What's the Matter with Money?

To have a maximally prosperous economy and eliminate depressions, we also need to attend to money and banking

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If a country switches to an ideal fiscal and regulatory policy, would monetary policy still matter? Yes it would. To have a maximally prosperous economy and eliminate depressions, we also need to attend to money and banking.

Of course fiscal policy is primary. Taxes and subsidies are the greatest governmental intervention and the most potent force in creating poverty, sprawl, depressions, and economic waste. Taxes distort profits and prices, making it impossible to perform efficient economic calculations. The elimination of stinky taxes - on wages, profits, value added, and sales - would leave land values as the basis for public finance, whether tapped by governments or by contractual civic associations and proprietary communities. These governing agencies would also charge folks for negative effects such as pollution and congestion.

To fully abolish poverty, market-hampering regulations also have to be eliminated, since regulations have the effect of taxes. All price controls, subsidies, and laws restricting peaceful and honest human action would have to vanish. The public collection of rent and true free trade would raise wages to the full marginal product of labor, and so extirpate poverty - pull it out of the economy by its roots. So there would be no more rationale for the welfare state.

But if the money and banking system remained status quo, the business cycle would not be eliminated. There would still be depressions, price inflation, and economic waste.

Money matters because it affects interest rates, and because price inflation is in effect a tax on money holdings, penalizing savings and reducing investment and economic growth. To understand the matter with money, we need to understand the role played by interest.

Unfortunately some economics texts and teachers are still stuck on antiquated and incorrect doctrines about interest. They recognize the three factors land, labor, and capital goods, and label the returns on the first two as rent and wages, but then put "interest" as the return on "capital," which is an error.

First of all, for discipline and precise terminology, never say "capital." Always refer to either "capital goods" as the factor of production, or else "financial capital" if you mean money or funds. There is also the "human capital" of skills and knowledge. Financial capital does obtain interest, but this should not be confused with the return on capital goods. If you hear somebody just say "capital," this means he is confused or sloppy. You should also avoid saying "inflation" and specify whether you mean monetary inflation or price inflation.

The origin of interest is time preference, the tendency of people to prefer goods at the present time to goods in the future. Future goods therefore have a discount relative to present-day goods, and the rate of discount over time is also the natural interest rate. The interest paid by a borrower is a premium paid to shift the purchase from the future to the present day.

Since interest is about time, we can see that interest can be a return to any factor, not just capital goods. If a worker borrows money to get some training that then increases his wage, the interest that the worker pays comes from his wage, and so that interest is a return to labor. If one borrows to buy land and rent it out, the interest is rent. If one borrows to buy capital goods, in that case the interest paid is a return on those capital goods. When one has a savings account, one gets interest on that financial capital, but in terms of returns to factors, that interest income can be wages, rent, or a return to capital goods, depending on which factors use the funds.

To understand the importance of interest, we need to understand the economic meanings of consumption and investment. Economic consumption means the using up of the economic value of a good or service. Economic investment means an increase in capital goods or the human capital of skills and knowledge. Capital goods are products which have not yet been consumed, so all capital goods are investments.

One of the myths about interest is that interest can only be paid by an expansion of money. This is wrong, because interest paid on loans for consumption shift consumption from the future to the present, thus the interest is paid by reducing future consumption. Interest paid from investment is paid from the increase in income due to the investment, if it is profitable. If the investment is not profitable, then the loan has the same effect as one for consumption.

The role that interest plays in the economy is like a thermostat that regulates the heat in a room. By definition, savings is income not spent for consumption. Since income is spent either for consumption or for investment, savings equals investment. But since different folks may be investing and saving, these are not automatically equal, but become equal by the adjustment of the interest rate. If savings increase, interest rates fall so that more is borrowed for investment. The interest rate equalizes savings and investment, and allocates production between consumption and investment, so that all income is spent.

Now we can see the effect of central banking, the control of the money supply by a monetary authority such as in the US, the Federal Reserve system. The Fed increases the supply of US dollars buy buying US treasury bonds in the market. They seller gets a check from the Fed which he deposits, and his bank in turn deposits the Fed check into its "reserve" account at a Federal Reserve Bank. The Fed covers the check by increasing the reserves or deposits of that bank, thereby creating money out of nothing. It's "fiat" money not backed by anything.

This increase in the reserves or funds held by banks has the same effect as increased savings. With more funds to loan out, the banks lower the interest rate. But now the "market" rate of interest differs from the "natural" rate that would take place without the increase in money. The artificially lower rate of interest induces a greater investment of "high order" capital goods, those which take a long time to build, such as real estate construction. The pushed-down interest rate also induces the purchase of real estate, and fuels land speculation during an economic boom.

So even if rent were fully tapped for public revenue, this manipulation of the rate of interest would distort the economy, fueling an excessive investment in interest-sensitive capital goods such as buildings, and getting more people to buy housing. The problem is that this excessive money creation leads to price inflation, so after the stimulus creates an price-inflationary boom, the central bank reduces the rate of money creation. With fewer loanable funds, interest rates rise, and as other costs also rise, many investments made with lower interest rates now become unprofitable. Investment spending falls, those employed in these fields lose their income, reducing their purchases, and the economy recedes into a depression.

Even if the land rent is collected by the community, there will be a speculative premium as the ratio of real estate prices to rentals increases, as the lower rate of interest induces a greater demand for real estate, so buyers are willing to pay more for land than is warranted by the current land rent, as the assessments for rental collections lag behind. The low interest rate capitalizes the price of real estate to a higher price.

Once price inflation kicks in, the nominal interest rate, as paid in money, is greater than the real interest rate, the nominal rate minus the price-inflation rate. The increase in price inflation punishes savers, who get a lower real return, and rewards borrowers, who pay back with cheaper dollars. The distortion of the interest rate and the rise in price inflation skews prices and distorts profits, creating the economic waste of misallocated resources.

The deep problem is that there is no way to know the natural rate of interest other than to have it emerge from a competitive free market economy. The amount of money supply needed to maintain the interest rate at its natural level is unknowable, as the effect of money depends not just on the supply of money but also on its velocity, how fast the money turns over, and on how much money is leaving and entering the country. There is no formula or method that can provide the correct amount of money creation.

To avoid monetary inflation and the distortion of interest rates, we need "free banking," a free market in money and banking. In free banking, there is a monetary base of real money, such as gold. Today, the base in the US could be the currency we use - federal reserve notes - whose supply is frozen, no longer increasing. The banks and other financial institutions would issue private bank notes as substitutes for the real money, and convertible in real money at fixed rates. For example, the Bank of Kropotkin would issue $20 Kropotkin notes, which one could buy goods with, and which would be convertible into $20 federal reserve notes. Convertibility would limit the issue of bank notes to the amount demanded by the public, avoiding monetary and price inflation.

With free banking, interest rates would be set by the supply and demand for loanable funds in the market, as affected by savings and time preference, not by the manipulations of a monetary authority. There would be no more waste and instability caused by the deviation of the rate of interest from the natural rate, as the interest rate would always be the natural rate.

So to eliminate the boom-bust cycle and maximize prosperity, we need three policies: 1) public revenue from land rent; 2) true free trade; 3) free banking. If we only have the first, it like sitting on a chair with one leg. The chair will wobble and fall down. We need a chair with three legs for stability and maximum comfort.

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FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org since 1997. Foldvary's commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary's areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.