Notes from Dr. Robert Batemarco's Presentation

Austrian Economics, Business Cycles, and the Theory and Practice of Money – Segment II

July 27, 2022

Central banks today have no legal restrictions on their ability to create money. The requirement to exchange gold for paper money ended in 1971. Central banks lend this money to banks, who use it to create more money through fractional reserves. This money is far above the amount of money that would be created by the free market – the original meaning of the word "inflation". Inflation is creation of money above the amount the market would create.

This kind of inflation has three bad effects: 1) Inflation of prices 2) Greater income inequality and 3) Business cycles.

The value of money is what you can purchase with it. Create more of anything and its value will decrease. Therefore true capitalism is inherently deflationary. Create more money and its value will decrease: i.e., each unit will purchase fewer goods. Thus, goods will cost more money, i.e., prices will rise. This can be offset to some extent if: A) More good are produced B) People don't spend all of the new money. There are different rates of productivity change for different goods.

Government does not intervene in all markets equally. Money enters the economy at specific points and it takes a long time to spread to the rest of the economy. This is the Cantillon Effect. Other things equal: Creating money increases prices. It does not increase them all at the same rate. Productivity and how much of the new money is spent cause rates of price increase to diverge from rate of money increase. Not everyone receives new money at the same time.

It takes time for new money to increases prices. Those who get the new money sooner gain at the expense of those who get it later.

Think of counterfeiters. Remember that most new money is created by the process of making loans. The central bank is the biggest lender. It lends to: Commercial banks, The central government, Large corporations. Money creation distorts interest rates. These distorted interest rates misallocate resources. Misallocated resources are wasted resources, reducing productive capacity.

Interests rate can be managed lower when people can save more, creating money to lend. This means they forego present consumption. Foregoing present consumption makes resources available for investment projects. Interest rates provide information that allocates resources the way consumers want – fewer goods now, but more in the future.

Central banks can create more money and lend it out. But more money does NOT create more goods. These lower interest rates give false information. This money is borrowed by businesses who want to start investment projects, letting them outbid consumers for these resources. This misallocates resources away from consumer desires.

When a business needs more resources to grow they could spend money on capital goods that would increase future output. In so doing, you would allocate more resources to future goods at the expense of present goods. How much you would invest in such productive projects depends on how much you expect to earn on your project and the interest you would have to pay or forego. This is an example of how people could value present goods over future goods.

Interest rates based on time preference balance the desires for present goods vs future goods. Some foregoing of consumption – in other words, saving – is necessary for high economic growth and productivity. They overestimated the resources available for capital investments and planned their projects accordingly.

These plans require more capital than is available. You can't costlessly shift resources from one type of good to the other. What do you do when you realize the resources for your plans are not there? You have to liquidate the investments at a loss. We call these errors malinvestments.

Monetary policy management. Cutting wasteful government spending and taxes makes resources available for sound investments and vibrant economy. The only way to prevent a recession from malinvestments is not to start the boom in the first place. Encouraging banks to maintain high reserves by not bailing them out. Stimulus policy does not work. It kicks the can down the road. It not only prevents cleaning out old malinvestments, but complicates the restoration to a vibrant economy.

- Murray Rothbard, *What Has Government Done to Our Money?*
- Murray Rothbard, *The Case Against the Fed*
- Richard Ebeling, editor, *The Austrian Theory of the Trade Cycle and Other Essays*
- Murray Rothbard, *America's Great Depression*
- Guido Hülsmann, *The Ethics of Money Production*
- Gary North, *Honest Money: The Biblical Blueprint for Money and Banking*