

1. Stimulating the economy works contra productive and creates tensions

We are living in an era of unprecedented economic stimulus. The European Central Bank (ECB) responded to the financial crisis in 2008 with unprecedented monetary measures such as negative interest rates. During the Covid-19 pandemic, governments increased their debt to levels previously only seen during war times. These stimulus policies are widely supported by most leading mainstream economists.

The idea behind these policies is that by creating new money and by increasing debt, economic activities can be financed that could otherwise not be sustained. Companies that would otherwise go bankrupt can continue their operations and additional investments can be made. Increasing debts and creating new money are seen as panacea to be applied to eternity. They are believed to stimulate economic growth and result in full employment.

Austrian School

Austrian School economists tend to disagree with these mainstream views. In a series of articles, I will explain the issues with stimulus policies and that as a result societies are not tuned to the requirements of the people, but to the economic growth ambitions of governments and central banks. The Austrian School is giving us important arguments why our current monetary and fiscal policies are counterproductive, based on a thorough theoretical framework.

The basis of the Austrian School is the theory of the price and interest rate mechanism. Prices are determined by supply and demand, step by step described for the first time by Carl Menger in 1871. Menger may have been inspired by the medieval 'School of Salamanca' and their ideas that prices depend on the subjective value a consumer attaches to those goods.

When people are working together in an efficient manner and more efficient ways of production are being enabled, it is likely that prices will go down. Prices going down are a form of 'profit to society'. Everyone in society benefits from lower prices, because with the same effort and the same salary, more goods and services can be bought by everyone. If a society does generate benefits for all the people, this society will develop in a stable manner.

Side effects of monetary policies

Economists and central bankers are however scared for prices to go down. The task of the ECB is to make sure that prices go up, on average by nearly 2% a year. The ECB maintains that their policies result in a growing economy, as measured by a rise in GDP. Their policies consist of increasing the money supply and reducing interest rates. In this article, when I am mentioning the ECB, I am referring to all major central banks.

Increasing the money supply and pushing down interest rate have negative side effects. Creating money out of thin air results in boom-and-bust economic cycles and an economy that is not developing in a stable manner. It is merely beneficial to those people or institutions who have access to newly created money first. People who do not have access only experience prices rising, which is the result of creating more money. They see their purchasing power going down. This is the reason people in many societies are complaining about not benefitting from a 'growing economy'.

Whereas it may be true that GDP goes up at first due to monetary policies, it says nothing about an increase in welfare. Nothing can be said about this, because value cannot be measured, let alone be summarised in GDP-statistics. From an accounting point of view, profit can be measured. From a welfare point of view 'society's profit' cannot be measured.

There is no need for monetary policies. As given by nature, we have two mechanism that help shape society, benefitting people in society: The Price mechanism and the Interest Rate mechanism. Prices come about in a free marketplace based on preferences of people in society. The interest rate is a compensation for giving up time. The market interest rate comes about in a marketplace, based on the time preferences of people in society.

Prices and interest rates determine the production structure and determine when and how much should be produced. Manipulating prices and interest rates, as central banks as the ECB do, are counterproductive. Prices and interest rates that are no longer in line with preferences of people, will eventually result in tensions in society.

In the next articles I will elaborate on prices and interest rates, how they shape the production structure and society and about the negative side effects of government interventions.