The Value of Money

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MOST ECONOMISTS are in agreement that the inflation in the United States during the past three years has been the worst since the early 1940's taking account of both severity and duration. But they cannot agree on the nature of the inflation that is engulfing the American economy. To some, inflation denotes a spectacular rise in consumer prices; to others, an excessive aggregate demand; and to at least one economist, it is the creation of new money by our monetary authorities.

This disagreement among economists is more than an academic difference on the meaning of a popular term. It reflects professional confusion as to the cause of the inflation problem and the policies that might help to correct it.

A review of some basic principles of economics that are applicable to money may shed light on the problem.

Two basic questions need to be answered: (1) What are the factors that originally afforded value to money, and (2) What are the factors that effect changes in the "objective exchange value of money" or its purchasing power?

Money is a medium of exchange that facilitates trade in goods and services. Wherever people progressed beyond simple barter, they began to use their most marketable goods as media of exchange. In early civilization gold or silver emerged as the most marketable good and finally as the only medium of exchange, called money. It is obvious that the chieftains kings and heads of state did not invent the use of money. But they frequently usurped control over it whenever they suffered budget deficits and could gain revenue from currency debasement.

When an economic good is sought and wanted, not only for its use in consumption or production but also for purposes of exchange, to be held in reserve for later exchanges, the demand for it obviously increases.

The Origin of Money Value

People seek money because it has purchasing power and part of this purchasing power is generated by the people's demand for money. But is this not reasoning in a vicious circle?

It is not. According to Ludwig von Mises' "regression theory", we must be mindful of the time factor. Our quest for cash holdings is conditioned by money purchasing power in the immediate past, which in turn was affected by earlier purchasing power, and so on until we arrive at the very inception of the monetary demand. At that particular moment, the purchasing power of a certain quantity of gold or silver was determined by its non-monetary uses only.

This leads to the interesting conclusion that the universal use of paper monies today would be inconceivable without their prior use as "substitutes" for real money, such as gold and silver, for which there was a non-monetary demand. Only when man grew accustomed to these substitutes, and governments deprived him of his freedom to employ gold and silver as media of exchange, did government paper emerge as the legal or "fiat money". It has value and purchasing power, although it lacks any non-monetary demand, because the people now direct their monetary demand toward government tender paper. If for any reason this public demand should cease or be redirected toward real goods as media for exchange, the fiat money would lose its entire value. The Continental Dollar and various foreign currencies over the years illustrate the point.

Determinants of Money Value

The American clearing system which gradually developed over more than 130 years from local to regional and national clearing, slowly reduced the need and demand for cash and thus its purchasing power.

But this reduction of the dollar's exchange value was negligible when compared with that caused by other factors, especially the huge increase in money supply.

The most important determinant of purchasing power of money is the very attitude of the people toward money and their possession of certain cash holdings. They may decide for one reason or another to increase or reduce their holdings. An increase of cash holdings by many individuals tends to raise the exchange value of money, reduction of cash holdings tends to lower it.

Even when it is in transport, money is under the control of its owners who choose to spend it or hold it, make or delay payment, lend or borrow. The mathematical economist who weighs and measures, and thereby ignores the choices and preferences of acting individuals, is tempted to control and manipulate this "velocity" in order to influence the value of money. He may even blame individuals (who refuse to act in

accordance with his model) for monetary depreciation or appreciation.

And governments are only too eager to echo this blame; while they are creating ever new quantities of printing press money, they will restrain individuals in order to control money velocity.

It is true, the propensity to increase or reduce cash holdings by many people exerts an important influence on the purchasing power of money. But in order to radically change their holdings, individuals must have cogent reasons. They endeavour to raise their holdings whenever they foresee depressions ahead. And they usually lower their holdings whenever they anticipate more inflation and declining money value. In short, they tend to react rationally and naturally to certain trends and policies. Government cannot change or prevent this reaction; it can merely change its own policies that brought forth the reaction.

The Supply of Money

No determinant of demand, whether it affects the goods side of an exchange or the money side, is subject to such wide variations as is the supply of money. During the age of the gold coin standard when gold coins were circulating freely, the supply of money was narrowly circumscribed by the supply of gold. But today when governments have complete control over money and banking, when central banks can create or withdraw money at will, the quantity of money changes significantly from year to year, even from week to week. The student of money and banking now must carefully watch the official statistics of money supply in order to understand current economic trends.

In the United States, we have two monetary authorities that continually change the money supply: the U.S. Treasury & the Federal Reserve System. As of February 28, 1969, the U.S. Treasury had issued some $6.7 billion of money, of which $5.1 billion were fractional coins. The Federal Reserve System had issued $46.3 billion in notes and, in addition, was holding some $22 billion of bank reserves. Commercial banks were holding approximately $150 billion in demand deposits and some $201 billion in time deposits, all of which are payable on demand in "legal money" which is Federal Reserve and Treasury money.

The vast power of money creation held by the Federal Reserve System, which is our central bank and monetary arm of the U.S. Government, becomes visible only when we compare today's supply of money with that in the past. Let us, therefore, look at the volume of Federal Reserve Bank credit on various dates since 1929:

Date		*Total in Billions*
1929	June	$1.3
1939	December	$2.6
1949	December	$22.5
1959	December	$29.4
1969	August 20	$58.2

Source: *Federal Reserve Bulletins.*

How Government Creates Money

Why and how do our "monetary authorities" create such massive quantities of money that inevitably lead to lower money value? During the 1940's, the emergency argument was cited to justify the printing of any quantity the government wanted for the war effort. During the 1960's, the Federal government through its Federal Reserve System was printing feverishly in order to achieve full employment and a more desirable rate of economic growth. Furthermore the ever-growing public demand for economic redistribution inflicted budgetary deficits, the financing of which was facilitated by money creation.

How was it done? The Federal Reserve has at its disposal three different instruments of control which can be used singly or jointly to change the money supply. It may conduct "open-market purchases", i.e., it buys U.S. Treasury obligations in the capital market and pays for them with newly created cash or credit. Nearly all the money issued since 1929 was created by this method. Or, the Federal Reserve may lower its discount rate, which is the rate it charges commercial banks for accommodation. If it lowers its rate below that of the market, demand will exceed supply, which the Federal Reserve then stands ready to provide. Or finally, the Federal Reserve may reduce the reserve requirements of commercial banks. Such a reduction will set Federal Reserve money free for loans or investments by commercial banks.

It does not matter how the new money supply is created. The essential fact is the creation by the monetary authorities. You and I cannot print money, for this would be counterfeiting and punishable by law. But our monetary authorities are creating new quantities every day of the week at the discretion of our government leaders. This fact alone explains why ours is an age of inflation and monetary destruction.

(to be continued)