What Has Government Done to Our Money?

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PART 2

III. Government Meddling with Money

1. The Revenue of Government

Unlike all other organizations governments do not obtain revenue as payment for services, but have to find methods of expropriating more goods without owner's consent.

In barter economy governments would seize goods *in kind.* In monetary economy they will find it easier to seize monetary assets (=taxation) with which they in turn can buy goods or pander to special interests.

Taxation is often unpopular and the emergence of money created the possibility of counterfeiting (inflation), creating new money out of thin air.

2. The Economic Effects of Inflation

1. Inflation confers no general social benefit, but instead redistributes wealth in favor of those who get their hands on the money earlier at the expense of those who get it later. Particular sufferers are fixed-income groups: fixed salary people, foxed money contracts made before inflation occurred, life insurance or pension receivers, landlords with long leases, etc.

2. it distorts the keystone of the economy, business calculation. Since prices do not change uniformly and at the same speed it becomes difficult for businesses to separate the lasting from the transitional and gauge truly the demands of consumers or costs of their operations. (e.g. the cost of replacing an asset is based on the amount paid for it, but with inflation replacing it in a few years will cost a lot more. So business may have then listed higher profits than they really have or consume capital whole presumably increasing investments.

3. By creating illusory profits and distorting calculation inflation will suspend market's penalizing of inefficient and rewarding of efficient firms. They will almost all seem to prosper.

1. And people will try to get rich fast. Inflation discourages saving, thrift and so lowers standard of living.
2. Hyperinflation causes the monetary system to break down: Eventually people wake up to the shrinkage in purchasing power. Then
    a) First they see prices rise and will postpone buying stuiff, thinking this is temporary.
    b) then they see that prices *continue* to rise and start buying before prices rise even further. This causes the demand for money to fall and prices to go up even more than the increase in the money supply
    c) Then the government is looked for to relieve the money shortage caused by accelerated prices, and so it inflates more.
    d) The crack-up boom phase in which people will want to get rid of money asap occurs. Money supply skyrockets, demand plummets, prices rise astronomically, production falls sharply. The Monetary system has broken down completely (hyperinflation)
3. When new money is first used as loans to business inflation causes the *business cycle*: new money is issued by banks and loaned to businesses., To them the new funds seem like genuine investments but they do not arise out of voluntary savings (people e.g. consumer 80 percent and save 20 percent but with the new money savings seem higher). New money gets invested in various projects and paid out to workers and other factors as higher wages and prices. As the new money filters down to the whole economy, people tend to re-establish their old voluntary consumption/saving (e.g. 80/20) proportions causing many investments to be revealed as wasteful so that liquidation of wasteful investments becomes necessary (depression phase)

3. Compulsory Monopoly of the Mint

How can governments *subtly, without it being too obvious,* inflate?

1. seize monopoly of *minting* business.

This enabled them to ask higher or lower or no prices for minting, reduce variety of coins, foster the *name* of the coin (separating it mentally from underlying weight of the coin); debasement.

4. Debasement

Governments could dilute gold with a base alloy, or melt coins and recoin them and give the same number back but of a lighter weight with the gov't getting the difference.

5. Gresham's Law and Coinage

a. Bimetallism

2. Fixed gold-silver ratio rather than freely fluctuating one. One *dollar* is now defined as 1/20 ounce of gold *and* one ounce of silver. This also means that the precise meaning of *dollar* is lost. It no longer is just a name for 1/20 ounce of gold and seems to take on an independent existence. Since exchange ratios on the market tend to fluctuate, Gresham's Law would tend to cause one type of coin (overpriced one) to drive out the other (under-priced one) n the end, one type of coin would tend to remain at the expense of the other.

b. Legal tender

3. Only by dictating what money could be (legal tender laws) governments were able to enforce price controls and monetary exchange rates.

6. Summary: Government and Coinage

Compulsory minting and legal tender laws were main tools used by governments, and they strove to drive out circulation of all coins minted by other governments. Still, this didn't give gov'ts much room for inflation. That couldn't occur till the emergence of money-substitutes.

7. Permitting Banks to Refuse Payment

The three limits of the inflationary power of banks (single bank's clientèle, total bank clientèle, confidence of clientèle in banks) are ultimately based on the requirement of banks to redeem their sworn liabilities on demand,

Gov't can foster inflation then by grant banks the privilege to refuse to pay their obligations while staying in operation. In the US this started in the 19th century and banks soon realized they need not fear bankruptcy after inflation. But this was not that successful as few people would give their money to banks that never redeemed and governments wanted fuller control over inflation. Hence the CB

8. Central Banking: Removing the Checks on Inflation

Central banks get a government granted monopoly of note issue. Private banks cannot issue notes but only grant deposits,. The CB is the banker's bank because private banks have to go to it to get notes. This way (or by law) all banks become clients of CB. Banks sold their gold in exchange for bank notes and in the US could no longer have gold as legal reserve. Gold from now on was stored at the CB and the Fed prescribed the reserves private banks must have in the form of CB notes.

Because of the enormous confidence of people in the CB (which had all the gold safely stored and which was backed by the mighty gov't and could not go bankrupt) and because people lacked the understyanding of what was going on, CB became trusted national institutions and people were drawn away from using gold in transactions.

Now how to get people to trust private banks as well? By acting as a lender of last resort to them, by discouraging "bank runs" (sometimes by permitting banks to suspend payment, or by outlawing public calls for bank runs, or by propaganda)

So CB remove two of the three checks on bank crsdit inflation. What about the third, the problem of narrowness of each bank's clientele, banks asking other banks for redemption for their clients? The CB can make sure that all banks expand at the same rate so that there is no relative redemption

problem and the entire population becomes each bank's client.

Another aspect of CBing only adds to the inflationary power it made possible. CB themselves only have a fractional reserve of gold for all *their* liabilities (to private banks).

9. CBing: Directing the Inflation

CB regulate private banks by controlling the banks' "reserves" their deposit accounts at the CB)
The CB can then stimulate inflation by:

1. pouring reserves into the banking system
2. lowering the reserve ratio

Re 1:
CB add to the quantity of bank reserves by buying assets on the market (or directly from a private bank), for example from Joe at a price of $1,000. The CB writes out a check to Joe. Joe takes the check to his bank, which in turn will go to the CB, which in turn will credit the bank with another $1,000 in reserves, which permits (through reserve ratio) a multiple bank credit expansion.

The CB's favorite asset has been government securities. The gov't can just order the CB to buy its securities. The CB often even commits to buying enough of them to keep their market price above a certain level.
CB can also inflate by *lending* bank reserves to private banks. The fee for this service is the rediscount rate (what you see in the press). But although this gets a lot of publicity, it is not that important compared with movement in quantity of bank reserves and reserve ratio.

CB can *deflate* by selling assets to banks or public which lowers bank reserves (which after all are used for buying the assets) and causes pressure for credit contraction and lowering of the money supply, or by raising the reserve ratio.

10. Going off the Gold Standard

There still is the check on credit expansion in the form of the amount of gold that the CB itself has to have. Citizens could make a CB run or, more likely, foreign governments will want redemption in gold.

One way to solve this problem is inter-CB cooperation. If they all agree to inflate at the same rate, no inter-country redemption problems will take place and they could inflate without end.

Another way to solve it is by just going off the gold standard altogether when confronted with redemption demands. Often this was a temporary measure, but even then it in essence undermines the general gold standard, it makes it a mockery.

Another step was the 'gold bullion standard' which meant that gold could only be redeemed in large quantities (not coins or nothing) which limits gold redemption to handful of specialists in foreign trade.

A final step is to go off the gold standard completely (often under indignant patriotic jingoism) and with government paper becoming the *fiat* standard money.