

Embracing a Globalized, Fiat Money Regime: Does Demand for Money Matter?

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Brave New (Monetary) World

- End of commodity-based monetary standards
 - USA “defaulted” on commitments to gold standard
 - FDR: ended domestic exchange of gold for \$ (1934)
 - Nixon: ended international exchange of gold for \$ (1971)
- Globalized fiat-money regime
 - Infinitely-elastic supply of (irredeemable paper) money
 - Weak restraints on monetary “misbehavior”
 - Loss of implicit, psychological, historical restraints → “unconventional” monetary policies → global debt bubble → ???
 - Central banks tend to follow in tandem with US Federal Reserve
 - Synchronized monetary policies → weakened disciplining effect of “out-of-step” monetary policies that would lead to adverse international flows
- Globalization & rise of emerging market economies transformed international monetary conditions & trade/capital flows
- Increased use of electronic transfers & credit card payments
- Can current monetary & macroeconomic theory → “good” policy?

Demand for Money ... What ... !?!

- Reconceptualization of demand for money (DFM) necessary since monetary theory relating to DFM conceived under commodity standards (or were of recent history)
- Notion of "idle balances" under sound money differs from DFM if there is infinitely-elastic supply of irredeemable, paper money
 - Commodity standard (i.e., gold is money; money is gold): holding money ("hoarding") → leakage of funds from financial system has consequences
 - DFM today: only "black" money is "hoarded" → few "idle" money balances outside of banking system (no incentive to hold deprecating paper)
 - Except for \$ held outside US by foreign nationals, most \$ are a unit of account in a financial intermediary & available for use in economic system

Monetary Theory & Demand for Money

- Demand for money (DFM) is a critical component of monetary theory & macroeconomic theory
 - Are current theories robust enough to explain new complexities/realities?
 - Has misunderstanding of DFM & “bad” models → monetary madness
- Impact of changes in DFM depends upon monetary regime
 - Commodity standard: increased DFM → rising “natural” rate of interest
 - Commodity standard (i.e., gold = money; money = gold) withholding money/gold → funds held outside financial system (i.e., “hoarding” has consequences)
 - Fiat-money standard: increased DFM induces central banks to offset deflationary effect by increasing money supply
 - Fiat money: few “idle” money balances outside of banking system due to weak incentive to hold paper money & disincentive from tendency for price inflation
 - Narco-traffickers “hoard” black money but seek to launder it!
 - Most paper money is deposited in financial intermediary & available to lend
 - 40% to 60% of total \$ used outside & 2/3 of global foreign exchange reserves

Conceptualizing Demand for Money

- DFM reflects choice to hold cash instead of interest-bearing assets (e.g., bonds) or inventories of goods
- DFM = hoarding (Selgin & Canaan) of “inside” money
 - Stock (cash balances)
 - Flow (monetary payments adjusted for increasing prices, i.e., real balances)
- DFM reflects expectations of future conditions
 - Increased DFM (increased cash balances) due to greater uncertainty or rising deflationary expectations with expected higher value of units of money → lower planned future expenditures due to expected deflation
- V is falling due to "financialization" of economy as banks (& borrowers) engage in leveraged speculation in relatively low-cost & low-risk financial assets → funds diverted from real sector to financial sector (lending more risky & more costly)

Velocity of MZM Money Stock (MZMV)
MZM Money Stock (MZMSL)



FRED

Shaded areas indicate US recessions.
2012 research.stlouisfed.org

MZMV
MZMSL

M1 Money Multiplier (MULT)
Source: Federal Reserve Bank of St. Louis



FRED 

Shaded areas indicate US recessions.
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Money Demand, Macroeconomics & Monetary Theory

- Keynesian (aggregate-demand managers/planners)
 - Interest rates: Keynes likes to have it both ways!
 - Interest rates determine how much in cash balances or bonds
 - DFM (liquidity preference) & supply of money → market rate of interest
 - High liquidity preference (DFM) → insufficient aggregate demand & large, sudden rise in DFM → systemic price deflation
 - Elastic supply of “inside” money prevents negative impact on aggregate demand from hoarding (liquidity preference) & increased investment would follow net increases in aggregate money demand
 - “Liquidity trap” (i.e., infinitely, interest-elastic DFM balances) → State can/must run fiscal deficits to “stimulate” economy

Money Demand, Macroeconomics & Monetary Theory

- Monetarist (money-supply managers/planners)
 - Quantity theory & $MV=PT$ (V is inverse of DFM)
 - Linearity of DFM & price level \rightarrow long-run neutrality of money
 - Insufficient monetary policy response to large, sudden rise in DFM \rightarrow systemic price deflation
 - Friedman focused on price (level) stability as equilibrium between supply & demand for money
 - Choice to hold cash part of generalized choice problem based on permanent income
- Interest rate & DFM
 - Determined by intersection of supply & demand for “loanable funds”
 - Opportunity cost of cash balances \rightarrow DFM

Money Demand, Macroeconomics & Monetary Theory

- Austrian (micro orientation)
 - Mises: DFM reflects individuals' marginal utility of cash relative to other goods
 - Focus on impact of changes in DFM on relative prices
- Time preference, DFM & interest rates as “price of time” (i.e., rate of discounting future)
 - Time preference: "category" of human action (i.e., actions bring actor's goal closer in time): prefer satisfaction sooner not later & smooth consumption over time with changing income & values
 - Intertemporal allocation of money income (including DFM) → positive interest rate on loans & monetary investments in production structure
- Mainstream theories look to relationships between macroeconomic variables but neglect monetary behavior of individuals

Demand for Money

Macro

Micro

Austrian

Keynesian

Monetarist

Liquidity Preference
("Hoarding")

Quantity Theory
(Equation of
Exchange)

Insufficient Aggregate
Demand

Linearity of
Relationships

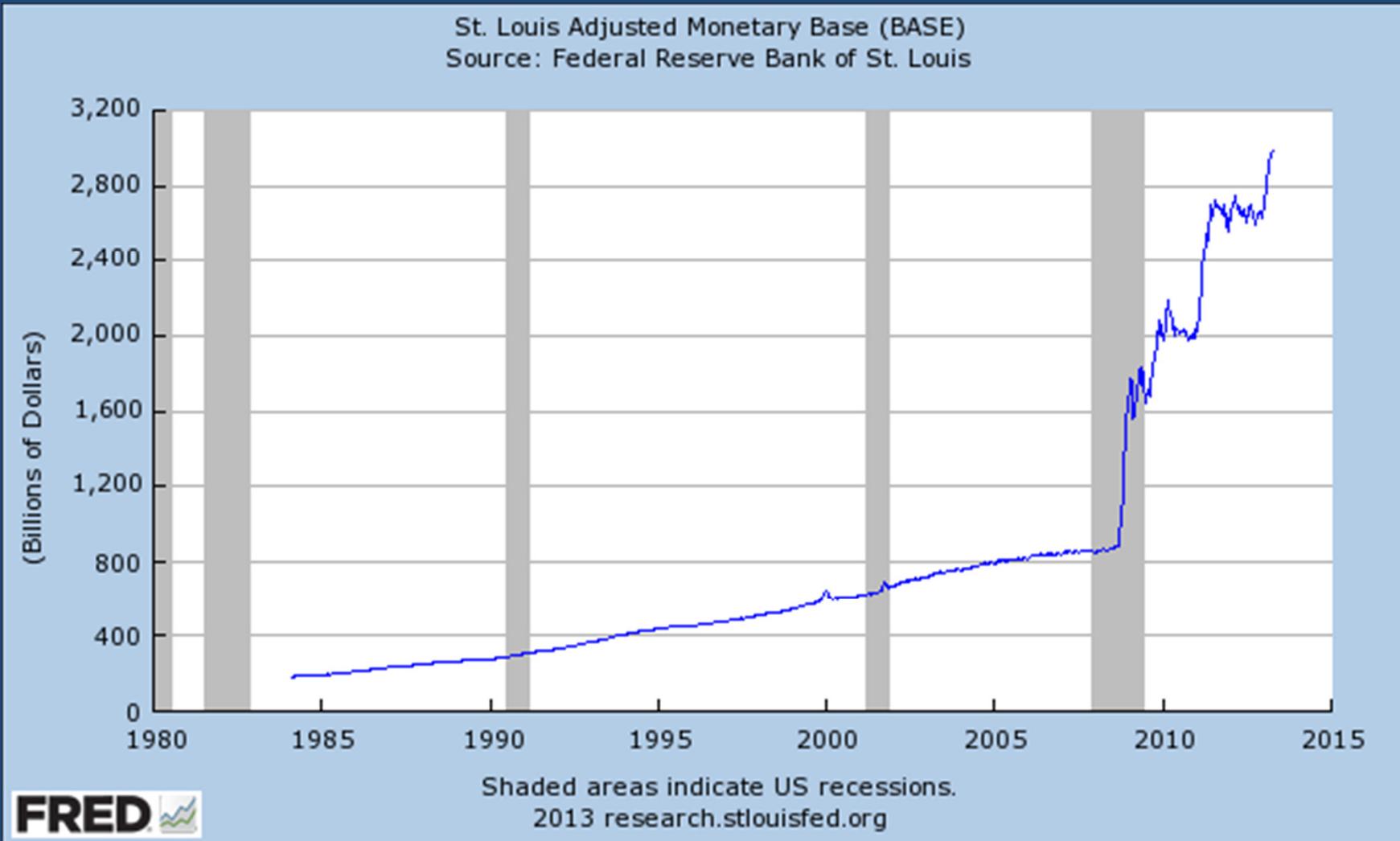
"Liquidity Trap"

Neutrality of Money

Monetary Theory & Central Banking

- Monetary theory provides predictions about impact of central bank policies upon economic conditions
 - Bedrock conclusion of monetary theory:
 - Excessive increase/decrease in rate of growth of money supply → falling/rising value of purchasing power of money (i.e., rising/falling CPI)
- Reality check: central banks have VASTLY increased most monetary measures without “price inflation”
 - Monetary base: money supplied by central bank, including cash in circulation & commercial banks’ reserves held by central bank
- Central bankers neither grasp nor control price inflation/deflation
 - Deflation (“low-flation”!?!) is bogeyman used to justify QE
 - Japan had no price significant price deflation
 - Japan’s CPI fell by 0.5% with CPI rising or falling but no broad price change over 20 years
 - Bank of Japan aggressive to create higher & rising price inflation

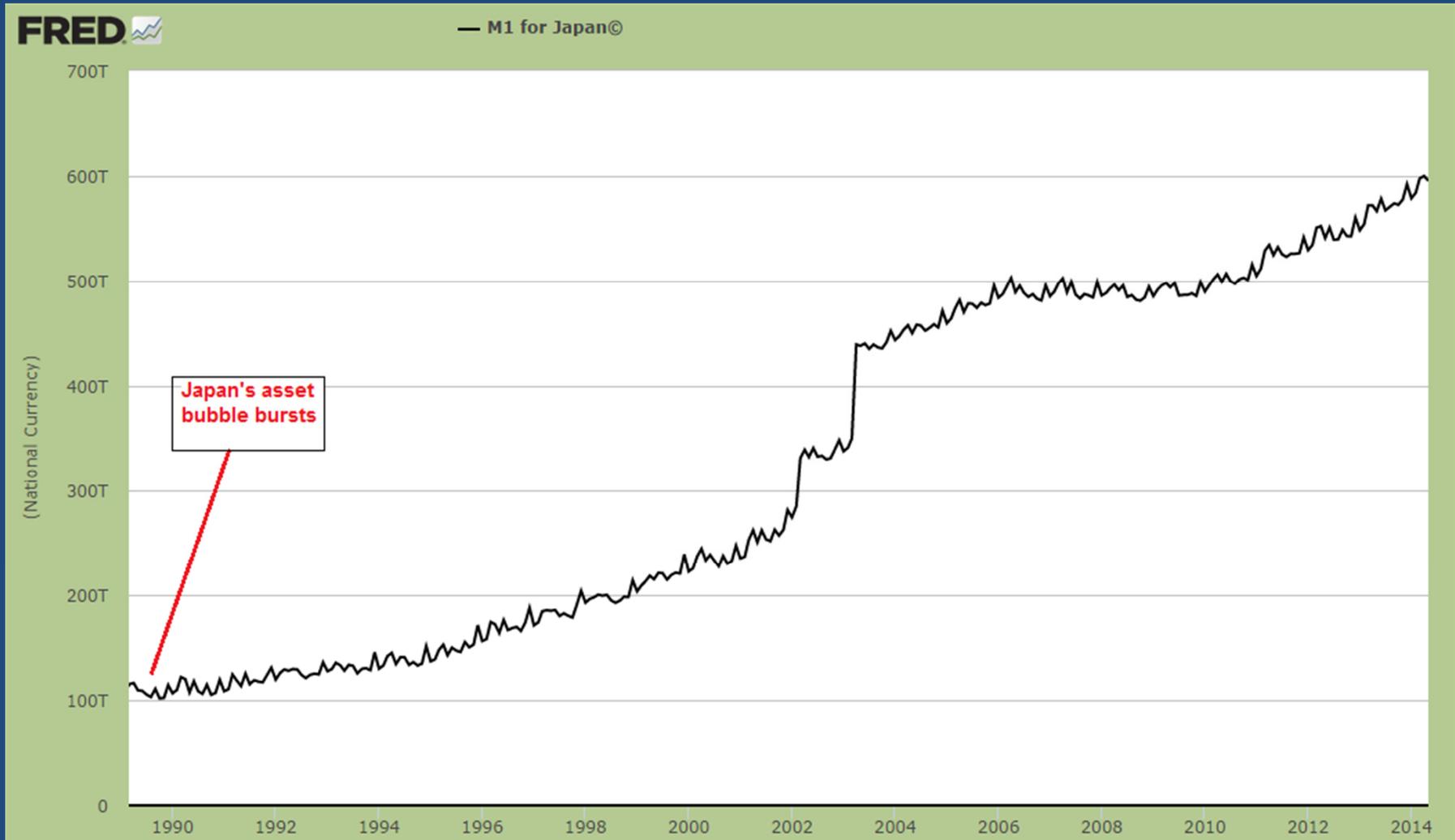
US Monetary Base: up by factor of 4 since 2008



Japan's Monetary Base: more than doubled since 2011



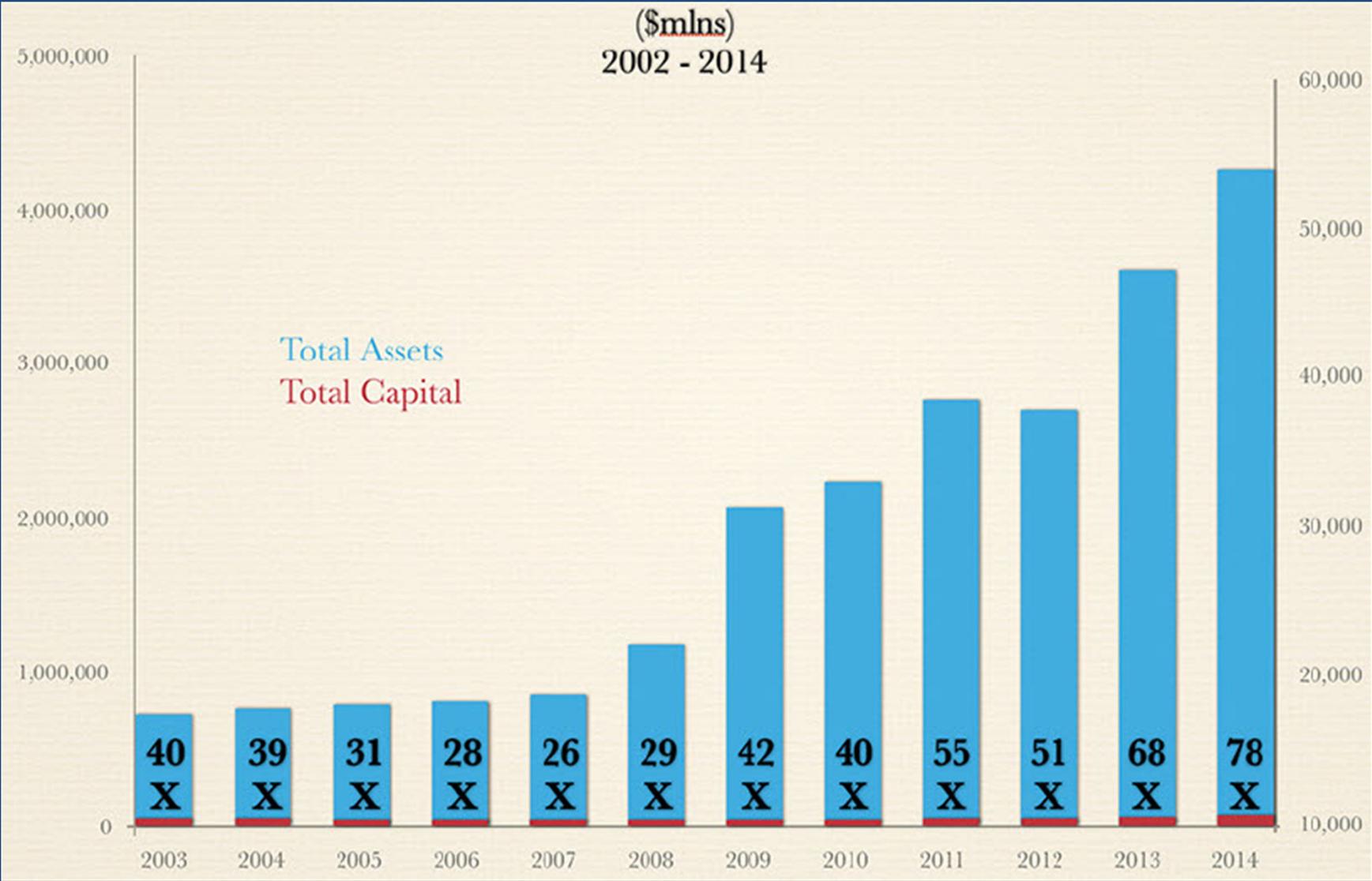
Japan's M1: up by factor of 6 since 1990



Incoherence of “Unconventional” Monetary Policy

- Exit strategy? What exit strategy!?!
 - Monetary madness: “What; Me Worry?”
 - Monetary central planners are trapped by incoherent policy positions
 - Financial sector & ultra-rich will resist taking away the “punch bowl”
- Fed’s ultra-easy monetary policy based on “dual mandate” to respond to employment conditions & maintain price stability
 - Speculators use cheap credit & create unsustainable booms (“bubbles”) while politicians increase borrowing (debt) & spend more (growth of State)
- Endless money printing eventually → debased currency unless “sterilization” is permanent (“perpetual-motion” machine?)
- Alternative exit strategies:
 - Capital controls (to avoid capital flight) & price inflation
 - Massive unemployment & bankruptcies
 - Virtual “default” on government debt
 - Exchange rate depreciation or rising price levels (CPI, WPI, PPI)

Leveraging of Central Banks Assets: US Federal Reserve



Monetary Theory & “Clueless” Central Bankers

- Central bankers, economic growth & price stability
 - “If you only have a hammer; everything looks like a nail”
 - Primary metric of appropriateness of monetary policy is CPI
 - Low growth from excess burdens of taxation & regulation cannot be “fixed” by monetary expansion
 - Market monetarists: Replace inflation target with nominal-GDP target based on aggregates & ignores individuals’ incentives
- “Deflationary spiral” is most dangerous risk ... ?
 - Japan had near-0 price inflation for 20 years despite doubling monetary base (since 2011) & M1 increase 6x (since 1990)
 - Sharp price fall → bond-holders expect government default → sell bonds & buy goods or other currencies → end “deflationary spiral”

Conceptualizing “Sound” Money

- What is “sound” money & why desirable?
 - Performs necessary roles of money (i.e., medium for exchange)
 - Durable value → greater predictability of transfers
 - Commodity standards; free banking; competitive currencies
 - “Sound” money = Free-market Money
 - Mises' sound-money principle:
 - Money should be privately produced like other goods
 - » Currency chosen & produced by demand for & free supply of money
 - » Monetary authorities cannot act to undermine purchasing value of money
 - Defense against government violations of property rights
 - “Sound” money **not** same as central bank “price stability”
- “Unsound” money: government monopoly to issue fiat money
 - Artificially-low interest rates → credit supply growth > GDP growth
 - Since 1980, US total debt grew at double rate of GDP growth
 - Higher debt-to-GDP ratio → debasement to reduce debt obligations
 - Asset & commodity “bubbles”

Can Central Banks Support Sound Money?

- Mainstream Economists (i.e., Keynesian & Monetarist)
 - Anchoring expectations of price inflation is most important aspect & indicator of “good” monetary policy
 - Friedman & Money
 - Central banks can create stable monetary framework (markets cannot)
 - Commodity standard uses too many resources: paper money less costly
 - Money supply "rule": fixed increases in rate of money supply growth to accommodate rate of real economic growth → economic stability
- Austrian Economists
 - Central bank with monopoly control over fiat money system cannot & will not support “sound” money
- Realities of Central Bank Oversight of Fiat Money
 - Monetary system did **not** deliver economic or price stability
 - In 1965, \$ was worth 889mg gold; now \$ worth 25mg (i.e., loss of 97%)
 - Central banks do **not** follow "rule"
 - Paper-money standard **not** less costly than commodity standard

Can Central Banks Support Macroeconomic Stability?

- Monetary “central planning”
 - Central banks control interest rates & price levels
- Myopic focus on price aggregates (e.g., CPI) as indicator of appropriate monetary policy actions
 - Most central bankers support of “inflation targeting”
 - Misplaced fixation on falling price levels or “too-low” inflation
- Central bankers use mainstream macroeconomic models
 - Ignore impact on asset or commodity prices (i.e., “bubbles”)
 - Explain “bubbles” with pop-psychology (animal spirits, irrational exuberance)
 - Monetary policies tend to move in tandem to maintain relative positions
- Artificially-low interest rates → macroeconomic instability
 - Mispriced risk → distorted production structure (i.e., “malinvestments”)
 - “Financial repression” whereby saving is punished
 - Provides support for growing public-sector debt
 - Suppressed price inflation

Can Central Banks Support Financial Stability?

- Regulatory & supervisory actions of central banks is guided by intention to promote financial stability
 - Create conditions so financial intermediaries can withstand shocks without disrupting access to borrowing
- Primary impact of central banks
 - Artificially-low interest rates create confusion by mispricing risk
 - excessively optimistic expectations about future → households, firms & financial institutions take on more risk during asset booms → increased instability of financial system
- Actions by central banks are primary cause of financial instability

Macroeconomic & Financial Stability

- Strict separation of money & state
 - No government-sanctioned monopoly on money production & management
 - Abolish legal tender laws
 - End restraints on emergence of currency substitutes
- End bailout guarantees & tax-backed deposit insurance to reduce moral hazard in financial sector
- Privately-produced “sound” money
 - Competing private currencies
 - Allow “Free” (unregulated, private) banking
 - Crypto-currencies
 - Return to commodity standard(s)

Thank you ... !!!

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