Triumph and Tragedy of Easy Money and Bailouts

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The temporary improvement of the economic performance of the US economy in the last quarter of 2009 will be one more source of deception in the long series of deceptions that have plagued policy makers and investors in the recent past. The current economic expansion is brought about by monetary and fiscal stimuli. Such a kind of economic expansion does not constitute genuine economic growth. While the official statistics register economic growth, the durable production potential of the economy is actually contracting.

It is easy, indeed, to fall into the trap of fake economic growth because as long as capacity utilization is below the normal level, demand expansion fueled by monetary and fiscal impulses tends to increase economic activity. Yet as much as the economy moves closer to full capacity, the more the effect on the real goods production gets weaker and the part which affects prices becomes more dominant up to the point when the monetary expansion does only have inflationary price effects and its impact on real production becomes nil.

The second trap of fake economic growth results from the fact that when economic distortions are still minor, and only a mild recession would be necessary to correct investment errors, stimulus packages prove to be successful to make the economy continue on its growth path. Chairmen and presidents of central banks and finance ministers and the Chancellor of the Exchequer and the Secretary of the Treasury get praised when they succeed in keeping the boom going what otherwise would have been only a minor recession. Yet thus, by not letting the minor recession happen, they go on and heap one pile of economic distortions upon the earlier pile until against there is no avail against the big downturn.

There is hardly disagreement among the economics profession that the so-called expenditure multiplier of Keynesian theory has quite different real and monetary effects relative to the state of the economy. What is less understood is that at the same time when the economy is expanding due to demand-based impulses, the production capacity of the economy – in economic textbooks also known as the “production possibility frontier” -- may decrease.

It is mainly only the Austrian school’s analysis of the business cycle that addresses this problem and which concerns itself with malinvestment. In the light of this theory, economic stimulus packages will induce the launch of projects that are bound to fail because their completion is cut short by the lack of funding based on authentic savings. In the short-run, stimulus policies will bring an increase of the nation’s gross domestic product (GDP), yet what matters for long-term economic growth is not demand but the nation’s capacity for production and in order to maintain and to amplify that, funds must be available that require the temporary abstention form consumption.

Many analysts and policymakers fail to distinguish between economic growth, which increases the production potential of an economy as a consequence of victories in the battle against scarcity, and that kind of economic growth, which reflects an economic expansion that is the result of macroeconomic fiscal or monetary stimuli. Keynesian economics, particularly in its modern degenerate form, is concerned with demand-based economic expansions and contractions and has nothing to say about how to bring about genuine growth, which is the foundation of sustainable prosperity.

An economic boom will be unsustainable if it takes place as the result of an expansion of credit that is not matched by a corresponding increase of authentic savings. As the recent developments of the real estate markets in the United States and in other countries demonstrate, the credit boom has produced malinvestment on a massive scale. The costs of many houses that were built under the impression of easily available loans turned out to be unbearable. Projects that seemed to be financially manageable during the time of easy money are now faced with the emergence of scarcity. Projects in real estate and related areas have to be stopped and abandoned as investors and consumers are forced to retrench. Capital is lost, debt burdens remains, and the fallout is felt throughout the entire economy.

Among the many problematic legacies of Keynesianism, the failure to distinguish between different kinds of economic growth is probably the most fundamental. Much harm has been brought about upon society by policy makers who have promoted expansionist macroeconomic policies without recognizing that while doing so they actually have contributed to weaken the productive capacity of the economy. Instead of fulfilling the promise of prosperity, policies of macroeconomic demand management, of fiscal and monetary stimuli, have resulted in impoverishment. Instead of realizing the promise of prosperity, these policies have laid the foundation for economic decline.

In the 1970s, in the face of the first oil price shock, great expectations to overcome the economic downturn were put into stimulus policies in Europe and the United States, yet the result was global stagflation. Japan practiced fiscal and monetary expansion on a grand scale since its economy entered a recession in the early 1990s and the result has been stagnation ever since. The lessons of history are clear: easy money and fiscal stimulus policies do more harm than good and do not cut short recession but prolong and deepen economic recessions. Prudence and rationality would have suggested only a few years ago that another onslaught of mindless easy money policies and frivolous government spending is out of the question.

Yet over the past couple of years we have seen a new wave of applications of the same kind of policies that produced so much damage in the past. Disregarding the evident failures and fallacies of Keynesianism, economic policies in the United States and Europe have come back to apply expansive monetary and fiscal policies, and this time on a scale like never before. In the US, fiscal policy has provided a series of stimulus packages since February 2008, and new packages are on the way. Monetary authorities have set the policy interest rate down close at zero bound and the reluctance of the Federal Reserve to initiate its exit strategy is all too obvious.

Despite its catastrophic consequences, fabricating fake economic growth with the help of stimulus packages is highly attractive to economy policy makers because it can easily be produced by wasteful consumption for war and welfare and for all kinds of popular government programs. Under a fiat money regime economic growth in terms of the expansion of monetary demand can go on until only the collapse of hyperinflation brings an end to the artificial boom or when the amount of accumulated debt makes bankruptcy inevitable.

While monetary spending is limitless and there is no scarcity in adding more zeros to the price tag, production is limited by the scarcity of the factors of production. In order for economic growth to be sustainable, current consumption needs to be in line with current production. Current investment must be matched by a corresponding amount of authentic savings. If it were only expenditures that mattered for economic growth any economy could become rich in a short period of time because there are no limits to monetary expansion and thus for expenditures. However, it takes the improvement of the factors of production to make economic growth sustainable, and it takes investment and technological and entrepreneurial ingenuity to enlarge the productive capacity of the economy.

What matters most for sustainable economic growth is the structure of production, and in order to attain an adequate structure of production, individual decisions based on considerations of scarcity have to be made. The market system is highly effective in achieving the spatial coordination of economic activities, and along with the allocation of production and consumption in the presence, inter-temporal coordination must also be accomplished. Yet this inter-temporal allocation between present and future goods as it is done by the financial markets gets thoroughly disrupted when the manipulation of monetary interest rates through central banks plays havoc with prevailing **time preferences.**

Demand-side economic policies ignore relative scarcities and negate the natural sequence that consumption comes after production and not the other way around. The Marx-Keynes theories in their popular vulgar varieties suffer from the fallacy of macroeconomics that the object of their inquiry -- the “macro-economy” -- does not exist outside of statistical constructs. This way, an economic crisis gets misdiagnosed as “unemployment equilibrium” in the Keynesian framework or as “over-production” and “under-consumption” in Marxist economic theory.

It is at the micro level where malinvestment happen when the price mechanism is not allowed to work properly in all areas of economic activity, including the interest rate. An economic expansion that takes place without the guidance of relative prices and the entrepreneurial calculation of profit and loss will lead to a capital structure that is characterized by disproportions that show up in specific bottlenecks and other mismatches between supply and demand. Malinvestment is a microeconomic concept and reflects the fact that economic activity in any meaningful sense is always related to human action.

Big booms and busts are directly linked to financial cycles, which in turn reflect the swings in money creation. Fiat money lies at the heart of this process. Credit-based economic expansions with its consequent malinvestments create economic illusions. The modern popular brand of Keynesianism suggests rather crudely that more consumption and government spending can create wealth. Yet it is one thing to fabricate an economic expansion by more expenditure; it is quite a different thing to produce economic growth as the result of the improvement of the factors of production which include, along with nature and labor, entrepreneurial spirit, technological innovation and the accumulation of capital. Fiscal and monetary stimulus packages augment demand, but their effect on the productive capacity tends to come along with a deterioration of the factors of production. In the initial phase, stimulus packages provoke irrational jubilation only to leave behind in the latter phase a wasteland of failed projects and frustrated expectations. It is mainly this mental discouragement of investors and consumers that will linger on for years after the boom has ended which impounds a swift recovery after the bust.

With no immediate limits of creditworthiness in place for the public sector, the state can go on almost without end in its spending spree. It is inherent to the political process that governments will practice deficit spending as long as they can, and thereby induce malinvestment of ever larger proportions. If policy makers do not recognize the folly of their doing and continue to promote expansion of expenditures through monetary and fiscal stimuli, the result is a prolongation of depression. Expansionary policies produce bottlenecks and other economic distortions and deepen the economic slump. The regime uncertainty that comes with erratic policy interventions will make that the notorious Keynesian multiplier can actually go into reverse.

There is fatal interaction at work between easy money policies and bailouts. Excessive credit expansion provokes malinvestment, and the more severe these become the more companies, banks and household are at risk of bankruptcy. Blinded by mistaken ideals of stability and growth, governments feel obliged to salvage economic actors or specific economic groups in the name of safeguarding the economy. In absolute denial that it was easy money in the first place that has provoked malinvestment, governments and central banks exacerbate the situation even more because now, along with the economic dislocations of malinvestment, they also produce extensive moral hazard.

Moral hazard is an economic disease. It is as malignant as corruption in its effect on economic progress. Easy money and its upshot, the bailouts, constitute the origin of this infection, and economic stagnation and decline are their consequences. In terms of its negative effects on economic well-being, moral hazard generated by easy money and bailouts is to developed countries what corruption means for many developing countries. Easy money policies produce bailouts, and bailouts incite moral hazard. Once an economy has come under the grip of widespread moral hazard, all basic laws of economics become distorted. It was indeed John Maynard Keynes himself who aptly described this process (a fact which also shows that it is suitable to distinguish between the original Keynes and vulgar Keynesianism) that "engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose".

The destructiveness of debt-induced economic expansion remains hidden to conventional economic analysis. The artificial creation of money with the availability of easy credit produces the illusion of wealth that does not exist in reality. The deception about the true availability of resources for projects that extend into the future induces businesses and consumers to pursue plans for projects that exceed available means. Sooner or later the over-dimensioned projects have to be abandoned. Malinvestment occurred, capital is lost, and instead of producing prosperity, society is now poorer than before. When the firework is over what will be left is not prosperity, but unmanageable amounts of private and public debts along with a weakened economy.

Easy money policies, malinvestment, bailouts, more easy money policies, fiscal stimuli and so on go hand in hand. There is no end to this vicious cycle until everything comes falling apart. Once this path of destruction is taken, there is no way back. The remedy has to come early. The modern monetary system of fractional reserve, fiat money and central banking is the source of that evil. Democracy itself is at risk when it is accompanied by a system that permits that governments can go on spending until state bankruptcy or hyperinflation looms. It is high time that much more intellectual and political effort will be put into the research about the practicability of monetary systems which are separate from politics and special interests and instead investigate and promote the employment of competitive market-based monetary systems.

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