
Guest Post: <u>The 'Free Lunch' and Capital Consumption</u> by: Pater Tenebrarum

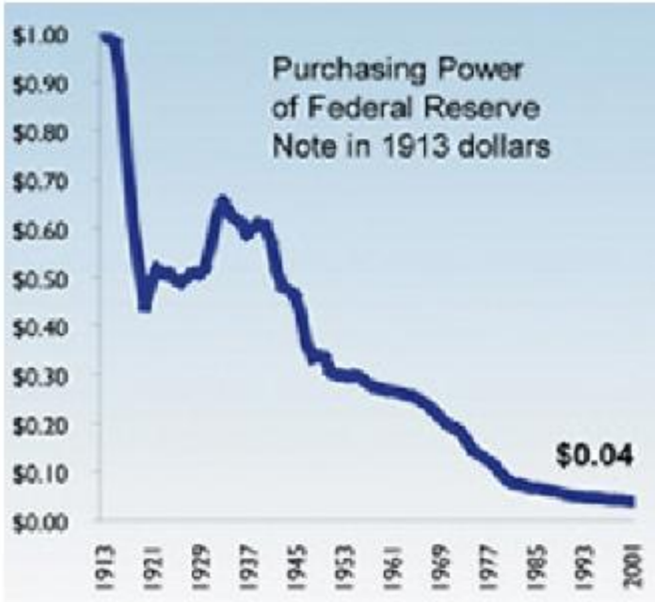
It is important in this context to understand what actually happens when a central bank bails out insolvent banks by buying up all their toxic sludge or helps the administration to amass more debt by monetizing government bonds. It isn't a free lunch. The commentary and advice by prominent interventionists always sounds as if there actually *were* a free lunch somewhere.

Deficit spending by governments as a rule is talked about as though governments could avail themselves of an inexhaustible pool of resources that exists somewhere outside the ambit of the market economy. Money printing by central banks is similarly invoked as a panacea that essentially amounts to the waving of a magic wand..

Whenever an economic downturn strikes, the calls for government 'to do something' are immediately heard from all directions. Whichever special interests are pleading with government, they are in essence demanding one thing: alleviate *our* plight, no matter who ends up paying for it. However, although everybody makes it sound as though there is actually no cost to this, the reality looks different. Every cent a government spends must be paid for by those in the private sector who are producing wealth. Every intervention not only ends up taxing wealth producers directly: in addition it makes their job more difficult, as government spending competes for the same pool of real resources they draw from for their wealth-generating activities.

In the same vein, when the central bank prints money to ostensibly 'stimulate the economy' or to bail out 'systemically important institutions', it is actually not the central bank that is really *paying* for this. The creation of new money is essentially costless. These days all that is required is a computer terminal, an internet connection and someone who marks up numbers in accounts. And yet, after the central bank's activity has magically transformed an insolvent institution back into a state of solvency, shouldn't we stop to ask: 'What has happened to the losses? Where are they now?'

In this particular instance the bulk of the losses is borne by savers who have seen their income reduced to nothing. What used to be *their* income now has become the banks' income, who can fund themselves at very little cost and 'ride the yield curve' to garner profits. Some of the losses will be borne by those who bought inflated assets at the top of the cycle. Some of the losses will be borne by everyone who uses the currency the central bank issues, as its purchasing power declines further. Even by the phony standards of measurement the government itself uses to document the currency's loss of value over time we can see what an enormous con the central-bank led fiat money system has been by considering what has happened to money's purchasing power over the past century. To wit, below is a chart that shows by how much the purchasing power of the US dollar has fallen since the Federal Reserve was founded – in terms of the CPI, which as we know has been tweaked over the years to essentially show as little 'inflation' as is possible without being laughed out of the room right away (this is beside the fact that it attempts to measure what is inherently unmeasurable).



4 US cents are left of the the purchasing power of a 1913 dollar. This is the result of instituting fiat money managed by a self-styled 'inflation fighting' central planning institution.

However, there is an even more insidious process to consider than merely the loss of the currency's purchasing power in terms of the money prices of final goods.

One thing we are always struck by when today's interventionist macro-economists (whom Dylan Grice of SocGen has recently compared to '*drunk drivers being asked to drive a car*') give us their opinions as to which of their plans government should implement to 'combat recession', is that they rarely investigate what has actually brought the recession on. The way economic downturns are talked about one always comes away with the impression that a recession is a kind of natural disaster, like a flood or an earthquake. The most widely held view is apparently that boom-bust cycles are an *inherent feature of the market economy*. In other words, they do not require an explanation. All that is required in the view of most mainstream macro-economists is that government stand ready to 'correct the faults of the market economy' and steer it toward smooth economic development when one of these 'bumps in the road' unexpectedly manifests itself.

Consider again our recent article on the economy's structure of production. As we have noted there, interest rates are an important signal helping to coordinate the economy's capital structure, as they influence the *relative* prices of goods that are more remote from the consumer goods stage and those that are closer to it. They tell entrepreneurs essentially how big a pool of real savings is available as a result of the time preferences of actors in the market economy. The size of this pool of real savings is what ultimately determines to what extent the production processes entrepreneurs engage in can be lengthened and hence be made more productive. In this manner the time schedules of consumers and producers are properly aligned – longer processes mean that consumption will have to be postponed to a later date, and in exchange for this longer period of waiting, more consumption will be possible than was possible with the configuration of the production structure prior to the addition of new savings and investment.

However, when 'money from thin air' enters the economy, it follows that the signal that coordinates this process is falsified. Entrepreneurs will begin investment projects for which not enough resources are in fact available. Consumers haven't changed their time preferences, it only appears so, as the addition of new money to the loanable funds market depresses interest rates (in practice the central bank maintains its 'interest rate target' by adding new liquidity to the system if market interest rates threaten to go above this target).

At first, large accounting profits will be made in the earlier stages of production (which is *inter alia* a reason why the stocks of producers of capital goods initially rise especially strongly when a boom begins). The prices of original factors in these production stages (land and labor) will be bid up, as will the prices of capital goods employed in these stages. Consumption has however not been restricted – on the contrary, over-consumption is likely to ensue, as the recipients of these accounting profits will increase their consumption spending. Alas, as we noted, all economic activity ultimately requires *real funding*. If consumption hasn't been restricted, this real funding will eventually be found lacking. As Ludwig von Mises put it:

“In a given economic situation, the opportunities for production, which may actually be carried out, are limited by the supply of capital goods available.”

Note in this context that in the hands of a capitalist who is advancing present goods to land and labor factors in the stage of production he invests in and to the capitalists of the preceding production stages whose products he acquires, these present goods are in fact capital goods, as they are 'used up' in the production process.

Eventually it always turns out that many of the investments that were made on account of an artificial credit expansion not backed by savings were misguided – they can not be finished, as the real resources required for bringing them to fruition are simply not available. When these errors are revealed, an economic bust ensues.

It is at this point – when the bust arrives – that most economists demand of the government to do more of the same of what has actually brought the economy to this juncture – i.e., they demand even more easy money and deficit spending. As we have noted before, this is akin to trying to cure a heroin addict from his addiction by administering more heroin to him. He may for a while give the impression that he is actually getting better as fresh doses of the drug course through his system, but in reality his health is deteriorating even further.

The above described sequence raises the important question of 'what actually *pays* for the over-consumption we see during a boom'. After all, money is merely the medium of exchange – it 'funds' nothing. The answer is that what is consumed is the existing stock of capital. An excellent example explaining the phenomenon has been provided by Fritz Machlup in his study of capital consumption in Austria during the inter-war years. We have discussed this before and interested readers should take a look at More On Money and the Fed's Predicament , where we have quoted from Machlup's study extensively.

We want to repeat an especially pertinent quote here:

"In spite of ordinary bookkeeping, inflationary price increases lead to insufficient replacement reserves. An example will make it clear. A manufacturer owned a plant worth one million crowns. He used to write of 100,000 crowns a year for depreciation; that is, ten percent. As inflation raises prices and costs, and as the costs of an equivalent plant would run up to two million crowns, the customary replacement quota represents only five percent; and the reserve, after the whole plant has been written off, allows the renewal of only half the equipment. If inflation raises prices to the fourteen-thousandfold, as was the case in Austria, the replacement reserve of a machine is just large enough to buy one new screw.

But does inflation not increase profits and therefore the ability to build up reserves? I wish to emphasize that those money profits are delusive profits; if parts of them are considered real profits – that is, as a base for increased consumption – capital is consumed.

Capital consumption is still better illustrated in the case of working capital. A dealer bought a thousand tons of copper. He sold them, as prices rose, with considerable profit. He consumed only half of the profit and saved the other half. He invested again in copper and got several hundred tons. Prices rose and rose. The dealer's profit was enormous; he could afford to travel and to buy cars, country houses and whatnot. He also saved and invested again in copper. His money capital was now a high multiple of his initial one. After repeated transactions – he always could afford to live a luxurious life – he invested his whole capital, grown to an astronomical amount, in a few pounds of copper. While he and the public considered him a profiteer of the highest income, he had in reality eaten up his capital."

(emphasis added)

To summarize: there is no free lunch. Ultimately, money printing by the central bank produces profits for a selected few on the back of society as a whole. It amounts to a violation of property rights, without there being a possibility to prove in detail whose property rights have been violated to what extent. Obviously though most citizens suffer greatly once an artificial boom turns to bust. The bust is not, as is widely held, a natural facet or the fault of the market economy. It is the inevitable end result of the credit expansion that has brought about the artificial boom.

As Ludwig von Mises trenchantly observed:

"Credit expansion is not a nostrum to make people happy. The boom it engenders must inevitably lead to a debacle and unhappiness."

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