

## 10. Central banks pushing prices up and interest rates down

As mentioned in the previous article, if there is no growth in the money supply and without a leap in quality of products or services, it is quite likely for prices to go down in any society. Deflation, a general decline in prices, is a boon to society.

However, economists believe that consumer goods prices must rise every year. The idea is that with stably rising prices, 'the economy' will do well. In the words of the ECB: 'When prices are stable, everyone is better off: price stability supports economic growth and employment, and allows people to make more reliable plans when taking decisions about borrowing, saving, and expanding businesses.'<sup>1</sup> The goal of Central bank's policies is to make sure that 'on average' all consumer products must become about 2% more expensive per year. Let's have a look at price stability first and then

### What is price stability ?

The ECB believes that a 'stable value of money' is good for 'the economy'. The ECB is however in no position to judge what is good or not good for 'the economy'. The ECB is not even in a position to say anything about 'the economy' because no such thing exists. 'The economy' are all the people in society who are working and living together. There is no way all these human activities can be measured by numbers as GDP or average prices.

The ECB may think that a declining GDP is 'bad for the economy', the people in society may completely disagree. Maybe people are more happy with more leisure. Maybe people prefer less goods because population declines, or they prefer higher quality goods. Maybe people prefer less goods in order to protect the environment. A GDP number only summarises how much money has been spent on certain goods and services, it nowhere reflects whether welfare has increased or decreased.

Somewhat related is the question: What is the Consumer Price Index (CPI) and what number are we looking at? The CPI price level is seen as a weighted average of the prices of various goods and services. If the price of an apple is 1, the price of a pear 3, and if 1 exists of both, is the average price in this case 2? What does this average price of 2 mean? The price of half an apple and half a pear? If in a next period people are eating three apples, the average price is 1.5? The average price it seems is related to how much has been spent on apples and pears or goods and services in general.

The inverse of the CPI is the purchasing power. The purchasing power of money depends on how many goods and services someone can purchase. So, if the price of 3 apples is one unit of money, we can say that the purchasing power of the one unit of money is three apples. It is however not possible to add up the purchasing power of money with respect to apples and pears in order to obtain the total purchasing power. One cannot add up 3 apples to one pear in order to establish the total purchasing power of a unit of money with respect to apples and pears together. This becomes even more difficult in case of a difference in quality of apples and pears over time or in products and services in general. An 'average price level' can be constant over many years, if the underlying basket

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<sup>1</sup> See ECB website:

<https://www.ecb.europa.eu/mopo/intro/benefits/html/index.en.html#:~:text=When%20prices%20are%20stable%2C%20everyone,%2C%20saving%2C%20and%20expanding%20businesses>

of goods has completely changed, it does not say anything about the stability of these different baskets of goods. If it is not obvious what the CPI number actually reflects, it does not make much sense to keep it stable in the first place.

### **Negative consequences of 'price stability'**

Most importantly, there is no need to manipulate prices. As explained in previous articles, as given by nature we have the price and interest rate mechanism. Prices are a means to shape society according to the preferences of society. Whether people need more phones, more leisure, clean air, better healthcare, etc., prices will develop in the marketplace as a result of the preferences of people in society. You may disagree with such prices, because they are not in line with your preference. You may disagree because the GDP or CPI-outcomes are not in line with your target. But all of this does not matter. What should matter is to meet the preferences of people in society, with a view to improving their situation. In a market economy where there is no intervention by central banks as the ECB, prices reflect the preference of people in society. By manipulating prices, the ECB causes the quality of the signalling function of prices to go down.

In practice, central banks as the ECB aim to 'stabilise prices' by increasing the money supply and by keeping interest rates low or as low as possible. With these policies the ECB is intervening in the market process. The result is that with every monetary interference, a central bank makes things worse for society, because due to the intervention prices and interest rates are no longer in line with society's preferences. To illustrate the point, there are two well-known negative consequences of increasing the money supply.

#### 1. The Piketty transfer of wealth effect

Not all prices are being impacted in the same manner by monetary policies. If the ECB increases the money supply by  $x\%$  it will never be the case that all prices rise by  $y\%$ . In our system of 'fractional banking' money is issued as credit, in the form of new loans in a cooperative structure between banks and central banks. The money spent on goods and services by people or companies receiving the loans, will cause the prices of those products to rise. These price changes reflect the impact of the spending of those people having received the newly created money.

Slowly, the inflated money and the price rises will find its way through the economic system. The people in society furthest away from the issuance source will experience the rising prices, but will not be able to appreciate the increase in availability of money. These people will see their purchasing power go down.

One part of society benefits. These are the banks and people and institutions that have been able to borrow. In general, this is the richer part of society, as they have assets which can be used as collateral. They are more creditworthy than poor people. Banks benefit, because for them this is an easy way of making money, by lending out money, some way or another, that did not exist before. The prices of goods and services these borrowers are buying will consequently rise. The providers of these goods and services will benefit as well. The other part of society, in general the poorer and people with less or without debt, will be worse off. The money creation process is not neutral, but results in a wealth transfer from poor to rich.

It was the French economist Richard Cantillon who already described this effect in 1730.

## 2. ABC: Monetary policy disrupts the structure of production

Due to monetary policies of central banks, interest rates will be kept lower compared to a situation where the ECB would not intervene. The additional money made available to borrowers at a lower interest rate, will result in a deepening of the production structure. More money will be invested in expanding the production structure, as if society has signalled that they would like to consume more in the future. However, if people would have preferred more in the future, the interest rate would have naturally gone down. If interest rates do not go down naturally, people in society do not signal that an expansion is needed.

Von Mises describes this process which is well known as the Austrian Business Cycle (ABC) theory:

- Initially, money growth will 'be good for the economy', because, for example, more is invested. Investors calculate the attractiveness of a particular investment by comparing the investment costs with future returns, by discounting them with interest rates. Future yields will become more attractive due to lower interest rates. It is as if consumers have indicated that they want to spend more in the future, at the expense of consuming now and that the production structure can be deepened.
- Projects that were previously unprofitable may well be profitable now due to the artificially lower interest rates. In this way, goods are bought, usually capital goods, but also houses or cars in the case of consumer loans, with money that did not exist before. As a result, these prices, as well as stock market prices, will indeed start to rise, the demand for production goods will increase, wages will rise and people will feel that they have become richer.
- However, consumers have not indicated at all that they want to consume relatively more later than now. Interest rates kept artificially low tend to rise. Producers and investors then see that the production costs and costs of refinancing have risen and are no longer in proportion to the prices that consumers are willing to pay. Price relationships have become skewed over time.
- There comes a time when the investments no longer prove to be profitable. The artificially low interest rates have misled economic participants. The relative prices will then adjust so that they are in line with the preferences of the people. This is when a correction begins. Certain investments prove to have been made incorrectly after all and must be written off. The time and money spent on many projects has proved useless, unemployment is created and value has been destroyed.

To reach their goal of low and stably rising prices, banks and central banks jointly issue more credit than what would have been possible by the savings of people alone. The additional offer of money is only accepted by borrowers at a lower interest rate than before. The balance that prevailed in the time market is artificially disturbed. This imbalance due to lower interest rates is ingrained in our 'fractional banking' system, whereby banks can effectively lend more than entrusted to banks on the

basis of savings<sup>2</sup>. The money supply can hence grow also without central bank monetary policies. The mentioned imbalance is only exacerbated by monetary stimulus by central banks.

This boom-bust is not good for society:

- Investments are written off. Efforts put into building new ventures and business were in vain. Time and energy of people were wasted and not spent properly.
- Periods of busts or recessions are stressful. People are being laid off, governments feel the need to taking difficult measures, these are periods of civil unrest
- Although central banks are aiming for (price) stability, they are accomplishing the opposite. Monetary policies aimed at stable prices result in instable economies and societies.

### **Price stability does not work**

According to central banks as the ECB: 'When inflation is low, stable and predictable, it helps people and businesses to better plan their savings, spending and investment. That helps the economy to grow, in turn creating jobs and prosperity.' However:

- Aiming for price stability is an impossible goal in itself. There is no such thing as 'stable value of money'.
- Monetary policies do not create prosperity, it re-distributes prosperity, in general to the benefit of the more richer part of society.
- There may be a short lived positive effect of monetary policies. However, every boom is usually followed by a bust that goes accompanied with job losses and investment write-offs, undoing the positive effects it had on prosperity.
- In the long run a change in the quantity of money supplied by the central bank (all things being equal) will only be reflected in a change in the general level of prices and will not cause permanent changes in real variables, such as real output or unemployment.

Monetary policies do not contribute anything to society's profit. On the other hand, it contributes to society's loss.

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2 See for instance: Can banks individually create money out of nothing? — The theories and the empirical evidence, Richard A. Werner, International Review of Financial Analysis Volume 36, December 2014, Pages 1-19