same fate." See also Rothbard (1991, p. 49).

[12]There might also be a case to punish the banks' employees, who—knowingly or not—helped the banks in committing the crime of fraud.

[13]See Rothbard (1998, p. 86): "The ideal situation, then, puts the criminal frankly into a state of *enslavement* to his victim, the criminal continuing in that condition of just slavery until he has redressed the grievance of the man he has wronged."

[14]Ibid., p. 42: "the theory must hold true for *all* men, whatever their location in time or place."

[15]But if bankruptcies (or holocaust) should be prevented, would not inflation be even better to prevent failure of debtors, like Reisman (1996, p. 961) proposes?

investments would change ownership. Rothbard does not explain what leads him to use the negative term of holocaust for a scenario that—in the light of his own theory—should not only be ethical, but corrective of an unsound monetary system.

With great insight, Rothbard analyzes the effects of deflation, showing that it can actually have beneficial effects and that there is nothing inherently bad about deflation; yet, he does not apply his theoretical insights when it comes to his plans for monetary reform. He fails to call for deflation as a great liberating power, which seems to be the natural conclusion to be derived from his economic analysis of deflation. Rothbard does not realize that deflation is—at any rate from the viewpoint of his own ethical and economic theory—the simplest and most ethical way to get back to a sound monetary system by purging a corrupt banking system.

Mises

Mises realizes that more studies are needed concerning deflation and price deflation (Mises 1978, p. 212).[16] He defines deflation not as declining prices *per se* but as "a diminution of the quantity of money (in the broader sense), which is not offset by a corresponding diminution of the demand for money (in the broader sense) so that an increase in the objective exchange value must occur" (Mises 1981, p. 272). He himself neglects the study of deflation to some extent. Mises, usually a systematic analyst, writes in *Human Action* that "it is not necessary to point out the consequences to which a continued deflationary policy must lead. Nobody advocates such a policy" (Mises 1953 p. 428). That seems to be an easy way out of analyzing deflation.

Later on, we finally get to his views on deflation in the special case when destroyed money is "taken from the loan market" (Mises 1953, p. 564). He gives three examples of such a scenario: first a government issuing a loan and destroying the money afterward; second, that banks, frightened about their reserves and wanting to increase them by credit contraction; and third, bankruptcies of banks during the crisis and the resulting "annihilation of the fiduciary media issued by these banks."[17]

Mises points out that all three cases involve a rise in the gross market rate of interest and the liquidation of projects that do not appear to be profitable anymore. He states that "business becomes slack" and that there is a "deadlock."

There are some major problems with Mises's view. Let me first point out some general observations, before discussing the three scenarios beginning with the last.

It is true that in all three cases there might be a tendency of the gross market rate of interest to rise. Yet, that is not necessarily the case, since "[t]he mere fact that the quantity of money changes does not prevent the entrepreneurs from judging correctly what influence it will exercise on market prices. Therefore, a [decreased] quantity of money does not imply that too [high] of an interest rate be established" (Hülsmann 1998). Entrepreneurs would simply bid the market interest rate down.

Moreover, it must be pointed out that if there had been credit expansion in the first place, there could have also been an artificial reduction of the gross market rate of interest that would have needed to be corrected sooner or later. The sooner these distortions are corrected, the fewer distortions will have to be readjusted. In this case, the increase of the gross market rate of increase would speed up the readjustment.

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[16]Mises's contribution to a *Festschrift* for Arthur Spiethoff (1978, p. 212): "unfortunately, economic theory is weakest precisely where help is most needed—in analyzing the effects of declining prices."

[17]Mises tells us that this "procedure has been, in the last two hundred years, adopted again and again" (1953, p. 564). Yet, only one page later he assures us that "Deflation and credit restriction never played a noticeable role in economic history." This seems to be contradictory.

Considering his third scenario, Mises does not point out that a bank's bankruptcy during a crisis is likely to occur, only if that bank has issued fiduciary media, i.e., committed a fraud. Would the elimination of banks that issued fiduciary media, instead of being "sources of disturbances" as he claims, not rather be an elimination of a disturbance? Furthermore, after the elimination of fraudulent banks, it becomes possible for sound banks to fill the gap created by unwise and expansionary behavior.

The same is true for his second scenario, where banks contract credit to increase their reserves. If banks, which have expanded credit become more cautious and increase their reserves, the credit expansion is partially set off. A sound bank that does not distort the structure of production has a reserve ratio of 100 percent. Increasing reserve ratios is a step in the direction of a sound monetary system and not a "source of disturbance."

The problem with Mises's first scenario, in which the government issues loans and destroys the money afterward, is not as apparent. It is necessary to make distinctions: If there was no credit expansion in the first place, there might be an artificial increase in the market rate of interest and therefore fewer investments. The structure of production might become less capital-intensive and shorter. Yet, if there was and is credit expansion by a fractional reserve system, the destruction of money through the loan market can offset or reduce the distortional effects the credit expansion has. The necessary readjustment of the structure of production will therefore be smaller in size and happen more quickly.

Mises's antideflationary attitude culminates in the assertion that "[d]eflation and credit contraction no less than inflation and credit expansion are elements disarranging the smooth course of economic activities, and sources of disturbance" (Mises 1953, p. 564). He adds that, of course, deflation in contrast to inflation does not lead to overconsumption and malinvestments and is not as likely to occur due to the deflation phobia.

There remains the question of what Mises means by "disarranging the smooth course of economic activities." Even though that is not necessarily the case, there are indeed likely to be more bankruptcies during a deflation than in its absence. Yet, he probably does not consider every bankruptcy a "disturbance," but a necessary readjustment to changed economic data. Would it not be arbitrary to claim that some bankruptcies are just necessary adjustments to changes in economic data and others are a "source of disturbances?"

Next, Mises points out that a credit contraction is not a necessary feature of crises and just an abstention from further credit expansion is sufficient to induce the crisis. Mises sees some problems with crises *per se* and states that "[t]he dearth of credit . . . hurts all enterprises—not only those which are doomed at any rate, but no less those whose business is sound and could flourish if appropriate credit were available" (Mises 1953, p. 566). It must be stressed that every business could flourish if there were enough credit available. Furthermore, it seems strange to call a business sound that would need credit from an inflationary banking system to flourish.

Adding that the crisis becomes general, Mises points out that "there is no means of avoiding these secondary consequences of the preceding boom. They are inevitable" (1953, p. 566). But why should they be avoided in the first place? Surely the readjustment will be faster this way and enterprises, which operate in harmony with the time preference rate and which did not rely on being bailed out themselves nor on the bailing out of other enterprises, can even flourish.

Mises is only partially right in that a deflationary policy does not set off "the consequences of inflation" (1981, p. 266). Surely the deflation might hurt the same people that were hurt during the inflation. Yet, deflation, in contrast to inflation, is not a "breach of the law" (ibid.); but rather, it is the restoration of the law. This is a restoration in the sense that it shows everyone who tried—knowingly or not—to profit from the inflationary "breach of law," that such profiteering no longer works and that a sound banking system is preferable. There is no guarantee of amnesty.

Another feature of Mises's weakly thought out theory of deflation is that he thinks a negative interest rate is possible, if there are deflationary expectations.[18] But negative interest rates are impossible if a profit-maximizing creditor is assumed. This potential creditor would hold on to his money and wait until factor prices fall to the expected level, thereby speeding about the price adjustments.

Overall, it must be said that Mises fails to see the beneficial effects of deflation,[19] i.e., the liberating power of deflation by purging unsound investment that rested on the assumption that they would be bailed out by an unsound monetary system, the partial or complete liquidation of an unsound banking system that continuously leads to business cycles, and the restriction of the welfare state that depends on inflation and the absence of deflation.

Sennholz

Hans Sennholz is a great fighter against inflation and demands that "the people must be liberated from the money monopoly, and all politicians be banned from monetary matters" (Sennholz 1987, p. 122). The early Sennholz, inspired by his teacher Mises, is deflation-phobic. He condemns the "extremely harmful policy of deflation in order to bring the pound back to par" (1955, p. 15) because the wages could not adjust downward due to union power. This is not a good argument since union power can raise wage rates above the market rate when the price level is falling and rising. Moreover, he embraces Mises's plan for monetary reform that prevents deflation (1955, pp. 296–99).

Later on, he writes that the deflation of the Great Depression was an inevitable result of the boom[20] and Sennholz is sometimes even close to praising deflation when he says that "He [the federal reserve banker] may kindle a world boom or squash it with deflation and depression" (1987b, p. 126). Since he speaks of a depression as a readjustment time, he seems to recommend squashing the boom with deflation.

Furthermore, he develops his own plan for monetary reform that consists of removing of "government from all monetary affairs" (1979, p. 149). That includes for Sennholz the abolishment of legal tender laws, as well as compulsory monopoly of the mint and the central banking system (1979, pp. 149–50). These reforms bring the advantage of a readjusting economy which was "so badly disarranged" (1979, p. 152). after the long period of inflation. Another advantage for Sennholz could be that his reforms might lead to a reduction of government spending, since the government will have lost inflation as a means to finance its spending.

Sennholz's plan for monetary reform is very likely to lead to a severe deflation, but he, unfortunately, never speaks explicitly about deflation in that context. Moreover, in his plan he does not address the privileges the government grants to banks by granting them amnesty and permitting fractional reserve banking, i.e., permission to expand credit by uncovered loans.

Overall, Sennholz does not see deflation as a liberating force *per se*, but is instead a byproduct of monetary reform. He does not address this and he fails to point out

[18]Mises: "In the case of a quickly progressing deflation, the negative price premium could not only swallow the whole rate of originary interest, but even reverse the gross rate into a minus quantity, a rate passed on the debtor's account" (1953, p. 539).

[19]Therefore he proposes a monetary reform without deflation. See (Mises 1981, part IV).

[20]"The contraction . . . was the inevitable consequence and by-product of the financial readjustment. A depression is a readjustment time" (Sennholz 1987a, pp. 157–58).

the role that deflation can play in the return to sound money and a sound banking system.

Huerta de Soto

In the case of Huerta de Soto, we face the problem that deflation is not clearly defined. He defines deflation as "any decrease in the quantity of money 'in circulation'" (Huerta de Soto 2004, p. 442).[21] In the next sentence he claims that "deflation consists of a drop in the money supply *or a rise in the demand for money*."[22]

Huerta de Soto distinguishes three types of deflation "with radically different causes and consequences" (p. 443): First an increase in real cash balances. Second credit contraction during a recession and third a deliberate deflation induced by the government.

The first type of deflation he distinguishes is the increase of real cash balances, i.e., increased demand for money (p. 446), which indicates that he at this point uses his "second" definition of deflation. He acknowledges that this second type of deflation does not have to change the consumption/savings proportion but concentrates on the case where consumption is reduced to increase real cash balances. This reduction in consumption leads to an increase in investment, causing a rise in productivity and an increased purchasing power of money.

The second type of deflation that Huerta de Soto describes is the "tightening of credit which normally occurs in the crisis and recession stage that follows all credit expansion" (p. 448). In contrast to deliberate deflation, it would have positive effects by accelerating the liquidation of unsound investment projects undertaken during the credit expansion. Yet, what does Huerta de Soto mean by "deliberate"? Is it not also a deliberate action of the government if it refuses to bail out banks anymore? Is it not also deliberate if the government lifts the amnesty for banks for the fraud of issuing uncovered titles? If we have to answer in the positive, we should add that deliberate deflation can do exactly the same as Huerta de Soto's recession deflation. For the government can deliberately cause or refuse to prevent a "tightening of credit."[23]

A second positive effect of this type of deflation, according to Huerta de Soto, would be that "it somehow reverses the redistribution of income" that occurred during the credit expansion. This is not necessarily the case since it is possible that persons who benefited from the credit expansion may benefit again during the credit contraction and vice versa, since their income and wealth position might have changed.

The third positive effect of tightening credit which Huerta de Soto names is that accounting losses may lead to an increase in savings which makes fewer adjustments necessary. It should be added that when the artificial accounting losses disappear real

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[21]Yet, he admits that money is never "in circulation" and is always part of someone's cash balance. The question remains why he does not drop this misleading term. Page numbers cited are from a draft of the English translation of Huerta de Soto's *Dinero, Crédito Bancario y Ciclos Económicos*.

[22]Huerta de Soto might have gotten that addition to his definition from Mises: "Every firm is intent upon increasing its cash holdings. This may be properly called deflation" (1953, p. 566). So Mises is not firm on the definition of deflation either.

[23]Someone might even argue that every deflation is deliberate in the sense that it is caused by the government. For the very government allowance of issuing fiduciary media is a precondition of it coming into existence and being destroyed. At least there are not necessarily "radically different causes and consequences" between a credit contraction during a recession and a deliberate deflation, since deliberate deflation can be the cause of a credit contraction and a recession.

savings might be reduced again, and adjustments in the form of a less capital-intensive and therefore shortened structure of production might take place.

Huerta de Soto's third type of deflation is conducted by a government that deliberately wants to reduce the money supply. He claims that the "whole process of deliberate deflation contributes nothing and merely subjects the economy to unnecessary pressure" (p. 445). Furthermore, this would distort the structure of production by rendering some investment projects unprofitable, which seemed to be profitable before. He also refers to two examples where such deliberate deflations occurred: after the Napoleonic wars and after World War I in Great Britain. Huerta de Soto repeats Ricardo's advice not to return to the gold standard at par.

Let us deal with these arguments in turn. First, the government can also deliberately reduce the money supply by not bailing out the banks, i.e., abstaining from further interventions into the monetary system. This liberating deflation induced by the abolition of a central bank reduces the money supply, can bring the prices back to preinflationary levels, purge the economy from unsound investments (Huerta de Soto's "unnecessary pressure"), and an unsound monetary system. Therefore, a deliberate deflation can contribute something, namely a sound monetary system.

It is also wrong that a deliberate deflation always distorts the structure of production. By eliminating unsound investments it rather brings the structure of production back to sound territory.

In the case of a coercive deflation by taxation and liquidating the money, there are indeed fewer investments and the structure of production becomes less capital intensive. Yet, this is not because the quantity of money is reduced as Huerta de Soto indicates (2004, p. 444). For "[t]he mere fact that the quantity of money changes does not prevent the entrepreneurs from judging correctly what influence it will exercise on market prices. Therefore, a [decreased] quantity of money does not imply that too [high] of an interest rate be established" (Hülsmann 1998, p. 4). Hence, a reduction of the quantity of money must not necessarily decrease savings/investments. The real cause for a less capital intensive structure of production, i.e., a shortened and flattened structure of production, by a coercive deflation is taxation. Hoppe shows that "by simultaneously reducing the supply of present and (expected) future goods, governmental property-rights violations not only raise time-preference rates (with given schedules) but also time-preference schedules" (Hoppe 2001, p. 14).[24] Therefore, the additional taxation or outright expropriation to liquidate the money supply will decrease savings, by raising the time preference rate. People will consume more than they would consume, if they could reap more fruits of their investments.

Furthermore, if the government gets the money it wishes to destroy not by taxation but by increasing public debt, there will be fewer loans available for private companies and a tendency for a rise in the market interest rate. Therefore fewer investment projects will be undertaken than without the increase in public debt, i.e., the structure of production will be shortened. But that does not mean that the structure of production will be shorter than it would be if it rested on consumer's savings. It could be the case that there had already been investment projects erroneously undertaken with expanded credits. In this case there are too few goods to complete all investment projects and the structure of production is artificially lengthened. In this case government intervention on the loan market corrects part or all of that distortion. It is easy to imagine the case in which the government directly offsets a credit expansion of the fractional reserve banking system by absorbing the new credits.[25]

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[24]See for other distorting effects of taxation Rothbard (1977, esp. pp. 84–88).

[25]The central bank gives an uncovered loan to the government that destroys the money. In this case the transaction is only an internal governmental transfer.

Next, Huerta de Soto deals with a general problem of deflation. Inspired by the "secondary depression" theorists Röpke and Hayek, he claims that if all attempts of liberating the labor market during the depression fail, the policy with the least disturbing effects would be an "adoption of a program of public works . . . for the actual completion of works of social value" (Huerta de Soto 2004, pp. 451–54). It must be clarified that the least disturbing effects are effects which do not disturb the market processes at all, i.e., noninterventions by the government. All taxation *and* spending by the government distort the free market.[26] The "works of social value" are just a waste in the sense of a misallocation of resources.

Furthermore, public-works income of the formerly unemployed removes not only the pressure for them to reduce their wage demands (Mises 1953, pp. 792–94) but also the pressure for them to push for a liberation of the labor market. Since Huerta de Soto stresses the difficult political situation, it should be added that it is not very probable that the public-works policy will be abandoned after the recession has ended. There remains another question: Is Huerta de Soto aware that his policy advice might be a welcome excuse for politicians to employ public works policies in times of any unemployment and when politicians do not feel like liberating the labor market?

Huerta de Soto is far from having the hysterical deflation phobia of the mainstream but he sees problems with some types of it and does not realize the liberating potential of deflation even if induced by the government. Furthermore, he unnecessarily calls for government intervention during a crisis if the labor market is inflexible.

Hayek

Hayek defines deflation as "a decrease in the quantity of money" (Hayek 1979, p. 40). Although he maintains this definition, his views about deflation continued to change quite dramatically over the course of his career. In his 1931 book, *Prices and Production*, he points out that the supply of money should be invariable in order to be neutral to the formation of prices (1967, p. 108). Two exceptions are given: An increase in the division of labor and an increase in the amount of payments (1967, pp. 121–23). This combating of price deflation is justifiable, in Hayek's opinion, because it does not distort the structure of production if the new money gets to the part of the economy where the increases have occurred.

Not only does it seem to be very difficult, in practice, to get the right amount to the right place at the right time, but also the question remains why price deflation should be prevented and why inflation in favor of some market participants is justifiable.

Furthermore, what Hayek means by "neutral" money is an entity that would bring about the same conditions as prevail in a barter economy (Hayek 1967, pp. 130–31; 1984). But money is a commodity (the most marketable) and its existence always results in another structure of production and allocation of resources that would not exist without it. Money can never be "neutral."[27] Money, in fact, enables very different conditions from that which occur in a barter economy.

Notable is Hayek's earlier attitude toward a depression. He states that monetary policy must resist proposals to fight the depression with inflation (Hayek 1967, p. 125).

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[26]See Rothbard (1977, esp. pp. 84–88 and 172–84). The disturbances of taxation would be less, if the government would not spend the tax money but destroy all of it. Therefore someone might argue that a coercive deflation tax is less disturbing than other taxes that additional distort the economy by spending.

[27]See Mises (1953, p. 250) on this point: "the notion of a neutral money is unrealizable and inconceivable in itself."

In other words if there is a deflation during the depression, it should not be prevented. That seems to contradict his statement, that the money supply should be invariable.

In the early 1930s, Hayek in his debate with Keynes considers deflation a possible effect (secondary phenomenon) of a depression. The crisis must be cured by the readjustment of the structure of production and "it cannot be removed by new inflation" (Hayek 1995, p. 194). He correctly points out that unemployment is the result of causes that are deeper than mere deflation. "Any attempt to combat the crisis by credit expansion will, therefore, not only be merely the treatment of symptoms as causes, but may also prolong the depression by delaying the inevitable real adjustments" (1995, p. 196).

But Hayek begins to abandon his position toward deflation over the years. Already in 1939 he states that the demand for consumers' goods during a depression may fall *too low*, and therefore, "supplementing demand by public expenditure may well be justified" (Hayek 1975, p. 63). But he still does not regard monetary expansion as a wise policy, since "it could only accentuate the later difficulties" and "perpetuate fluctuations."

In 1960, in his *Constitution of Liberty* he maintains that deflation has "bad effects," but that "it is, however, rather doubtful whether, from a long-term point of view, deflation is really more harmful than inflation" (Hayek 1971, p. 330). He argues that deflation and inflation cause unexpected price changes twice. First, when the prices are (in the case of deflation) lower than expected, and second when the prices stop falling after the expectations have adapted to falling prices. This is an extremely mechanical view of the price anticipation of market participants. Surely it is imaginable that some or all market participants anticipate the price change. Moreover, he states that deflation depresses business. Hence, Hayek implicitly assumes that in some cases deflation should be prevented.[28]

He fails to see that deflation is not depressing to all businesses and does not necessarily decrease overall production. Only the business owners who depend on further inflation will get into serious trouble, while those entrepreneurs who correctly anticipate the deflation will receive gains. The ownership of companies can change but the "real rate of return remains the same" (Rothbard 1993, p. 696).

In 1975, after having received the Nobel prize he mentions the "secondary depression" in which unemployment leads to a decrease in aggregate demand and therefore more unemployment. "Such a 'secondary depression' caused by an induced deflation should of course be prevented by appropriate monetary countermeasures" (Hayek 1985, p. 210). He denies that he ever thought that the deflation during a depression would be a "curative process." He tells us that he thought deflation would be necessary to break the downward rigidity of wages and that inflation is no longer for him a politically possible measure against wage rigidities. This seems to contradict his previous statement that "appropriate monetary countermeasures" (inflation) should be used to prevent a "secondary depression."

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[28]See Hayek (1971, p. 333):

> As soon as deflation makes itself felt, there will be immediate attempts to combat it—often when it is only a local and necessary process that should not be prevented. There is more danger in untimely fears of deflation than in the possibility of our not taking necessary countermeasures.

He seems to imply that there could also be deflation that is not local and unnecessary and that therefore should be prevented.

With public works at low wages he wants to fight unemployment and inhibit the misdirection of labor that would result from monetary expansion.[29] It is hard to see why public works do not represent a misdirection of labor and resources since the labor done is not based on consumer wishes. He furthermore argues, that in order to avert a political revolution in Germany in 1930, the government, hoping to postpone the crisis, would have had to induce a credit expansion. That does not seem logical because there is no reason why a postponed and therefore severer crisis would not have lead to a political revolution.

In other lectures that same year, Hayek makes more interesting comments about his new attitude towards deflation (Hayek 1979). There he explicitly confesses that he has changed his opinion about it. A threatening deflation must be stopped because due to the disappointment of expectations, it tends to induce a "secondary deflation," that "performs no steering function" (p. 15). Hayek states that were he responsible for monetary policy, he would prevent deflation by announcing that he would fight deflation with all means. This very announcement, he believes, would help to stave off a deflation. And he again shows his new inflationary bias by pointing out that "monetary policy must prevent wide fluctuations in the quantity of money or in the income stream" (p. 17).

Hayek does not realize that deflation in a depression speeds up the readjustment process by speeding up the liquidation of malinvestments. The business depression he talks about can accelerate it too, by making the entrepreneurs save more because they suffer book losses. The argument that there may be high real wages during a deflation might be true, but during a time of inflation, or at any time, real wages may also be too high because of privileges given to unions or direct government interventions into the labor market.

It is interesting that Hayek changed his opinion about deflation so dramatically. While he rightly said in the 1930s that monetary expansion only postpones and prolongs the depression, at the end of his career he calls for monetary counter-measures to combat a "secondary depression." Hayek gives no valid theoretical argument for his change of opinion. The reason for that radical change might have been his experience with Germany's turn to national socialism (p. 15). That led him to give excuses for all kinds of interventions.

Reisman

Reisman defines deflation as "a decrease in the quantity of money/volume of spending" (Reisman 1996, p. 520) which is in his eyes an "evil."[30] He names several symptoms of deflation besides a reduction of prices: a reduction of the "availability of funds with which to repay debts;" a "[w]iping out of business profitability due to the immediate decline in sales revenues in the face of costs that fall only with a more-or-less significant time lag;" and "[m]ass unemployment until such time as wage rates and prices fall, to correspond to the reduced quantity of money and volume of spending for goods and labor" (1996, p. 574; 2000, p. 14). How he jumps from these symptoms to the ethical judgment that deflation is evil, is not clear. But let us deal with the symptoms one after another, starting at the end.

It is true that there can be unemployment, if wage rates fall slower than other prices. But why can wage rates not fall as fast as other prices? Why can they not drop

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[29] See above, for Hayek's influence on Huerta de Soto on this point.

[30] See Reisman (1996, p. 574): "To view the fall in prices brought about by increased production as the same as deflation and depression is gratuitously to confuse the enormous economic good that is constituted by increases in production with the evil that is constituted by depressions."

even faster?[31] There is no systematic reason why Reisman's scenario should be more probable. Government interventions and union power can lead to wage rates over the market rate, when general prices fall and rise.

And is there really a "wiping out of business profitability" due to a time lag in the fall of prices? First, it must be stressed that there is not necessarily a time lag, since the price drop can be anticipated. In this case, the prices would drop immediately to the expected levels due to an abstention of buying. The "business profitability" would not be changed at all.[32]

Even if the fall in prices was not anticipated the "real rate of net return" (Rothbard 1993, p. 696) does not have to be affected, since the essential price differential (between buying and selling prices) might not change. The price differential might even rise. In this case, the entrepreneur can buy even more factors of production with his revenues than before. Surely, the entrepreneur will have suffered an opportunity loss, if he did not anticipate the price drop and did not hold to his money; but he is not forced into bankruptcy simply because of that, but only might have difficulties if he has debts.[33] This is, in fact, the next argument.

It is true that the real burden of debt is higher due to a deflation since there are fewer funds available. But why would that cause severe difficulties for the economy? It would just imply a mere change of ownership of the companies.[34] The creditors' share of the assets would rise, in some cases, so far that the creditors would take over all assets of the company. That would not change the physical integrity of the assets and the company at all. They would not just disappear. To some extent, Reisman sees that too, by pointing out that "[c]reditors gain, but not even all creditors—only those able to collect the debts owed to them" (Reisman 2000, p. 15). But creditors can always recover at least some part of their investments by receiving the assets that back the loan. Therefore, they will not be left with nothing. Depending on the judicial system, the debtors might also have to pay the debts they cannot pay when due, later.

At one point, he stresses the practical difficulties of mass bankruptcies during a deflation:

> [M]ass bankruptcies, which, given the inability of today's judicial system to keep pace even with its current case load, would probably take a decade or more to get sorted out. That would mean that in the interval the economy would be largely paralyzed, because no one would know just who owned what. (1996, p. 961)

The ability of the present-day judicial system to handle cases of mass bankruptcy is not, of course, a theoretical argument against deflation. For Reisman's argument deals with the practical difficulties a severe deflation might have to face in today's judicial system. Yet there is no theoretical reason why there could not be a judicial system that could settle the lawsuits quickly. But let us deal with this practical argument.

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[31] See Hutt (in Hazlitt 1995, p. 398): "We can conceive, that is, of prices falling rapidly, keeping pace with expectations of price changes, but never reaching zero, with full utilization of resources persisting all the way."

[32] See Rothbard (1993, p. 697): "if the changes were completely anticipated, the purchasing power would change immediately."

[33] Of course some entrepreneurs can have difficulties in the sense, that other entrepreneurs who anticipated the price drop and held their money back, can bid resources away from them. Entrepreneurs who anticipate price changes can always profit relative to the entrepreneurs who did not anticipate them. Reisman's argument was probably not intended to be an argument against any price change.

[34] See Rothbard on that argument (in 2000, p. 51 and above).

It must be stressed that an increased demand for judicial services on the free market brings about an increased supply of those services. Yet, Reisman could contend that we face a government monopoly of judicial services. However, politicians would likely come up with emergency measures if deflation caused bankruptcies which overstrained the judicial system.[35] For politicians are eager to search and find problems they can fix. Also the judicial system itself could come up with solutions for this problem.

But let us for the sake of argument assume that the government and the judicial system would not react at all. There still remains the fact that in practice every change of ownership involves some transitional period. Would it not be arbitrary to name a time of transition that must be avoided? Let us furthermore assume that it would take "a decade or more" until the ownership of some companies has turned over and the former owner, in the mean time, would not invest or even disinvest in that particular company. In contrast, the former owner would spend his profits during the transitional "decade" on consumption or other investments. Why would that be something inherently bad from Reisman's economic point of view?

Naturally, Reisman wants to prevent deflation in his plan for a monetary reform (Reisman 1996, p. 960). Because he assumes that under a gold standard the "velocity of circulation of money" would fall, he suggests "the gold supply equal to enough dollars to leave spending in terms of dollars unchanged at the lower velocity" (p. 961) and thereby prevent a contractionary process.

What would that mean? Like Rothbard's proposal, Reisman's bail out of the unsound banking system would transfer gold to the banks (Reisman p. 961) and redistribute wealth from the cheated depositors—who should be the owner of the banks—to the actual owners of the banks.

The fraud[36] of fractional reserve banking would be sanctified *ex post*. Furthermore, it would lengthen readjustments of the structure of production that had become distorted during the inflationary period. Moreover, the proposed inflation of the money supply in terms of dollars to offset the alleged decrease in the velocity of circulation of money would be an additional redistribution in favor of all debtors.

In Reisman's opinion this redistribution would be advantageous: "Solving the problem of 'an excessive debt burden' by means of inflation in any form is a reprehensible practice" (p. 961). His suggestion for monetary reform shows that if someone wants to prevent "debt problems" for some people, there is no quasi limit in the inflation that would help the debtors. His proposed amount of inflation seems to be arbitrary by his own standards.

Reisman, however, justifies this inflation by claiming that it would be impractical and time consuming for the judicial system to sort out the bankruptcies. That argument has been addressed above, but, since he brings justice into the picture, it must be added that justice is not a question of time or practicability.

In considering the ethical part of his proposal for a monetary reform, it must be stressed that Reisman's proposal contradicts not only Rothbardian ethics but also his own version of capitalism. According to Reisman, "capitalism is characterized by laissez faire" (p. 21). Only the government has the right to violate freedom, i.e., "the absence of the initiation of physical force" (p. 22) in order to secure freedom.[37] The only task the government would have would be "upholding individual freedom. Every violation of that principle—every act of government intervention into the economic

[35]Governments actually did that before. See for blanket measures during the German Great Depression (Hamburger 1933).

[36]Reisman himself calls it fraud. See Reisman (1996, pp. 958 and 514).

[37]This is not the place to criticize this contradiction.

system—represents the use of physical force either to prevent individuals from acting for their self-interest or to compel them to act against their self-interest" (p. 26).

Yet, Reisman's plan of monetary reform is not the direct abolition of government interventions into the monetary system, which would bring about deflation, but it is a new intervention, guaranteeing the results of past interventions. He proposes a new government intervention into the economic system, i.e., according to his own standards, a violation of freedom, in order to bail out the unsound banking system. To conclude with his own words:

> every attempt to justify any form of restriction or limitation on freedom is actually an attempt, knowingly or unknowingly, to unleash the initiation of physical force. As such, it is an attempt to unleash the destruction of human life and property, and for this reason should be regarded as monstrously evil. (Reisman 1996, p. 27)

Conclusion

The aforementioned six Austrian economists, especially Rothbard, refute most arguments that mainstream economists mention against deflation. To differing degrees they are much less deflation-phobic than the mainstream. Nevertheless, when it comes to deflation, they diverge very much and do not staunchly champion the free market. In contrast to their laissez-faire views on most other subjects, in order to fight deflation, they come up with an arsenal of state interventions, like government bailouts, redistribution of gold, amnesty and privileges for the banking system, government-planned monetary reforms, public works, credit expansion, and inflation.

Curiously, with these interventions they want to prevent the liberating deflation, i.e., the free market reaction to an abstention of all government interventions into the monetary system, especially the fractional reserve banks' privileges and amnesty. They fail to see that deflation is a fast, smooth, direct, and ethical way to a sound financial system.

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