Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

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Low Rates Make Public Debt Soar To Unsustainable Levels

The U.S. Federal Reserve will cut interest rates by 25 basis points at each of the remaining three meetings in 2024, according to a Reuters poll. The same survey sees no risk of recession.

However, central bank rate cuts are an admission of an exceedingly weak economy. Adding one more rate cut to expectations means that the risk of a recession is not small.

It is interesting to see how market participants debate the optimum rate level. We have grown accustomed to the notion that central planning must determine the quantity and price of money.

However, this is an incorrect notion. Markets should freely set rates. This would significantly reduce the risk of bubbles as well as curb the accumulation of malinvestment.

Artificial interest rates always have two negative consequences: when rates are too low, bubbles and increased risk-taking ensue. When rates are too high, families and small businesses suffer.

Furthermore, in both cases, governments ignore the risks and continue to add to public debt, knowing that they can raise taxes and refinance their liabilities at the expense of private investment and family credit.

How do we know if rates are high or low?

How do we know if rates are high or low? The markets should settle it, not a central bank. Some economists argue that the Federal Reserve does not “set” rates but just adapts to market demands. The argument makes no sense. If the Fed only acts on what markets demand, why not let rates float freely?

The answer is simple. The Fed acts not in response to market demands, but rather in accordance with conditions that maintain the affordability of public debt and prevent inflation from rising.

However, if free and open markets set rates and the quantity of currency, inflation would not soar, and bubbles would not occur. Free market interest rates would immediately rise before inflation creeps up, and accumulation of risk through bubbles would not happen as rates would rise and liquidity would drop once the first signals of excess appeared. So, why do central banks set rates and manage liquidity?

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The central bank has gone from being the provider of liquidity of last resort, acting in emergency situations, to being the provider of liquidity of first resort, which means that governments do not have to worry about their fiscal imbalances; they know they will be disguised by the central bank.

This manipulation of interest rates and liquidity is designed to maintain the illusion of public debt as a haven and low-risk asset. Conversely, this manipulation destroys the currency's purchasing power.

That is why gold has outperformed all currencies and sovereign bond indices in the past two decades. Central banks are more focused on sustaining unsustainable public debt levels than on defending the purchasing power of the currency.

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System rewards fiscal irresponsibility

Central banks must set rates and manage the quantity of money to ensure that the banking system continues to hold public debt as the lowest-risk asset.

Regulation contributes to this mirage by allowing banks to use no capital when purchasing sovereign debt.

Free floating of rates would result in significantly higher interest costs for fiscally irresponsible governments compared to the private sector, thereby rewarding fiscal responsibility.

Private sector investment and financing, not unproductive government debt, would provide liquidity in a free-market system - Daniel Lacalle

Today's system rewards fiscal irresponsibility and views public debt imbalances as the primary source of market liquidity. However, that is an entirely political construct.

Private sector investment and financing, not unproductive government debt, would provide liquidity in a free-market system.

When the financial system rewards government expenditure and debt and penalizes the private sector when inflation rises, it leads to a process of nationalization of the economy.

Government spending and currency printing create inflation, and when it bursts due to a loss of money's purchasing power, families and businesses bear the brunt of restrictive policies.

Expect a continued slump in productivity

In summary, the current monetary system has evolved into a perverse incentive mechanism that enlarges the size of government on the way in, helped by expansionary monetary policies, and increases the size of government further on the way out, when higher taxes and higher rates are imposed on the private sector to “reduce” the inflation caused by the government.

There is only one way in which bubbles and excessive debt are eliminated. With free rates and private bank liquidity. It will not happen.

> Expect a continued slump in productivity, a weakening of the fabric of society, families, and small businesses, and a destruction of the purchasing power of the currency

So, expect a continued slump in productivity, a weakening of the fabric of society, families, and small businesses, and a destruction of the purchasing power of the currency.

Rate cuts will make the federal government very happy. It will increase its deficit beyond the already unsustainable $2 trillion, and public debt is expected to rise by $22 trillion in ten years, according to the Congress Budget Office.

You will pay for it through persistent inflation, lower real wages, and higher taxes.