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The Money Mess

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How much money do you have? If you ask 10 equally wealthy people how much money they have, you would probably get 10 different answers, because no one knows what "money" is anymore. Everyone would say the paper currency and coin in their pockets is money. Most people would say the balance in their checking accounts is money, and many would say the value of their CDs is money. Are bonds money? How about stocks?

If you have a line of credit against your home (an unused home equity loan), is that money? After all, you need merely to write a check and you have "money." In times past, there were reasonably clear lines between what was money, what were financial assets, and what were real assets (land, buildings, machines, intellectual property, etc.). As a result of financial engineering and securitization of assets in recent years, many of the old distinctions are fast disappearing — if the value of a machine in a factory or copyright to a song is almost as liquid as the coin in your pocket in its ability to acquire other goods and services, which is "money" and which is not "money"? As money becomes increasingly difficult to define, so does the ability of central banks to control the money supply and credit, which in turn determines whether there is inflation or deflation.

To understand the current global money problem, it is useful to go back to basics. Assume a simple economy where there are no banks, and only wheat and potatoes are being produced. Exchange takes place through use of a fixed number of gold coins produced by the royal mint. Normally, it takes four gold coins to buy a bushel of wheat and two gold coins to buy a bushel of potatoes. But if in one year the weather turns out better for wheat and worse for potatoes, the price of wheat will fall and that of potatoes will rise by the same amount because the number of gold coins is fixed (the money supply) — hence, no inflation, even though the price of potatoes increased.

Last week, the U.S. government announced a big increase in "inflation," by which was meant more prices were rising (gasoline and food) than were falling (computers and flat screen TVs). This inflation could only occur if the central bank (the Fed) had increased the money supply faster than the supply of goods increased. The Fed controls the money supply by rationing how much new money the banking system creates: The Fed does so by controlling banks'

reserve requirements, the rates bank charge each other for loans and the purchases and sales of federal notes and bonds, etc.

The problem for the Fed and other central banks is that in recent years financial innovators have found ways to make it easier to "securitize" loans and assets, thereby taking them off the bank balance sheets, which enable banks to make more loans.

The ability to more easily turn assets into liquid capital causes asset prices to be bid up faster than the growth in the money supply (as traditionally measured). Meanwhile, more and more countries either fix or peg (e.g., the Chinese) their currencies to the U.S. dollar or the euro. The combination of the growth in the dollar and euro-based global economy, along with a huge growth in largely opaque financial engineering, means the Fed and other central banks have less understanding and control of what is happening with "money."

The other problem is that the Fed has two tasks which can conflict with each other. One is to keep the value of the currency stable (no inflation or deflation) and the other is to keep the economy growing. To keep inflation down, the Fed should restrict the growth of money and credit (and, as noted above, their tools to do this are becoming less precise, in part, due to the growing measurement problem), but in the short run that will slow economic and employment growth.

Congress and some of the regulatory agencies add to the Fed's problem by passing regulations not based on solid cost-benefit analysis, spending wastefully (remember: even according to the government's own numbers, about 50 percent of the taxpayer dollars are not properly spent), and engaging in destructive tax policy. All this saps real economic growth, making the Fed task much harder.

No one knows for certain whether the central banks, through luck or skill, can get us through the current financial mess with only modest pain. The late, great economic Nobel laureate, F.A. Hayek, farsighted as always, understood and argued decades ago that the long-run problem would only be solved by the "denationalization of currency" — taking away the government monopoly in producing money.

Governments need merely allow citizens to choose the currencies in which they wish to contract (including gold and private currencies) and remove the capital-gains tax from changes in the prices of commodities, including gold and private and foreign currencies.

Taxing such gains and deducting such losses is a zero sum game, in which the government gains almost no tax revenue, but the need to calculate the tiny gain or loss on each transaction is extremely costly, and thus inhibits sensible financial innovation.

Without government shackles, entrepreneurs will eventually find the best solution to the current global money mess.

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