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Making Money Disappear

by Richard W. Rahn

Currency not tied to gold or other standard becomes worthless

The major world governments are in the process of destroying the value of the money their citizens hold. On Nov. 16, the Cato Institute held its annual monetary conference. Speakers included high-ranking officials from the Federal Reserve and monetary experts from the academy, think thanks and financial institutions. There was unanimous agreement that the world monetary system is in deep trouble, which is obvious to anyone who keeps up with the news. It is easier to observe the problem than to come up with a solution.

Economists define money as having the following characteristics:

- A unit of account, meaning that we can define the value of goods and services in it;
- A medium of exchange, meaning that others will accept your “money” (e.g., the U.S. dollar) for goods and services;
- A store of value, meaning that it keeps its intrinsic worth.

Since the beginning of the Federal Reserve System in 1914, the U.S. dollar has been a lousy store of value. It is now worth just one-twenty-second of what it was worth in 1913 and only less than one-quarter what it was worth as recently as in 1971, when the United States officially cut the last tie of the dollar to gold. Even so, many people around the world prefer to keep U.S. dollars because dollars have been less subject to inflation than most other major currencies. At the moment, the U.S. dollar is losing value at a rate of about 4 percent per year.

Inflation occurs when the central bank - the Fed in the United States or the European Central Bank in Europe - creates money at a faster rate than the supply of goods and services increases. Changes in the rate with which people spend money (referred to by economists as changes in the velocity of money) also affect inflation in the short run. If people hold on to money rather than spend it, inflation will fall and vice versa. Central banks can control the supply of money but not changes in velocity. In the United States, velocity has fallen because regulators have been increasing lending standards, so, in many cases, banks cannot even make what they think will be good loans. Also, regulators have been increasing the amount of reserves banks must hold. The result is that even though the Fed has been rapidly increasing the money supply, much of it is sitting in banks rather than being used for additional investment or consumption. Even so, the growth in the money supply has been greater than the growth in new goods and services; hence the current inflation.

Democracies have an inherent flaw in that many seek to use the political process to transfer wealth from some to others. This leads to counterproductive levels of government spending. People also dislike paying taxes. Therefore, the politicians tend to spend more than the tax revenue provides, and this excess spending is funded by the sale of government bonds. Under a classic gold standard, the sale of bonds by government was limited to the amount of gold the government held, plus the amount of gold that the bond buyers could reasonably expect the government would be able to buy from projected tax revenues if it became necessary.

Now, almost all government-produced money is a “fiat” currency, meaning there is no explicit backing for the currency, such as gold, other than the amount of real goods and services the government can coerce the citizens to pay through taxes or other means. The problem with fiat money is there is no limit to the amount of it the government can print. Accordingly, history demonstrates that fiat currencies eventually are debased through overprinting as the value is inflated away. Three years ago, the debasement of the currency in Zimbabwe reached a point where the government was printing 100-trillion-dollar – yes, trillion – bank notes, which were almost valueless. The citizens of Zimbabwe then converted their money as rapidly as possible into U.S. or other “hard” currencies, and the financial system in Zimbabwe collapsed.

It is apparent that the political classes in Europe, the United States and even China are not yet prepared to cut government spending back to a rate that can be supported by their economies. Thus, the pressure will increase on the central banks to cover more and more of the debt by printing money, which goes by the deceiving euphemism “quantitative easing.” When a central bank creates more money to buy bonds, whether they be Greek or Italian bonds in the European case, or U.S. government bonds in this country, no new wealth is created. Only the real-money value of the existing wealth is reduced (in essence, a hidden wealth tax). At some point, politically intolerable rates of inflation or economic stagnation will result. This, in turn, will force a massive monetary contraction or a move back to a gold standard or some other real backing for the money. The United States has more than 8,000 tons of gold, with a current market value of almost a half-trillion dollars, which would be enough to move to some form of a gold standard. A gold standard for money is not a panacea, but it is far better than an undisciplined fiat standard.

The real solution to the money dilemma is for governments to give up their monopolies on the issuance of money and allow free competition to determine who produces the best money. If innovative minds like Thomas Edison and Steve Jobs had been free to develop sound money, I expect many of our money problems would be relics of the past.

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