

11. To intervene or not to intervene?

When a central bank starts to intervene by monetary policies, with a view to creating inflation and to increase 'the average price level', prices and interest rates will be distorted. Prices and interest rates are no longer just determined in the marketplace, reflecting the preferences of society, but also by the policies of central banks. With a central bank intervening, the signalling function of prices no longer has the same quality as before. If a financial crisis develops, for whatever reason, the free market or 'capitalism' cannot be blamed, because there is no free market when a central bank or government intervenes. For society it would be better if central banks and governments would not intervene at all and would simply accept declining prices.

More discipline without intervention

Under a gold-standard it is not possible for central banks to intervene in the market processes by growing the money supply. This was for instance the case when the world was on a gold standard in the 19th century and before. Such a system brings a form of discipline to the market.

If a gold-standard country experiences a growing fiscal deficit, it will be more difficult for this country to get loans from investors, because the counterparty risk will increase. Ultimately, there is no other way for that country than to reducing expenditures and/or to increasing their revenues.

If a country runs a trade deficit their imports are higher than their exports. A country that is on a gold-standard will then see gold leaving their country because net imports are paid by gold. As a consequence, the money supply in this country goes down. As a result, all things equal, prices will have the tendency to go down. This makes exports more competitive and imports less competitive, and with exports rising and imports declining, the trade deficit will be restored over time.

More generally speaking, under a gold standard or without monetary interventions, people have no choice than to best meet the demands of society, bound by the price and interest rate mechanisms. A free market in the absence of monetary interventions is what I call a capitalist society. Such a society has an automatic form of self-discipline built in where people truly depend on each other. This applies even if people are solely concerned with achieving their own individual goals. The only way to improve your situation is to sell something to other people in society and to buy the things you would like to have from the proceeds of that sale. If you are only concerned with yourself, you will not make any money. In the end, you cannot sell to yourself. You have to meet the requirements of your fellow citizens and use the price signal and interest rate signals as guiding tools in your actions.

Less discipline when money is created

In the fiat currency world we are living in now though, it is easier for a country to keep on running deficits. Money is created out of thin air in the form of debt. Central banks can come to the rescue by buying debt, as they for instance did after the 2008 Great Financial Crisis.

Human beings have the tendency to interfere though. In the last century, economists have become convinced about the make-ability of the economy. Since the beginning of the 20th century central banks started to intervene in the marketplace. Also the U.S. were since then no longer on a gold exchange standard, but on a fiat currency standard. This made monetary interventions possible, to a limited extent initially and more extensively over time. Because central banks were pushing their

limits and printing too much money, the agreed upon exchange price between dollar and gold and British pound and gold was adjusted several times. The currencies were devalued against gold at several occasions.

In 1971 Nixon decided to stop the gold exchange standard as agreed upon under Breton Woods. From that moment onwards, the last bit of discipline in the marketplace was gone. Since that moment, central banks can print money freely and debt levels started to rise in the US. Because other central banks embraced similar monetary policies, money supply worldwide and debt levels worldwide started to rise up until now, the 2020's. During the 1990's, central banks started to further fine-tune their operations, based on inflation targeting. In 2001 the ECB started operating this way, based on a target of 'an average price level' rising each year for nearly 2%.

Slaves to the model

In 21st century central banks seem to have mastered the art of monetary policies. The current economy is shaped to the ideal world of central bankers and economists. Because the world is 'complex', economists came up with easy to understand steering variables and an easy to understand model of the world.

Our economic policies and more specifically our monetary policies are all based on a growth model. In this model, the GDP number will rise a good percentage points each year. With prices rising about 2% annually, it is argued that a normal interest rate could be around 3% to 4%. Whenever there is a crisis of some sort, such as the financial crisis of 2008 or the Covid situation starting in 2020, central banks will stand by, cutting interest rates with the aim to increase the money supply and to 'stimulate the economy'. Because money is created in the form of credit, this means that more debt is being allowed for. The amount of debt compared to GDP just keeps on rising. These debts will have to be paid back at some time in the future though.

There are 4 ways to pay back these high debts

1. Higher taxes: Governments income consists to a large part of taxes, but taxes do not come out of thin air. Taxes are paid by people who are working and by companies, where people are working. One way or the other, this is always to the disadvantage of people in society. One could argue to better tax the rich or to increase corporate taxes. Even in the case of the latter, normal citizens will pay the price, in case they own stocks in such companies, if they work for such companies (at higher risk of being laid off or with less attractive salaries) or as buyer of their products when companies are forced to increase their product prices, to remain the required rate of profitability.
2. Inflation: With most debt issued in nominal terms, higher prices and a rising price inflation will benefit governments as they can pay back a lower real amount of money. This however assumes that government income is going up in case of inflation. This can be the case due to higher VAT taxed at higher product prices or higher corporate taxes if companies turnover and profits are increasing. Government expenditure is in many cases also linked to a price index though, so it is not by definition that the governments budgets will improve. Generally speaking though, most economists assume price inflation enables governments to better deal with paying back nominal debt. As extensively discussed before, inflation is just as well a tax for people in society, as their real income and/or their purchasing power is going down, all things equal.

3. Economic Growth: Government Debt is seen by many economists as a positive. Like a private equity firm creates leverage in a firm, such economists propose to imposing leverage on a country, with an optimal debt to GDP ratio of 60% or maybe even higher. Debt is seen as way to increase investments, to generate economic growth. As a result governments and society at large are able to pay back their debts, as the increased consumption and production result in increased government income, foremost in the form of taxes. This sounds great, but it is not.

For people there is no choice. They cannot decide to work less or stop working sooner. On the contrary, if central banks are pushing interest rates lower, expected returns on investments will go down as well. With the lower interest rates, investments are now made in projects with lower expected returns, projects that were not profitable before. With lower expected returns and with prices going up due to the money printing, our savings are not generating enough real income.

It is no wonder that people living in our (European) society are getting frustrated. They have to work longer and longer and with their efforts are getting less and less in return. Their situation does not improve as much as they deserve.

By lowering interest rates, by creating money and by ever increasing debt levels, one may get higher growth, but this is not growth that has come voluntarily by the people in society. It is growth that is enforced upon them.

4. Debt write-offs: Central banks can keep on buying debt, by creating more money out of thin air, continuing the endless cycle of increasing debt. The more they engage in such policies and the longer these policies lasts for, the larger the problem gets and the more frictions we will be observing in society. There comes a point where citizens will no longer trust or accept the monetary system. Authorities can then step in to force the public to accepting the rules, although surely this will do nothing to improving the situation of people in society. Governments can also decide to change the rules and decide not to pay back their debts. Such debt write-offs clearly solve the government debt issue. The owners of the written off debt will see the value of their assets being written off. If the public at large does not own any government debt, this will not immediately hurt society. However, one way or another, this will likely result in more frictions.

Central banks as the ECB have been praised for having rescued the European economies after the financial crisis in 2008. It is not Mr Draghi that should be praised by creating money out of thin air and by reducing interest rates to below zero. It is the people of Europe who should be praised, for their hard work despite their profit being taxed away.

Expansionary monetary policies are forcing societies to grow beyond their needs. Reducing interest rates beyond people's time preference and ever increasing debt levels are unsustainable.

Intervention results in in-stability. An alternative to creating money and debt in an undisciplined manner is to accept the GDP growth and the price index numbers as outcomes of people working and living together voluntarily. Not intervening forces a disciplined economic process that results in stability and prosperity for the people in society.

Any economic model is there to support policy makers. If the economy does not develop as the models prescribes, the people in society should not adjust their behaviour caused by central bank interventions. In that case the economic model should be adjusted.

