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How Central Banks Distort the Price of Money in Today's Economy

Before central banks took on a much more interventionist role in the economy, interest rates were generally left to their own devices. They rose and fell depending on the volume of savings, or capital, available at any given time. In this way, they played a vital role in telegraphing the price of money; in fact, interest rates are often described by Austrian economists as the price of money.

As the economist Saifedean Ammous notes, it is the interest rate that regulates the relationship between the opportunity cost of capital, which is foregone consumption, and the opportunity cost of consumption, which is foregone capital investment.

As people demand more investments, the interest rate rises, incentivising more savers to set aside more of their money for savings. As the interest rate drops, it incentivises investors to engage in more technologically advanced methods of production with a longer time horizon. A lower interest rate, then, allows for the engagement of methods of production that are longer and more productive.

The problem today

Interest rates are largely determined by central banks, which generally ignore this fundamental trade-off. Instead, they believe that artificially lowering interest rates is enough to finance investment, allowing consumers and businesses to access new credit without having to forgo consumption. In other words, to have their cake and eat it.

To lower interest rates, central banks simply lend money to commercial banks very cheaply. This they can do by conjuring new money into existence, just as commercial banks create new money whenever they make new loans.

Engineering artificially cheap money

As people start spending more and saving less, a gap begins to grow between savings and loanable funds. This is the inevitable result of central banks increasing the money supply while simultaneously lowering interest rates, leading to a larger quantity of loanable funds than available savings. Over the long run, this translates into less capital available for investors. Central banks try to make up for this by printing yet more new money, which does nothing to increase the economy's physical capital stock; what it does is devalue the existing money supply, leading to inflation and a debased currency.

It also creates dangerous distortions in the economy that only become evident years later. All the artificially cheap money sloshing around the system encourages manufacturers to borrow, operating under the delusion that the money will allow them to buy all the capital goods necessary for their production process. Businesses undertake projects they might never have done if it weren't for the

cheap, abundant bank credit while new businesses start up that might never have otherwise received loans if it weren't for the central bank's loose monetary policy.

An economy built on bubbles

Inevitably, certain sectors of the economy begin to experience bubble-like conditions as more and more money flows into them. The higher asset prices rise, the more money pours in. There are plenty of recent examples: the nascent tech sector during the dotcom bubble and the housing market in the years leading up to the Global Financial Crisis. And, just about everything during the 'Everything Bubble' of the 2010s, when nearly every asset class surged in value – all made possible by loose monetary policy.

But all bubbles eventually burst. This normally happens when the central bank in question begins to worry about the fallout of the huge bubble(s) it has stoked, including surging inflation. Their response, usually years too late, generally involves rapidly reversing the same policies that helped create the bubble, including the artificially low interest rates.

When the boom turns to bust

As rates begin rising, consumers begin to save more rather than borrow and spend. As a result, companies that depended on their spending begin to struggle. At the same time, many businesses must start paying higher interest on their debt. The same goes for anyone who took out a variable rate mortgage in the low-rate era. As households and businesses pay more to service their debts, their spending on products and services declines.

The result? Economic activity rapidly dies off as boom turns to bust. Many heavily indebted households lose their homes, and many heavily indebted companies go bust. Unemployment begins to rise, debts go unpaid and some banks begin to struggle. Some end up collapsing. This is where we find ourselves right now after central banks around the world spent the past two years hiking rates at the fastest pace in decades in a desperate bid to tame the inflation they themselves helped create.

So, in other words, artificially low interest rates trick people into thinking that there are more physical resources available in the real world than there are. People make plans accordingly and then a few years later reality hits and the plans made are no longer realistic. This is usually because the price of those physical resources is higher than originally assumed. Central banks then choose to either keep tricking us to keep the game going for longer or allow reality to bite and people's plans need to be reset. But the damage doesn't end there.

Is there really an economic boom at all?

As readers may recall from a previous article, the Cantillon effect ensures that those who are closest to the central banks' money spigot benefit disproportionately from both the new money creation as well as the artificially low rates. They get richer while most other individuals and businesses scarcely benefit at all during the boom phase while suffering disproportionately from the inflation that follows. Inequality surges.

Crucially, a key possibly controversial conclusion of this analysis is that the bust is directly caused by the preceding artificial boom, not the other way around. And, neither the bust nor the boom are random

events. They are not caused by investors all of a sudden and out of nowhere deciding to get greedy or panic. Therefore, to avoid the bust we must first avoid the artificial boom. Or, in other words, when a central bank forces interest rates down it has huge ripple effects throughout the economy that must be unwound in some way at some later point.

If the central bank continues to try to counter the impacts of the bust then, as Ludwig von Mises said in 1949: "There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."

Conclusion

Understanding this huge influence on the ups and downs of the economy is essential to building an investment portfolio that can withstand these impacts, and to also take advantage of the market volatility that comes with it. It also explains why the exact timing of market volatility is impossible to predict, so being prepared to act at short notice is critical for continual success. At the date of this article (February 2024), following the recent sharp rise in interest rates, this understanding indicates that there is a substantial risk of a downturn in the economy soon which would bring us to this stage of the cycle discussed above. Central banks can then choose to either keep tricking us to keep the game going for longer or allow reality to bite and people's plans need to be reset. How prepared are you?

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If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.