

Principles of Economics – Lecture 14 (Credit and Banking) • Study Notes

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Big Picture

- Credit and banking emerge from **declining time preference** and the accumulation of savings.
 - **Two core functions of banking:**
 - **Deposits** → safekeeping of savings.
 - **Investment banking** → channeling savings into productive use.
 - Distinction between **commodity credit** (backed by real savings) and **circulation credit** (created without savings) is essential to Austrian economics.
 - Interest is explained as the **price of time**: a reflection of differing time preferences between borrowers and lenders.
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Core Claims

1. **From Time Preference to Credit**
2. Lower time preference → more saving → capital accumulation.
3. Capital requires specialized management → birth of banks as institutions.
4. **Two Banking Functions**
5. **Deposits**: pay a bank to keep money safe, reducing risk of theft or loss.
6. **Investment banking**: savers provide funds for entrepreneurs, expecting returns but bearing risk.
7. **Bankers as Entrepreneurs**
8. Banks act as intermediaries between savers and entrepreneurs.
9. They specialize in allocating capital productively.

10. **Commodity Credit vs. Circulation Credit**
 11. **Commodity credit:** every loan matches actual savings in amount and duration.
 12. **Circulation credit:** banks lend more than savings available → expansion of money supply.
 13. Commodity credit = sustainable. Circulation credit = root of the business cycle.
 14. **Interest as Price of Time**
 15. Borrowers have higher time preference (want resources now).
 16. Lenders have lower time preference (willing to wait).
 17. Interest rate emerges as the market price reconciling these valuations.
 18. **Austrian vs. Productivity Theory of Interest**
 19. Austrians: interest reflects time preference.
 20. Mainstream: interest reflects productivity of capital.
 21. Ammous sides with Austrians – infinite variation in productivity means only time preference determines the general rate.
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Originary Interest

- Defined by Mises as a **category of human action**.
 - Present goods are always valued more highly than identical future goods.
 - The interest rate harmonizes time preferences across society, becoming the market discount rate for future goods.
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Capitalist's Role

- Capitalist defers consumption so that workers and suppliers can be paid **before** production finishes.
- Interest is the payment for this **time input**.
- Profit ≠ interest:
- **Profit:** difference between input and output valuations.
- **Interest:** compensation for deferring consumption (the cost of time).

Interest and Civilization

- Declining time preference → lower interest rates over millennia.
- Historical trend: interest rates fell from ~16% in ancient Greece to ~2.5% in 19th-century Europe, interrupted by wars, plagues, and fiat money.
- Ammous speculates: under hard money, interest could naturally fall to **zero**, replaced by equity financing.

Religion and Usury

- Religions banned usury to enforce low time preference.
- Ammous argues free markets may achieve the same outcome without bans: as capital becomes abundant, lending shifts to equity.
- At extreme abundance, loans for emergencies could be interest-free, while business finance relies on equity partnerships.

Key Concepts & Mental Models

- **Commodity credit** vs. **circulation credit**.
 - **Interest = price of time**.
 - **Originary interest**: universal discounting of future goods.
 - **Capitalist function**: time provider in production.
 - **Declining interest rates = civilizational progress**.
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Quotable Ideas

- “The banker is an entrepreneur specializing in the allocation of capital.” — Ammous
 - “Interest is the price of time.” — Ammous
 - “Capital outside a market economy is like a fish out of water.” — Mises (via Ammous)
 - “Civilization is the process of declining time preference and interest.” — Ammous
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Study Prompts

- What are the two essential functions of banking?
 - Define commodity credit and circulation credit.
 - Why do Austrians see interest as rooted in time preference rather than productivity?
 - Distinguish profit from interest.
 - How can declining time preference lead to interest-free lending?
 - Why do religions oppose usury, and how does Ammous reinterpret this?
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TL;DR

Credit and banking arise from declining time preference and saving. Banks specialize in safekeeping (deposits) and capital allocation (investment banking). The Austrian distinction between commodity credit (backed by real savings) and circulation credit (unsupported money creation) explains why the latter causes business cycles. Interest reflects time preference, not productivity — it is the market price of time. Over centuries, civilization lowers interest rates, potentially

toward zero, where equity replaces lending as the primary financing model. Religion's ban on usury echoes this: both point toward a world where saving, abundance, and low time preference make interest unnecessary.
