

# Principles of Economics – Lecture 15 (Monetary Expansion) • Study Notes

By Saifedean Ammous

---

## Big Picture

- This lecture contrasts **commodity credit** (backed by real savings) with **circulation credit** (created without savings).
  - Expansion of credit without prior saving is not harmless – it causes the **business cycle**.
  - Fiduciary media (unbacked claims on money) distort economic calculation, misallocate capital, and inevitably lead to recession.
- 

## Core Claims

1. **Credit Cannot Substitute for Capital**
2. As Mises argued: *“Expansion of credit cannot form a substitute for capital.”*
3. Real capital comes only from **foregone consumption** and saving.
4. Circulation credit attempts to “cheat physics” by creating financial claims without real resources.
5. **Mechanisms of Monetary Expansion**
6. **Fractional reserve banking**: deposits lent while simultaneously available on demand.
7. **Maturity mismatching**: short-term deposits lent as long-term loans.
8. **Rehypothecation**: collateral reused for multiple loans.
9. All create **fiduciary media** – redeemable claims without full backing.
10. **Money Substitutes**
11. **Money certificates**: 100% backed, fully redeemable.

12. **Fiduciary media:** partially backed, inflate supply, cause instability.
  13. Fiat emerges when redemption is suspended and certificates circulate as money.
  14. **Inflation Through History**
  15. Roman emperors debased coins with base metals, creating more coins without more gold.
  16. Modern states debase through unbacked credit and fiat issuance.
  17. Both reduce purchasing power and amount to theft.
  18. **Why Fiduciary Media Are Dangerous**
  19. Money is unique: a claim on money can circulate almost as easily as money itself.
  20. This makes unbacked claims indistinguishable at first from real savings, leading to **malinvestment**.
- 

## **Austrian Business Cycle Theory (ABCT)**

1. **The Boom**
  2. Circulation credit lowers interest rates artificially.
  3. Entrepreneurs undertake longer, more capital-intensive projects.
  4. Appears profitable because input prices haven't yet risen.
  5. **The Bust**
  6. Real resources are insufficient to complete all projects.
  7. As input prices rise, projects fail simultaneously across sectors.
  8. Malinvestment is revealed; businesses liquidate; recession follows.
  9. **Key Point**
  10. Printing more credit cannot create real resources.
  11. It only distorts calculation, misleads entrepreneurs, and wastes capital.
-

## Graphical Framework (Hayek / Garrison)

- **Production Possibilities Frontier (PPF)**
  - Trade-off between consumption and investment.
  - Real growth requires lowering consumption, saving, and investing.
  - **Stages of Production Triangle**
  - Longer stages possible only with real saving.
  - Artificially extending stages without saving = collapse.
  - **Loanable Funds Market**
  - True decline in time preference shifts savings supply rightward → lower interest.
  - Artificially low rates from fiduciary media → investment > savings → malinvestment.
- 

## Analogies

- **Seed corn:** you cannot consume corn and plant it at the same time. Unbacked credit pretends you can.
  - **Bricks & houses:** promising 120 houses with 800k bricks when 1M are required. Result = unfinished, worthless houses.
  - **Thermometer & lighter:** lowering interest by credit expansion is like heating a thermometer to fake a warmer room.
- 

## Key Concepts & Mental Models

- **Commodity credit vs. circulation credit.**
  - **Fiduciary media** as root of business cycles.
  - **Malinvestment:** misallocation caused by distorted prices.
  - **Boom-bust cycle** as inevitable result of credit expansion.
  - **No free lunch:** real resources can't be conjured from paper claims.
-

---

## Quotable Ideas

- “Expansion of credit cannot form a substitute for capital.” — Mises
- “Monetary expansion is cheating reality: it promises resources that do not exist.” — Ammous
- “The boom is the disease; the bust is the cure.” — Austrian insight

---

## Study Prompts

- Differentiate between commodity credit and circulation credit.
- Explain why fiduciary media cause business cycles.
- How do fractional reserves, maturity mismatching, and rehypothecation expand credit?
- Illustrate malinvestment with the bricks-and-houses example.
- Why does artificially lowering interest rates lead to collapse?

---

## TL;DR

Monetary expansion through fiduciary media creates financial claims without real resources. While it initially fuels booms by lowering interest rates and encouraging long-term projects, these projects are unsustainable. Rising input prices reveal insufficient real capital, leading to widespread failures — the bust. True growth requires saving and investment, not paper promises. The Austrian Business Cycle Theory explains why credit expansion always ends in malinvestment and recession.

---