NATIONAL CENTER FOR POLICY ANALYSIS

The Federal Reserve and Sound Money

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We are living in a time of monetary chaos. The U.S. Federal Reserve has manipulated key interest rates down to practically zero for the last six years, and expanded the money supply in the banking system by $4 trillion over that period. And with the true mentality of the monetary central planner, the Fed Board of Governors now plans to manipulate key interest rates in an upward direction that they deem more desirable.

Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
202.830.0177
governmentrelations@ncpa.org

Interest Rate Manipulation and Monetary Expansion. The European Central Bank (ECB) has instituted a conscious policy of "negative" interest rates and planned an additional monetary expansion of well over a trillion Euros over the next year. Plus, the head of the ECB assured the public and financial markets that there is "no limit" to the amount of paper money that will be produced to push the European economies in the direction that monetary central planners consider best.

Remember, the Federal Reserve undertook a similar monetary expansion and policy of interest rate manipulation earlier in the 21st century which, in conjunction with federal subsidies that distorted the housing market, set the stage for the severe and prolonged "great recession" that began in 2008-2009.

The media and the policy pundits may focus on the day-to-day zigs and zags of central bank monetary and interest rate policy, but what really needs to be asked is whether or not we should continue to leave monetary and banking policy in the discretionary hands of central banks and the monetary central planners.

Central Banking and Monetary Planning. Central banking *is* monetary central planning. The United States and, indeed, virtually the entire world operate under a regime of monetary socialism. Historically, socialism has meant an economic system in which the government owned, managed and planned the use of the factors of production.

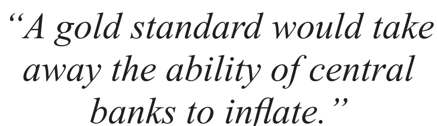
Modern central banking reflects those themes. In the current system, the government, either directly or through some appointed agency such as the Federal Reserve, has monopoly ownership and control of the medium of exchange. Through this control the government and its agency has predominant influence over the value, or purchasing power, of the monetary unit, and can significantly influence a variety of market relationships. These include the rates of interest for borrowing and lending in the banking and financial sectors of the economy, and therefore the patterns of savings and investment in the market.

If there is one lesson to be learned from the last one hundred years — during which the world and the United States moved off the gold standard

and onto a government-managed fiat, or paper, money system — it is the fundamental disaster of placing control of the money supply in the hands of governments.

Continual Government Abuse of Money. Money did not originate in the laws or decrees of kings and princes. Money emerged out of the market transactions of a growing number of buyers and sellers in an expanding arena of trade as the most widely used and generally accepted medium of exchange. Commodities such as gold and silver were selected over generations of market participants as the monies of free choice due to their useful characteristics, to better facilitate the exchange of goods in the market place.

For almost all of recorded history, governments have attempted to gain control of the production of money and manipulate its value to serve their seemingly insatiable appetite to extract more and more wealth from ordinary members of society. For example, ancient rulers would clip and debase the gold and silver coins of their subjects to sustain their own power.



More modern rulers — whether despotically self-appointed through force or democratically elected by voting majorities — have taken advantage of the monetary printing press to churn out paper money to fund their expenditures and redistributive largess in excess of the taxes they impose on the citizenry. Today the process has become even easier through the mere click of a "mouse" on a computer screen. In the blink of an eye a planner can create tens of billions of dollars out of thin air.

Monetary debasement and the price inflation that normally accompanies it have served as a method for imposing a "hidden taxation" on the wealth of the citizenry. As John Maynard Keynes — before he became a "Keynesian"! — insightfully observed in 1919:

> "By a continuous process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method, they not only confiscate, but they confiscate arbitrarily; and while the process impoverishes many, it actually enriches some. The process engages all of the hidden forces of economic law on the side of destruction, and does it in a manner that not one man in a million can diagnose."[1]

It is the corrosive, distortive and destructive effects from monetary manipulation by governments that led virtually all of the leading economists of the 19th century to endorse the "anchoring" of the monetary system in a commodity such as gold. This would prevent governments from using their power over the creation of paper money to cover their budgetary extravagance.

The Social Benefits of a Gold Standard. Under a gold standard, gold is the actual money. Paper currency and various forms of checking and other deposit accounts used in market transactions are *money substitutes*. They represent a fixed quantity of the gold-money on deposit with a banking or other financial institution that is redeemable on demand.

Any net increases in the quantity of currency, checking and related deposits are dependent upon increases in the quantity of gold that depositors add to their individual accounts. And any withdrawal of gold from their accounts through redemption requires that the quantity of currency notes and checking and related accounts in circulation be reduced by the same amount. Under a gold standard, a central bank is relieved of all authority and power to arbitrarily "manage" the monetary order.

Many critics of the gold standard consider this a rigid and inflexible "rule" that constrains the monetary system and the quantity of money in the society. Yet, the advocates of the gold standard have long argued that this relative inflexibility is essential to confine governments to a "hard budget."

A Gold Standard Can Limit Government Monetary Abuse. Without the "escape hatch" of the monetary printing press, a government either must tax the citizenry or borrow a part of the savings of the private sector to cover its expenditures. Those proposing government spending must either justify it by explaining where the tax dollars will come from and upon whom the taxes will fall or make the case for borrowing a part of the savings of society to cover those expenditures. Modern government simply monetizes its debt and increases the money supply; a gold standard would prevent that. The borrowed sums could not be created out of thin air through central bank monetary expansion. Under a gold standard, the

government cannot create the illusion that something can be had for nothing.

Milton Friedman's "Second Thoughts" About the Benefits of Paper Money. Some advocates of economic freedom and limited government have also championed paper money. Nobel Prize economist Milton Friedman often argued that maintaining a gold standard was a waste of society's resources. Why squander the men, material and machinery digging gold out of the ground to then simply store it away in the vaults of banks? It is better to use those scarce resources to produce more of the ordinary goods and services that can enhance the standard and quality of people's lives. To control the potential arbitrary recklessness of central banks, Friedman proposed setting up a monetary "rule" that says: Increase the paper money supply by some small annual percent, with no discretion left in the hands of the monetary managers.

But years after winning the Nobel Prize in Economics in 1976, Friedman had second thoughts about this monetary prescription. In a 1986 article on "The Resource Costs of Irredeemable Paper Money," he argued that when looking over the monetary mismanagement and mischief caused by governments and central banks during the 20th century, it was "crystal clear" that the costs of mining, minting and storing gold as the basis of a monetary system would have been far less disruptive and destabilizing than the inflations and the booms and busts of the business cycle brought about by central bank manipulations of paper money and interest rates.[2]

In his 1985 presidential address before the Western Economic Association on "Economists and Public Policy," Friedman said that Public Choice theory — the use of economics to analyze the workings of the political process — had persuaded him that it would never be in the self-interest of governments or central bankers to manage the monetary system according to some hypothetical "public interest." Those in government or holding the levers of the monetary printing press will always be susceptible to the temptations and pressures of short-run political gains that monetary expansion can fund. He admitted that it had been a "waste of time" on his part to try to get governments and central banks to follow his idea for a monetary rule.

"Central bank manipulation of money, credit and interest rates generates instability."

And in another article in 1986, Friedman said that while he was not ready to advocate a return to the gold standard, he did conclude that "that leaving monetary and banking arrangements to the market would have produced a more satisfactory outcome than was actually achieved through government involvement."[3]

Monetary Mismanagement versus Markets and Gold. But it is not only the political dangers arising from government mismanagement of paper money that justifies the establishment of a gold standard. Monetary central planning is also unworkable as a means to maintain economy-wide stability, full employment and growth.

Especially since the 1930s, many economists and policy makers influenced by Keynes and the Keynesian Revolution have believed markets are potentially unstable and susceptible to wide and prolonged fluctuations in employment and output, which can only be prevented or reduced in severity through "activist" monetary and fiscal policy. But, in reality, central bank manipulations of money, credit and interest rates have generated more instability and periodic swings in economy-wide production and employment.

Financial institutions and interest rates have important work to do in the market economy. Banks and other financial intermediaries are supposed to serve as the "middlemen" who bring together those who wish to save portions of their earned income with others who desire to borrow and invest that savings in profit-oriented, productive ways that generate capital formation, technological improvements and cost-efficient production of new, better and more goods and services. Market-determined interest rates are meant to bring those savings and investment plans into coordination with each other, so the amount of invested capital and the time-shape of investment horizons are consistent with the available real savings to support investment plans to completion.

Monetary expansion by central banks creates the illusion that there is more actual investable savings in the economy than really exists. And the false interest rate signals generated in the banking system by the monetary expansion not only misinforms potential investment borrowers about the amount of real savings available for capital projects, but also creates an incorrect basis for

determining the present values that influence the time horizons for the investments undertaken.

These false monetary and interest rate signals induce a misdirection of resources, the mal-investment of capital and an incorrect allocation of labor among employments in the economy. That sets the stage for an inevitable and inescapable "correction" and readjustment, representing the recession stage of the business cycle that follows the collapse of the artificial boom.

Monetary central planners can no more determine an "optimal" quantity of money or the "right" interest rates to assure savings-investment coordination than past socialist planners when they tried to centrally plan agricultural production or investment output for an entire society. All such attempts are what Friedrich A. Hayek called in his Nobel Lecture a "pretense of knowledge," that they can know better and do better than the outcomes generated by the competitive interactions of market participants. And as Adam Smith warned, nowhere is such regulatory power "so dangerous as in the hands of a man who had the folly and presumption enough to fancy himself fit to exercise it."[4]

There is no way of knowing the optimal amount of money in the economy other than allowing market participants in the competitive exchange process to decide what they want to use as money — which has historically been a commodity such as gold or silver. And there is no way of knowing what interest rates should be other than allowing the market forces of supply and demand for lending and borrowing to determine those interest rates.

Return to the Gold Standard as a Monetary Constitution. Under the current government and central bank-controlled monetary system, the simplest method might be for the monetary authority to stop creating and printing money and credit. Over a short period of time a fairly reasonable estimate could be made about the actual quantity of a nation's currency and checking and related deposits. A new legal redemption ratio could be established by dividing the estimated total quantity of all forms of these money-substitutes into the quantity of gold possessed by the government and the central bank. A country following this procedure would then, once again, be on the gold standard.

Its long-run maintainability would require the government and the central bank to follow "rules of the game" that no increase in the quantity of money-substitutes may be created and brought into circulation unless there have been net deposits of gold in people's accounts with banking and other financial institutions. The temptations to violate those rules will still remain strong in a political environment dominated by ideologies of wealth redistribution, special interest favoritism and numerous "entitlement" demands.

It is why the real long-run goal of monetary reform should be the denationalization of money. That is, the separation of money from the state by ending central banking altogether. In its place would emerge private, competitive free banking — a truly market-based money and banking system.

But nevertheless, in the meantime, a gold standard can serve as a form of a "monetary constitution" setting formal limits and imposing restraints on those in government who would want to abuse the monetary printing press, similar to the way political constitutions, however imperfectly, are meant to limit the abuses of power-lusting monarchs and the plundering majorities in functioning democracies.

Conclusion. If a gold standard fails, it should not be for want of trying. It could be one of the positive institutional reforms in the attempt and on the way to a fully free market monetary system.

Richard Ebeling is the BB&T Distinguished Professor of Ethics and Free Enterprise Leadership at The Citadel in Charleston, South Carolina.

Notes

1. John Maynard Keynes, *The Economic Consequences of the Peace* (New York: Harcourt, Brace, 1920), page 235.

2. Milton Friedman, "The Resource Cost of Irredeemable Paper Money," *Journal of Political Economy*, Vol. 94, No. 3, Part 1, June 1986, pages 642-647.

3. Milton Friedman and Anna Schwartz, "Has Government Any Role in Money?" *Journal of Monetary Economics,* 1986.

4. Adam Smith, *The Wealth of Nations* (New York: Modern Library, [1776] 1937), page 448.