

THE BACKSTAGE OF RECURRING MONETARY BOOMS

By Luis Enrique Ponce Goyochea, MSc

Master of Science in Management, SBS Swiss Business School

Austrian Economist

Thematic Area: Readings on the Austrian School of Economics

Abstract

Despite the recessive adjustment in progress, evidence is clear that such process has long been subject to delay by successive bubbles continuously leading to unsustainable booms and downturns.

This ultimately explains the occurrence of business cycles on a recurring basis, although at some point in time it should become inevitable for a subsequent depression to finally set in.

In this sense, the Austrian approach analytically exposes the extent to which monetary issues exert a crucial effect on the aforementioned fluctuations by prolonging the distorting expansive stage through the manipulation of individual time preferences and the underlying inconsistencies stemming from this.

Introduction

Throughout this essay I will elaborate on how primary monetary expansion initially sets in motion artificially distorting booms that highly influence the evolution of other aggregates such as M1, thus reflecting the way in which secondary expansion complementary offsets or deepens such booms depending on the trends experienced by people's demand for money.

In this sense, I will start by going over the core theoretical groundwork regarding the relevance of an aprioristically causal approach on inflation and its close connection to business cycles, by highlighting some relevant misconceptions derived from the mainstream framework on the monetary determinants of business cycles.

Then, I will further analyze the recent evolution shown by the gold backing of the monetary base versus that of M1 over the past ten years, so as to provide a clear overview on the depreciation of paper money in terms of gold as the classical commodity standard for sound money.

Misconceptions on Inflation and Business Cycles: The Brainwashing Master Plan

When approaching a theoretical analysis of inflation, Ludwig von Mises specifically refers to a “semantic confusion”, leading to noticeable inconsistencies regarding the causes and consequences of such unsustainable policy (Mises 2007, 1990: 111-116; Bien Greaves 2010: 59-61).

In this sense, emphasis is often placed on how the advent of the Keynesian framework back in the 1930s brought about a misleading shift in the focus from the real causes of inflation (increasing quantity of money outstanding) to merely its most widely acknowledged consequence (rising prices).

Such a misconception appears to have left behind the significant theoretical distinction between money inflation and price inflation, the former referring to the causes eventually leading to the latter.

In the light of the misleading interpretations on inflation ascribed to the newly established approach reigning from the Great Depression forward, it is now common to experience how in practice there seems to remain an unchallenged lack of distinction between the causes and consequences of inflation.

That is why, before going into further detail regarding the evolution of monetary aggregates, it is relevant to first distinguish between primary and secondary monetary expansion.

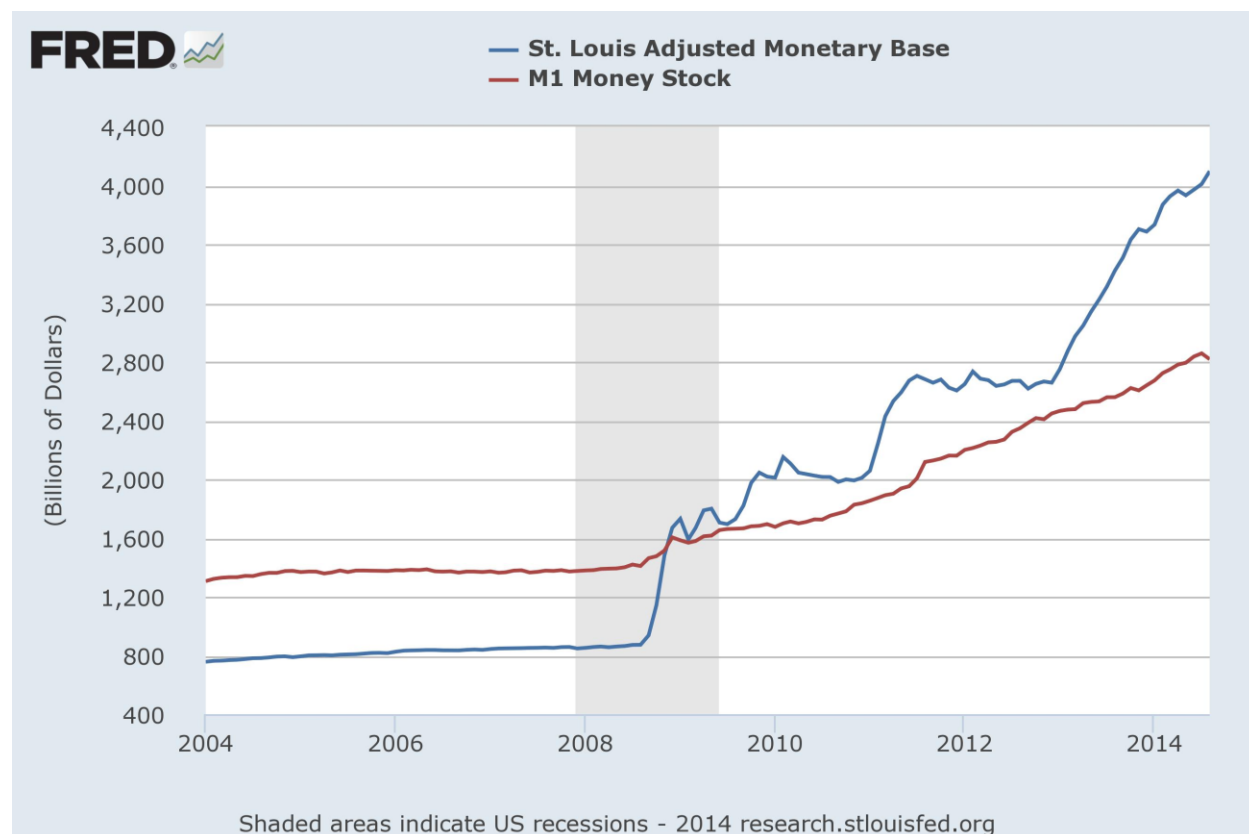
On the one hand, primary monetary expansion refers to the increase in money conducted directly by governments through their central banks, the core aggregate reflecting such process being the monetary base.

On the other hand, secondary monetary expansion is derived from primary expansion in the sense that it stems from the process of credit expansion led by commercial banks through a pyramiding effect on the monetary base, which is ultimately made possible by fractional reserve banking, thus reflecting in aggregates such as M1 and M2 for instance.

Having stated such distinction, there arises a clear parallelism between the aforementioned cause-effect relationship between money inflation versus price inflation on the one hand, and primary versus secondary monetary expansion on the other hand.

When applying this analytical framework to the context of the ongoing recession, it is utterly relevant to highlight a historical turning point occurred in December 2008.

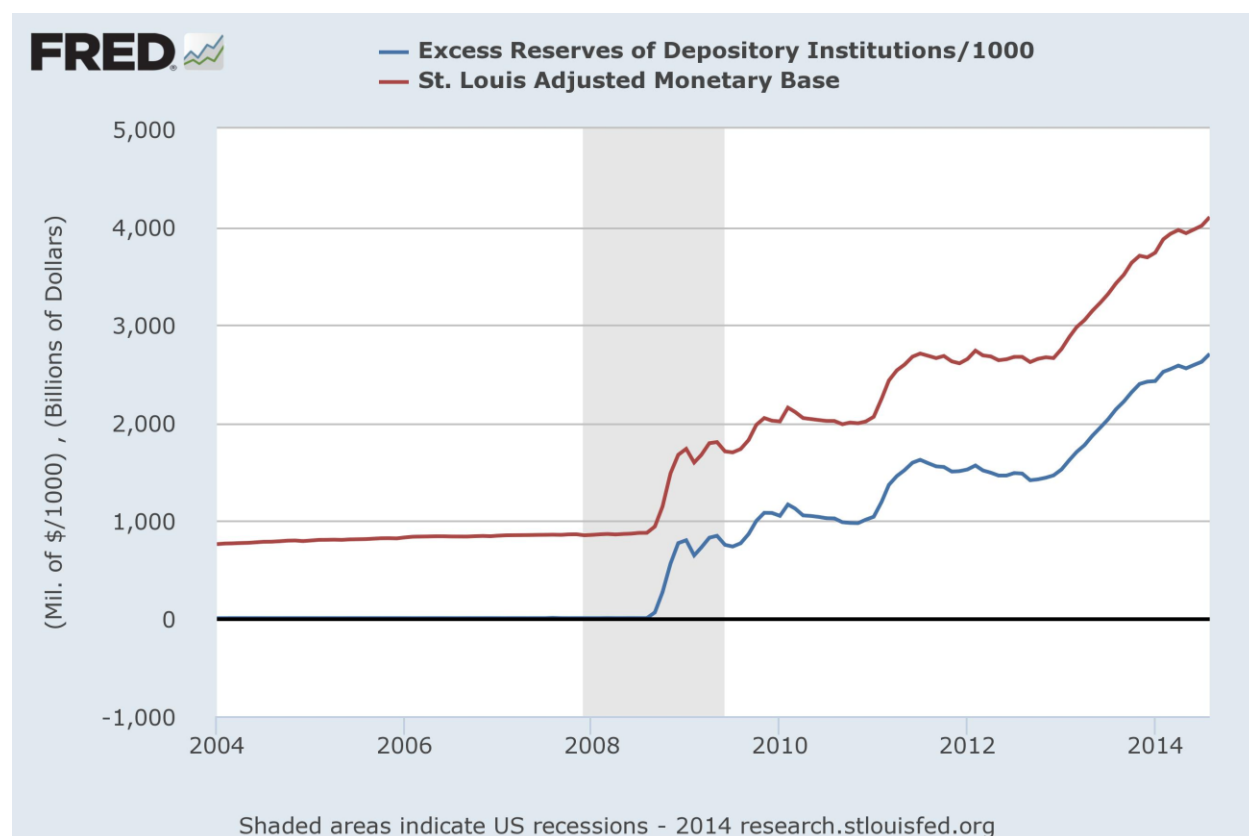
Up until such period, not only had the monetary base remained lower in amount as compared to aggregates like M1, but also it never had experienced such an unprecedented expansion leading it to multiply by more than five-fold over the period 2004-2014:



Throughout the same period, we can observe how the amount of M1 in billions of US Dollars only experienced less than half the level of expansion formerly shown by the monetary base, thus denoting a shift in booming tendencies regarding monetary aggregates from secondary to primary expansion, the latter now being dominant over the

former, given the fact that the lingering lack of confidence from the latest credit crunch appears to have brought credit expansion to a halt.

However, such a frozen state of affairs regarding credit expansion is merely temporary, given the unsustainability of the unconventional policies conducted by the Federal Reserve, namely interest rates paid on excess reserves piling up in the vaults of commercial banks, thus leading them to refrain from channeling the primary expansion into secondary business credit expansion, which is clearly reflected in the fact that since late 2008 the evolution of such excess reserves has perfectly mirrored that of the monetary base over the exact same period:



Yet once the point is reached at which the opportunity cost of holding excess reserves actually exceeds the potential market risks derived from business lending, this should inevitably unveil a process of secondary monetary expansion.

It is precisely this recurrent nature of business cycles that is analyzed in depth by Murray N. Rothbard in the light of the Misesian roots of Austrian Business Cycle Theory (Rothbard 2009: 29-45).

Such an enlightening framework, often neglected by the focus on mainstream analysis limited to merely addressing the effects of downturns, emphasizes the unsustainability of the expansive stage as the cause for the subsequent recession.

Hence, when analyzing the types of credit expansion performed during booming periods subsequently leading to recessive adjustments, within the framework of Austrian Business Cycle Theory (ABCT) it is often highlighted that during such an artificially distorting stage credit expansion is performed precisely through loans to businesses investing on capital goods, as derived from the artificial decline in interest rates caused by such expansion in the first place.

Moving further into the bust stage, once the real proportions have been restored between saving/investment versus consumption and then evidence becomes clear that former investments in capital goods are unsustainable through completion, we may then infer that consumption credit, even to a certain lesser extent, also influences the advent of the bust stage as it helps speed up the restoration of market ratios between saving/investment and consumption, precisely by fostering the demand for consumer goods over that for capital goods.

From the formerly presented analytical framework, we may also contend that the Austrian approach clearly addresses the business cycles issue on the grounds of an ex-ante perspective focusing on the causes for such fluctuations, that is, aprioristically, as opposed to the mainstream viewpoint, which merely concentrates ex-post on their subsequent effects and therefore lacks consistence when attempting to provide a thorough understanding on the subject.

Hence, this wide array of misconceptions stemming from the underlying inconsistencies in the mainstream approach might be labeled as part of some sort of “brainwashing master plan” aimed at neglecting the real cause-effect approach on inflation and business cycles.

Furthermore, it is precisely this misleading approach that has ended up inducing most individuals to disregard the actual connection between money inflation and credit expansion as the core determinants of recurrent business cycles and prolonged recession periods.

In this sense, such a disconnection might ultimately be regarded as the leading cause for many people to act as if the booming stage of the cycle, throughout which most of the damage is actually done, could last forever even despite its evident unsustainability in terms of inconsistency among other relevant issues.

This clearly exposes how manipulation is conducted on individual time preferences during the booming stage, on a two-level basis.

At first, demand for money is fostered via demand for loanable funds by expanding businesses investing on capital goods in order to perform long-term projects, as if the ratio between savings/investments versus consumption had actually increased, when it actually remains the same or even lower than before.

Eventually, once people's demand for consumer goods has proven to be the same or even higher than that for capital goods, the latter declines as businesses realize those long-term projects they had embarked upon are unsustainable and must thus be liquidated before completion, that is, within a temporal horizon much shorter than expected.

This ends up showing the aforementioned inter-temporal inconsistencies in terms of actual time preferences, given the fact that the tradeoff cannot and should not be overlooked between real savings and available funds for consumption: capital and consumption goods sectors cannot expand simultaneously on a sustainable basis.

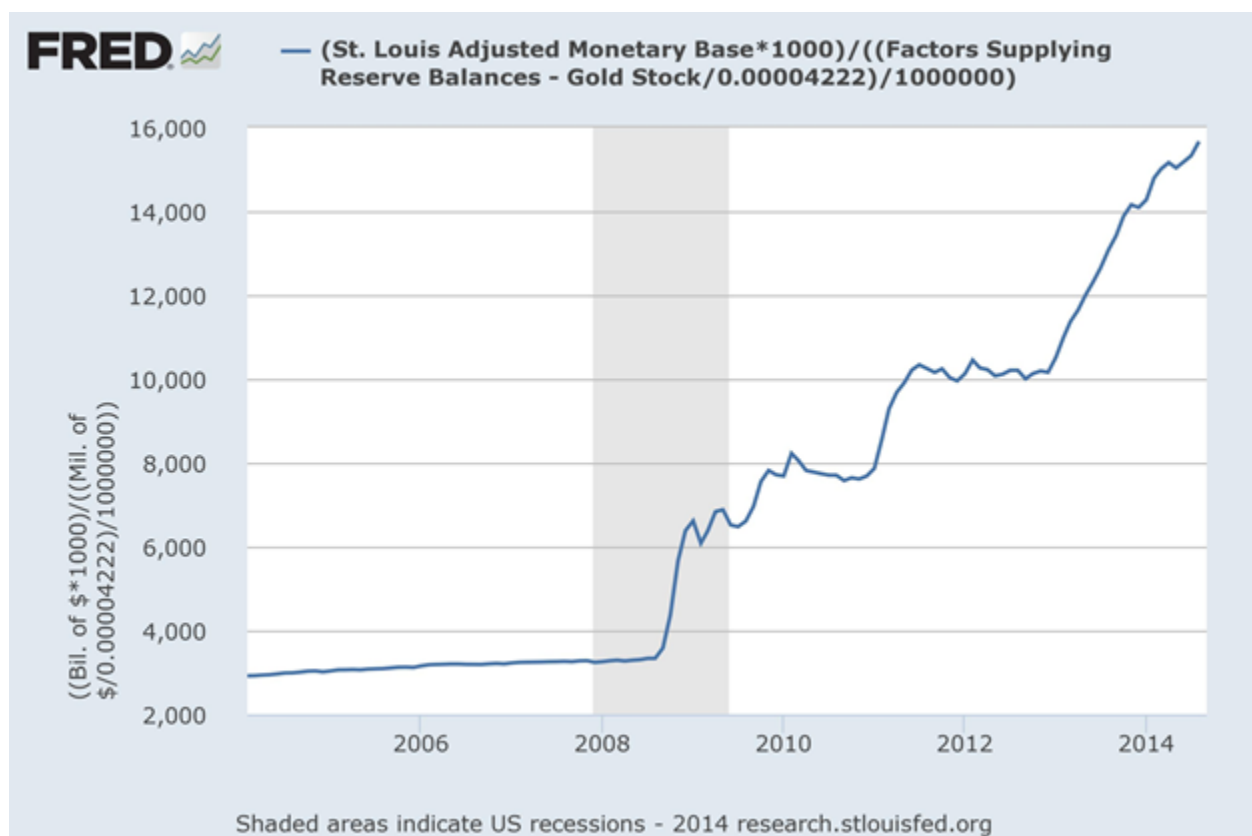
Any overestimation of the amount of real savings necessary implies an overestimation of people's demand to hold money in a strictly Rothbardian sense, which becomes even more evident when demand for capital goods in the first place proves unsustainable and then demand for consumer goods accelerates the erosion in the purchasing power of the currency, precisely by exposing the declining demand for money in terms of goods and

services, thus leading to price inflation as one of the effects exerted by prior money inflation along the way.

The Gold-Backing Slippery Slope: Evolutionary Overview and Turning Point

When taking a glance over the recent trends regarding the monetary base and M1 in US Dollars, we can clearly notice a turning point in late 2008, when the first round of QE was fostered as the core unconventional countercyclical monetary policy throughout the ongoing recession.

Furthermore, regarding the gold-backing of the monetary base over the period 2004-2014, the amount of dollars per troy ounce has significantly risen more than five-fold, from USD 2893.49 (January 2004) to USD 15666.40 (August 2014):



This shows the extent to which the dollar has seen its purchasing power significantly eroded against the market value of gold over the recent decade.

On the other hand, when looking into M1 in terms of the recent evolution of its gold-backing, we may clearly observe that the amount of dollars of M1 backed by every single troy ounce of gold has slightly more than doubled over the period 2004-2014, thus

reflecting the slower upward trend experienced by secondary expansion as compared to that seen in the case of primary expansion.

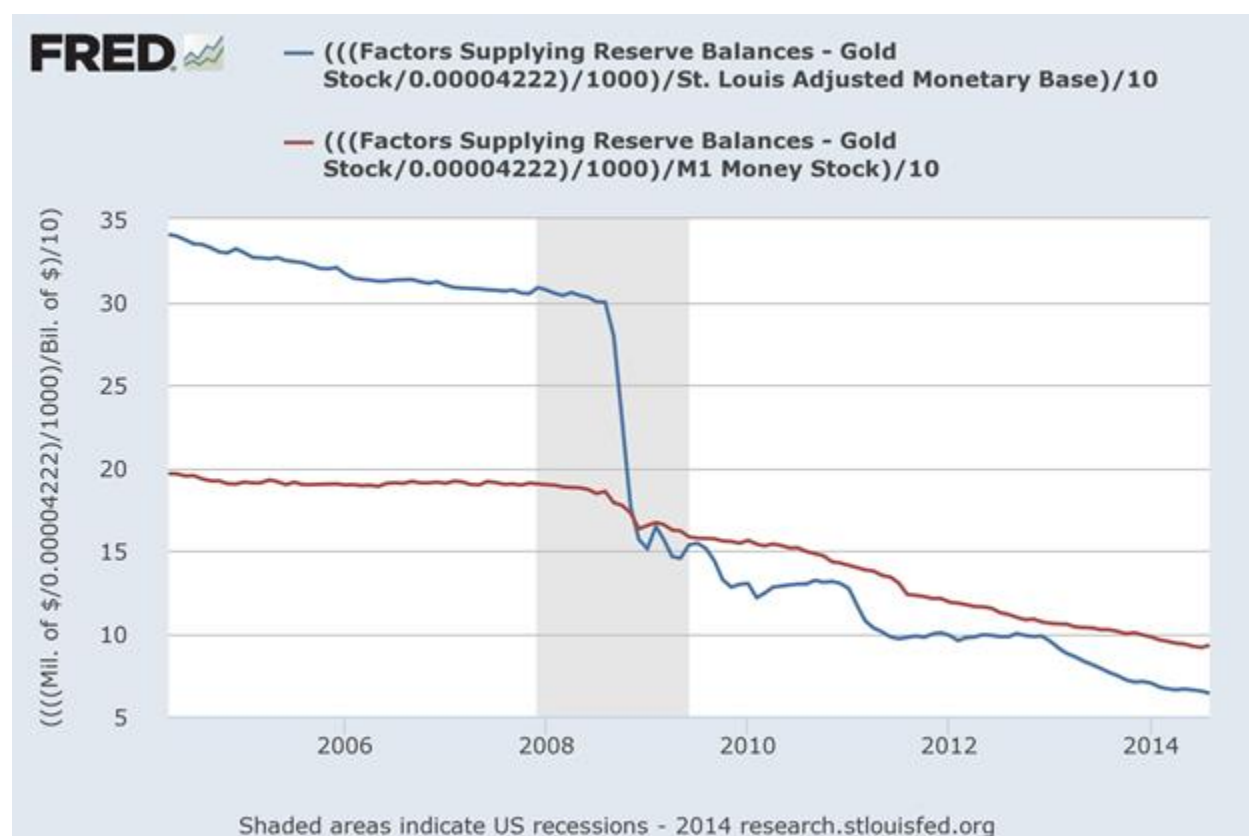
In this sense, the following graph depicts a comparative overview of the gold-backing of the monetary base versus that of M1 over the aforementioned 10-year period:



The turning point observed towards the end of 2008 marks a reversion of tendencies regarding primary versus secondary monetary expansion, mostly and essentially explained by the fact that from that point forward the Federal Reserve has been paying interest on excess reserves sitting in the vaults of its depository institutions, thus encouraging them to accumulate the newly issued dollars instead of channeling them into credit expansion.

This previously highlighted reversion precisely denotes that such turning point in terms of gold-backing for the monetary base and M1, in relative terms as compared to the total amount of such aggregates in terms of monetary units (namely US Dollars), is also clearly

reflected in the significant contraction observed in both cases over the period 2004-2014, as shown below:



As depicted in the previous graph, the monetary base has seen its gold-backing plummet from almost 35% in January 2004 to roughly 6% in August 2014, thus declining to nearly a sixth as compared to its relative proportion at the beginning of the analyzed decade.

When it comes to M1, the core reference for the stock of money outstanding has seen its gold-backing decline by little more than half over the past ten years, from nearly 20% to less than 10% in 2014.

This clearly reflects how, in the light of a strictly Misesian framework, paper money has lost a great deal of its purchasing power against commodity money as reflected by the evolution of the market price of gold quoted precisely in terms of US Dollars as worldwide reference for the reigning floating exchange monetary standard.

This leads us to analyze the evolutionary gap that denotes the deep erosion in the purchasing power of the dollar as a standard for paper money versus the market price of gold quoted precisely in terms of the former.

In this sense, evidence is clear that throughout the pre-crisis period (namely 2004-2008) the amount of dollars backed up by every troy ounce of gold held as reserve stock in the US official vaults has gone down from nearly 8 to roughly 4 times the market price of such commodity in terms of the monetary base and from over 13 times to merely 6 times in terms of M1.

Throughout the downturn and recession years, in particular since the aforementioned turning point occurring in late 2008, a clear upward trend has been observed in the gap between the amounts of dollars backed up by gold in the case of both aggregates and the market price of the precious metal, thus moving back up to nearly a 12:1 ratio for the monetary base (even higher than ex ante) and over 8:1 for M1 (thus tending to move back to pre-crisis relative proportions), as reflected below:



On an ex post basis, we may therefore conclude that despite the reversion observed in recent upward trends, the gap now still being deeper for the monetary base as compared to that for M1 versus the market price of gold quoted in dollars, this stems from the fact that, as analyzed above, the recession period as from late 2008 has seen an unparalleled primary expansion not yet channeled into credit, which has so far been keeping a potential yet underlying secondary expansion from unravelling.

However, were the Federal Reserve to refrain from paying interest on excess reserves or even lower the interest rates denoting the cost of opportunity of expanding credit through business loans, then the risk would become utterly evident for a greater gap to arise between the gold-backing of M1 and higher aggregates versus the market price of gold towards the medium and long run.

Following such pattern, basing on available data from the pre-crisis period (2004-2008) as analyzed before, the slowdown in primary expansion might be eventually offset by a subsequent process of secondary credit expansion conducted through the market for loanable funds, thus leading the M1 gold-backing versus gold market price ratio back to a level of nearly 14:1 on an empirical basis.

Conclusion

The analysis performed throughout this essay empirically reflects the Austrian framework on core theoretical issues regarding the connection between money and business cycles, by exposing the extent to which the evolution of monetary aggregates ends up causing the cyclical fluctuations most widely perceived on a macro level from the mainstream viewpoint, yet specifically focusing on the underlying micro level determinants leading to such arising effects in the first place, thus looking beyond the tip of the iceberg through a causal approach.

In this sense, the enlightening Misesian-Rothbardian approach, by analytically elaborating on the Mengerian heritage on the social dimensions of money as an evolutionary landmark of transactions within advanced civilizations, clearly denotes that no monopolistic power on the issue of legal tender currency is capable of imposing a medium of exchange that is not generally accepted in practice.

Hence, it is precisely such level of acceptance that continuously refers us back to the way in which Menger (2007 [1976] [1871], 2009 [1892]) describes the way in which just as indirect exchange ultimately derives from the outperforming marketability of a commodity throughout a previous stage of direct exchange, following the regression theorem elaborated by Mises (2009) [1953] [1912]) we may then move on to assert that paper currencies ultimately derive their exchange value from their initial tie to gold as reference standard for monetary assets within a free-market framework.

Evidence is therefore clear that cyclical fluctuations stem from the systematic manipulation of such evolutionary process, given the fact that acceptance is the reflection of subjective valuation and is thus not susceptible to being artificially enforced overnight by nonsensical decree.

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