Scarcity of Money as a Macro Choke

Mason Gaffney, Working Paper

This seems pretty tame and controllable compared to the limits of Earth itself. Money is cheap to print. Failing that, prices can fall so that any amount of nominal money, however small, can finance all the transactions in the world. A penny used to buy what takes a dollar today, and it could again if 99% of the money were destroyed.

So why is money a problem?

A. Past hyperinflations have left a legacy of suspicion, so that most advanced countries have strict controls on issuing money. Some of these experiences were: France, 1720, under the Scotch adventurer John Law; the American colonies, 1776-1781 ("not worth a Continental"); France again after the Revolution, the assignat and mandat currencies supposedly backed by confiscated lands; America again 1825-1836, the era of "wildcat" banking; the Confederate States of America, 1860-1865, with their "shinplasters" ("save your Confederate money, the South will rise again"); the German mark, 1923; the Chinese yuan under the Kuomintang; and today, the Israeli shekel and various pesos down south.

B. But these controls, once in place, can prevent monetary expansion ("dM" for short) when needed. Examples: United States, 1893; England, the 1920s; United States, 1929-1933.

C. Why was dM needed? The United States needed it in 1933 because half the banks in the country had failed, taking one-third of the M with them (bank deposits serve as M, as we will see).

D. Why did the banks fail? Because banks lend on the security of collateral, and collateral values collapsed. Collateral values collapsed for reasons of their own, just as farm land values and oil patch values and Texas urban values have collapsed in the last few years, taking hundreds of banks with them. Once the banks started collapsing in 1929 a snowball got started wherein every -dM caused a further decline of land values, which caused a further -dM, etc.

Monetarists today, who dominate discourse in the field, are staunchly myopic and single-minded about this, as you will see from reading ordinary texts. They see only the collapse of banks, which they attribute to some minor cause like the personality or ideology of a leading banker. If they look at the fall of collateral values at all, it is only as an effect. They shut their eyes to the historical fact that collateral values initiated the collapse then, even as they are doing now before our very eyes. Cycles in land values occur independently of cycles in banking ("systemic" and "endogenous" are the scholarly buzzwords for that).

After every bust, if it is bad enough to change the government, laws are passed forbidding banks to lend on real estate; in every ensuing boom banks break down those laws and do it again. They say we learn from history that most people never learn from history, and this is a splendid case in point: it's been going on for centuries.

E. Have we solved the problem? Only in part, and for a while. Following the Great Collapse we revived the banks by issuing floods of federal bonds for banks to buy, and securing those bonds with a combination of federal revenues and a new federal willingness to print money if need be. This is really what Keynes was all about, although he and his expositors are so circumlocutious you'd never guess which word is really the bottom line.

The Bank of America, for example, had foreclosed on 20,000 farms in California, but liquidated these holdings and substituted government bonds. For a while we had an uncollapsible money supply.

F. Where were we in 2000? The banks had gone back to their old ways. Most debt had become "defaultable," meaning it is not federal debt. Banks had expanded wildly into several shaky fields, the worst of which now are farms, oil, commercial real estate in collapsible cities like Houston, and of course Less Developed Countries like Brazil and Peru and Mexico. We will be looking more closely at this matter.

G. Where are we in 2005? Federal debt has ballooned, with foreign creditors holding a large share of it. They might bail on us *en masse* someday. Defaultable loans on real estate have also ballooned with land prices. Warning flags should be flying.