The Actual Monetary System

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I. THE CURRENCY

Money is a **social institution** created spontaneously through gradual trial and error to overcome those of barter. States have **understood the power of this instrument**: they gradually took control of money.

Unlike barter, money also makes it possible to **preserve value**. Barter made it necessary for two exchangers who wished to exchange a good at the same time to meet. On the contrary, money retains its value to allow exchanges to take place at any time. Thus, **money allows investment**.

With the gold standard, in the 19th century, each national currency was only a **representation of gold in a certain weight**. In concrete terms, therefore, there was a world currency, gold. If some states issued too much national currency, **there was a mechanism to balance it out by increasing prices**.

What is interesting is to imagine a system **with self-balancing mechanisms to avoid abuses in order to protect consumers and the role of the currency as an intermediary in trade**: that is really what should be the priority, because this role is fundamental for civilization.

Finally, money has **a social value**. It requires the meeting of individuals who will exchange; these inter-individual relationships will often be unequal (bosses/employees). Money therefore fulfils its social role by giving a different place to individuals and bringing them together.

II. MONETARY THEORY: HOW DOES THE STATE USE MONEY?

The Neo-chartists consider **"money as a creature of the state"**; they are therefore led to believe that one cannot **"separate monetary theory from the theory of the state".**

1. Tax pressure and currency integration in circulation.

According to the Neo-Chartist thesis, the state plays a leading role in the integration of money into the economic system through fiscal policy. Once the state imposes a tax on its citizens payable in a currency it creates, it does not need the public's money in order to spend; on the contrary, **it is the public that needs the government's money to pay taxes**. This means that the government can buy anything that is for sale in terms of its currency, simply by providing its currency.

2. Monetary creation and inflation

The quantitative theory of money, formulated by the English economist David Ricardo, highlights **the monetary origin of inflation**: if prices rise, it is because of a swelling of the money supply greater than the swelling of output. The general price level adjusts to balance the demand for and supply of money. When the central bank increases the supply of money, the price level increases. **A persistent increase in the money supply causes continuous inflation**. The government pays to cover its expenses by printing money. This can result in a situation of **hyperinflation** (e.g. Germany after World War I).

Inflation targeting is a policy aimed **at keeping inflation close to a target without going through an intermediate target**. The central bank can define a numerical target (e.g., 2 per cent), a zone of indifference (e.g., between 1 per cent and 3 per cent), or a target surrounded by a certain fluctuation band (e.g., 2 per cent to ±1 per cent). **Advocates of inflation targeting have argued that inflation targeting has several advantages**:

- It allows agents' expectations to be set at a relatively low level (close to the target), which helps **to ensure price stability over the medium to long term and to limit the variability of inflation**;
- **It increases central bank transparency.**

3. Central bank and interest rates

For the English economist John Maynard Keynes, the interest rate measures the **reluctance of holders of money to dispose of their right to dispose of it at any time because it leads agents to choose between holding liquid assets and investing them for a fee**. The interest rate is the price to be paid to the lender for relinquishing its preference for liquidity.

The influence of interest rates is considerable. **When interest rates are low, households, companies and the government can borrow at low cost**. They therefore tend to increase their consumption and investment, which puts the spotlight on activity and boosts growth and employment. **Conversely, when credit is expensive, economic agents limit their borrowing and cut back on purchases, which slows activity**. Low rates boost the economy, high rates slow it down.

The Central Banks (the European ECB, the US Fed, etc.) have a **decisive influence**. They can set the "key rate" as they see fit. When they consider that inflation is too low (less than 2.5%) or that employment needs to be boosted, **they reduce their key rate by a few decimals**. If, on the other hand, they consider **inflation too high or the economy overheating, they raise it.**

III. AUSTRIAN ECONOMIES AND THE CURRENCY

1. Overview

The Austrian tradition is usually considered to have originated with Carl Menger, generally associated with Leon Walras and William Stanley Jevons in the invention of marginalism. In reality, these three authors held different positions on many issues, and were the origin of three distinct schools of thought. The Austrian school thus derives specifically from Menger's ideas.

Austrian theorists conceive **Economic Science** as a theory of **action** rather than **decision**.

On the question of how to limit money creation, economists in the Austrian tradition are divided into two camps. In addition to flexible exchange rates, **some recommend the gold standard and limiting the amount of credit granted by banks to the amount of their assets**. The others recommend the **free banking system**, they consider that banks are free to make their own decisions but fully bear the consequences of their actions. Competing for the issue and maintenance in circulation of monetary signs and without the possibility of recourse to a central bank, they would be obliged by their customers and by competition to maintain a relatively **high reserve ratio which would guarantee them against risk.**

One of the Austrian school's main and exclusive contributions to the economy is **the Austrian business cycle theory**, known by the acronym TAC in French, and ABCT in English, for Austrian business cycles theory. According to the Austrian school, economic cycles (a succession of prosperity and crisis), are explained by monetary creation. **They are due to deliberately low rates, money creation and inflation, which result in bad investment and the transformation of an initial boom into a final crash.**

They show that mainstream economists are wrong when they suggest that market failure can be corrected by regulation and intervention: markets are indeed more likely to solve problems than governments.

But why is this thinking not widespread? According to Eamonn Butler, **"Perhaps it's because most people still have a touching faith in the power of governments to identify and cure our problems...".**

2. Inflation in the sense of the Austrian economies

Usually, inflation is associated to **the general increase in the price level**. For Austrians this definition is too **vague**. This increase can have a wide **variety of causes**: shortage of production of a major good for the digital economy; changes in demand; etc. If we just look at the net result of **the price increase**, it tells us nothing about the root causes of this increase. For the Austrians, we must define **monetary inflation**: **the increase in the money supply that is not based on an increase in bank reserves**.

Monetary Inflation Accused of Fostering Business Cycles

The 20th century was marked by **a significant number of economic cycles**, with periods of euphoria and severe crises. However, when we look in detail, we see that these crises were due to reversals of confidence after phases of euphoria **created by excessive monetary growth, which was intended by the public authorities**. If we had a less inflationary currency, as gold was in the 19th century, **its value would be more stable and there would be fewer economic cycles.**

What about this example?

By the late 1960s, the United States had gone so long without a recession that economists were giving lectures with the title: "Is the Business Cycle Obsolete? "But why are market economies subject to recessions? »

If the market can match supply and demand, recession is a very special phenomenon. During a recession it seems that supply is everywhere, and demand is nowhere: There is a workforce that wants to work, but there are not enough jobs, the factories are quite efficient but there are not enough orders.

How can there be a shortage of goods in general?

To answer this question, Paul Krugman bases his answer on a true story: "The Great Capitol Hill Baby-sitting Co-op Crisis".

It was a baby-sitting cooperative that took care mainly of the children of the members of the American Congregational Association. The Capitol Hill co-operative issued its own securities: coupons entitling the bearer to hours of babysitting. When baby-sitting, the baby-sitters received several coupons corresponding to the number of children. The aim was to provide as many hours as they received. Such a system requires a considerable flow of vouchers. Couples with several free evenings in a row, and without immediate plans to leave, would try to build up reserves for later use: this accumulation would be at the expense of the other couples' reserves.

There came a time when there were too few coupons in circulation to cover the needs of the cooperative. Couples were more eager to baby-sit and reluctant to go out. Basically, the supply was there but the demand was non-existent: the co-op was in recession.

What was the solution? The number of coupons was increased significantly, and the result was magical. With larger coupon reserves, couples were more inclined to leave, which significantly increased the supply of childcare.

In other words, one way to combat recession is to create money.

3. Monetary inflation fosters over-indebtedness and over-consumption (including of natural resources) ...

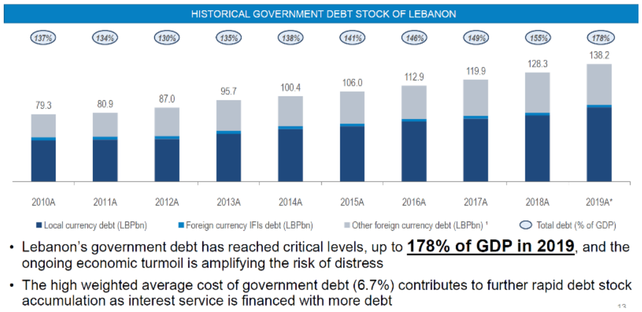
It is always said that the consumer society **is the product of capitalism**; in fact, it is also the product of **exaggerated monetary growth by the public authorities**. Since a lot of money is created, interest rates are low, and everyone goes into debt to consume, instead of planning for the long term: saving and investing. **We consume a lot of consumer goods but also natural resources.**

4. Money creation creates temporal distortions in purchasing power

The increase in the money supply leads to a r**edistribution of relative purchasing power, favoring the richest** - those who have the capacity for debt - or those who are politically connected, **disadvantaging the poorest** - those who cannot get into debt to buy an apartment in Paris, for example.

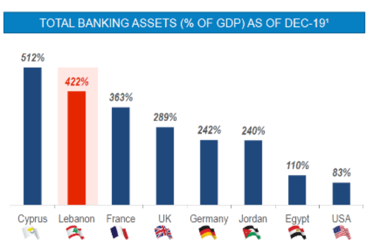
This is an extremely disruptive social effect, leading to increased **social inequality**. That is an interesting argument, and only Austrians raise it.

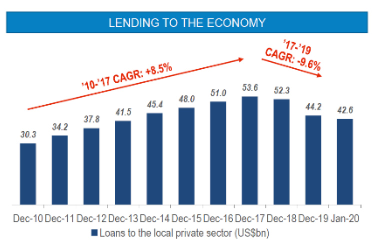
IV. EXAMPLE OF A DISASTROUS MONETARY POLICY

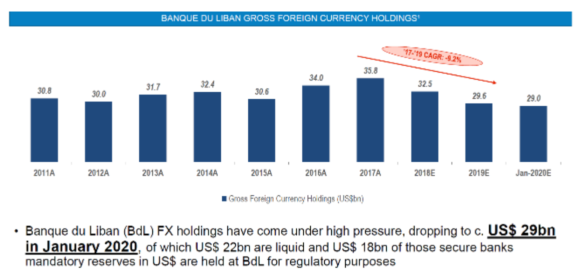


1. The heart of the problem: a growing public deficit

Since the beginning of the slowdown in economic growth in 2011, following the outbreak of the conflict in Syria and the desertion of wealthy Gulf nationals, the Lebanese state has found it **increasingly difficult to make ends meet**. The difficulties faced by the private sector have in fact had an impact on its tax revenues, which have changed only slightly: they amounted to USD 8.8 billion in 2011, reaching only USD 8 billion at the end of September 2018, according to the latest available figures. Meanwhile, its spending has continued to grow: $13.2 billion at the end of September 2018 compared to $11.6 billion in 2011.



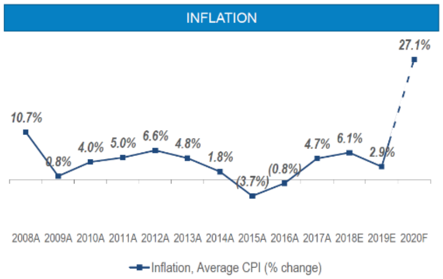


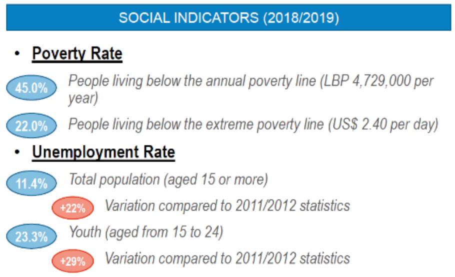


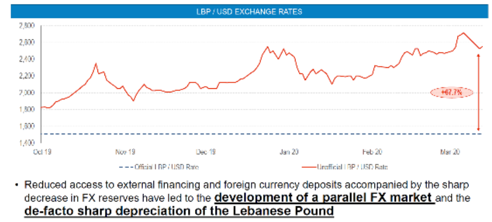
2. Why are the banks directly involved?

In order to cover this growing deficit, the government had an increasing need to go into debt. The public debt in fact rose from $54 billion in 2011 to $83.6 billion at the end of October 2018. In Lebanon, **it is the local banks that lend to the government, either directly by subscribing to bonds (Treasury bills in pounds and Eurobonds in dollars), or indirectly through the Bank of Lebanon, by making deposits, which are then used by the BDL to subscribe to bonds.**

In order to continue to finance the State, **banks need to be able to rely on a growth in their deposits**. However, this growth is slowing down more and more at a time when the need for indebtedness is increasing. **The BDL then decides to raise interest rates**. This increase in interest rates is at the **expense of borrowing.**







3. The crisis

Extremely **high interest rates** (up to 15%), accompanied by a **social crisis** plunges Lebanon on October 17, 2019 into an **unprecedented economic crisis**. Custodians no longer have confidence in an institution that lacks **transparency**. A campaign to withdraw deposits forces the Bank of Lebanon **to inject money**, which only makes the situation **worse**. Inflation increased drastically and the Lebanese pound is experiencing an unprecedented devaluation. **The exchange rates in the black market reach phenomenal values in April** (official rate 1$=1500 LBP vs. exchange rates 1$=3000LBP). In a stagnant economy (high unemployment), social inequalities are constantly being created. **Lebanon declares bankruptcy on March 9, 2020**. This first payment default in the country's history will lead to a debt restructuring, after negotiations with creditors.

4. Conclusion

- **State intervention is at the root of the economic crisis**
- Monetary inflation has fostered **the recession**
- Inflation has created temporal **distortions in purchasing power**
- The **centralization of monetary power** (BDL and commercial banks) led to the fall of Lebanon.
- In fact, Lebanon is one of the best examples of a **Ponzi scheme**.

V. ANNEX AND SOURCES

The different phases of a business cycle

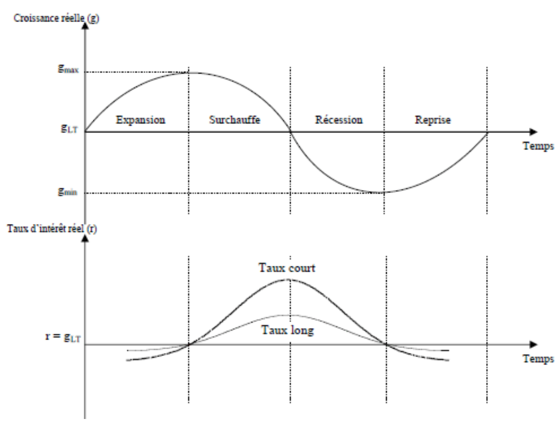
There are **4 phases in a business cycle**:

- **Economic recovery**: This is a turning point between the recession phase and the growth phase. We are trying by all means to get out of the crisis, and we are witnessing a lot of restructuring. The state then tries to give a relay of growth by investing massively to regain growth and restore confidence, or by applying an austerity policy to reduce spending. This phase is also the time for technological innovation that can help to get out of the crisis. Little by little, growth returns and a virtuous circle is set in motion.

- **Economic expansion**: This is the prosperity phase. All the indicators are green and there is an increase in production, wages, profits and consumption. Private investment is then very strong, as economic actors want to increase their production capacity to meet growing demand.

- **Economic overheating**: This is a turning point between the growth phase and the recession phase. Indeed, as the expansion progresses, inflation appears because there is more and more money in circulation (wage increases, interest rates still low at the beginning of the expansion phase). We are therefore witnessing a general rise in prices, which will lead to a fall in consumption and therefore investment. As manufacturers have stocks to sell off, they gradually reduce their production and lower their prices in order to sell off their stocks. The beginning of the crisis is then near.

- **Economic recession**: The overheating phase leads to massive layoffs which has a major impact on consumption. Wages are frozen and household dissatisfaction is growing. A crisis of confidence sets in at all levels. Indeed, some economic actors (the least solid) disappear and a certain mistrust is present between the actors. On the interbank market, this results in a drying up of liquidity. Banks no longer dare to lend to each other, and households no longer consume much, for fear of the economic crisis. Consumption is shrinking, and companies are continuing to adapt their production levels to this declining consumption. A vicious circle begins.



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Pourquoi les crises reviennent toujours ? Paul Krugman

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