Does Money Really Need to Be Controlled by Enlightened Experts?

Many who understand how a planned economy — wage and price controls, government-mandated production goals, industry standards, subsidies, and the like — destroys market productivity still make an exception with regard to one indispensable economic good: money. Many of the adherents of the so-called Chicago School of economics, such as the late Milton Friedman, were for the most part eloquent defenders of laissez-faire capitalism. Yet Friedman and his epigones also believe that, while the rest of the marketplace should be allowed to operate with a minimum of government interference, the money supply should be controlled by enlightened government managers at central banks such as the American Federal Reserve. While market forces are adequate to maximize market productivity and efficiency for all other goods and services, they are allegedly insufficient for the "stuff that dreams are made of." Left to market forces, the money supply will destabilize prices and hamstring productivity. This, at least, is the argument.

To believe this is to ascribe to money some mystical property that no other market good possesses, and to assume that money is somehow exempt from the ordinary interplay of supply and demand. But this is not true. Money is an economic good like any other, but with the specific purpose of providing a convenient means to store wealth and to carry out indirect exchange. No fully formed economy can exist without some form of money.

When government is able to manipulate the money supply, it is argued, it can provide greater economic stimulus, allowing for far more rapid economic growth and technological progress than what would be possible under the old system of gold- and silver-backed currency. But in fact the reverse is true. When government is given the power to create money out of thin air, it can no more calculate what the optimal money supply is than it can calculate optimal production goals for any other good. And this means that government-created money, like all other forms of government economic planning, will do far more harm than good.

Governments do not ordinarily create money by simply running printing presses and handing out free cash. More subtle mechanisms are required to introduce new money into the economy. Usually those mechanisms involve the creation of new debt in some form, and always they involve privileged intermediaries to carry out what amounts to legal money laundering.

In the Federal Reserve System, although the Fed has a considerable number of tricks for manipulating the money supply, the most important is what are called "open market operations." These are regularly scheduled purchases and sales of government debt by the Fed, using a small number of elite banking and financial concerns as agents. Usually — but not always — these debt instruments are already in circulation; that is, the Fed does not — except in times of extreme economic duress — issue new debt in order to sell it directly on the open market. Instead, it buys and sells already-existing Treasury bonds and bills. In general, the Fed prefers to sell such government paper, which will then create a demand for more government-issued debt — and the money to purchase it.

Over time, no matter how disciplined a government's financial policies may be, the actions of modern central banks always increase the money supply. This is because, under a fiat currency system (that is, a system where government can create money with no commodity backing it), government has every incentive to create new debt and money, and very little to keep a tight lid on the money supply. The infusion of new money into the economy (properly defined as "inflation") dilutes the value of each dollar already in circulation, resulting in higher prices. Yet the price increases are blamed on businesses' greed, rather than the increase of the money supply.

The terrible effects of inflation do not harm everyone equally. Large banks and financial firms that have privileged access to new debt and money can make spectacular profits; but the rest of us, farther down the financial food chain, have access to new money only after its effects have rippled through the system, driving up prices to the detriment of savings accounts and grocery bills everywhere.

One of the most pernicious effects of "fiat money" — money created at whim by government banks — is the destruction of savings. With interest rates set far below free market levels coupled with constant inflationary rising prices, there is little incentive to save money in any form. It will earn next to no interest, and besides, its purchasing power is constantly declining. The only way to preserve wealth in such an environment is to seek out risky, potentially high-yield investments such as real estate and growth stocks — investments that, as often as not, turn sour. But the alternative is safe investments and savings that lose value over time, impoverishing the frugal. Thus in a fiat money environment, the customary rules of human behavior are turned upside down, as the frugal and the thrifty are punished even as the pie-in-the-sky speculators and heedless risk-takers are (temporarily) rewarded.

Because fiat money can be created by governments at no cost, it carries with it the irresistible temptation to covertly print money to pay for government expenses — rather than overtly raising taxes to do so. This process creates endless inflation and distorts prices, leading to artificial booms and busts that only the wealthiest are able to exploit. Everyone else, who sees their savings and assets degraded by inflation, is systematically impoverished in a form of tax far more pernicious than open levies.

A free money market would quickly select a type of money whose supply cannot be manipulated by the state. The customary choice, for thousands of years, has been some kind of scarce, durable precious metal, usually gold, silver, or both. In a money market free from government interference, pricing in terms of gold and silver has been remarkably stable over the centuries, and would put an end to the general impoverishment and indebtedness brought about by government manipulation of the money supply.