



The Ethical Implications of Monetary Manipulation

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“If one regards inflation as an evil, then one has to stop inflating. One has to balance the budget of the government.. But the certain fact about inflation is that, sooner or later, it must come to an end. It is a policy that cannot last.”

- Ludwig von Mises

I. Introduction

When the arguments for sound money become clear, all arguments for the only modern alternative, which is arbitrary monetary manipulation, become illusory. Students of economics and the educated public have long been told that a constantly devaluing unit of currency and the resulting price inflation are a necessary evil, the price a nation must pay for lasting prosperity. They are told that the alternative to inflation – deflation – is far more destructive than its counterpart and must be avoided at all costs. In the nation's high school economics courses, students are taught that price inflation is the result of natural market forces, whether it is the businessperson raising his or her prices, or an increasing demand for goods and services on the part of the consumer. And for the past century of this country's history, it has been taken for granted by academics that the central bank serves to smooth the natural fluctuations inherent in a free economy. These popular notions have led the general public into a state of confusion and apathy in regards to monetary issues and have acted as a shroud for those who are responsible for monetary manipulation, protecting them from public scrutiny and outrage. Once the true causes and costs of monetary manipulation are revealed to the public at large, this nation and nations abroad will be on the path towards sound money and higher sustainable living standards for future generations.

II. Sound Money

In order to define monetary manipulation and effectively examine its ethical implications, we must first briefly establish the origin of money and a definition of sound money, which is the alternative to, and safeguard against, monetary manipulation. Those who have studied economics have likely read some discourse on the origin of media of exchange – money. Described in these

writings is a primitive economy wherein trade occurs only through individuals exchanging physical goods for other physical goods – this is the barter economy.¹ It quickly becomes obvious to the observer that this method of trade is inherently inefficient. How does one go about determining how many gallons of milk a specific portion of his land is worth, or how much his horse is worth in terms of firewood? What if the citizen who has milk or firewood is not interested in trading those goods for horses or land? It becomes clear that there is a necessity for a medium of exchange, for example, a certain quantity of wheat bushels which both traders can agree upon. Surely, bushels of wheat are more likely to be desired by a future trading partner and are far more divisible than a horse or land. A primitive price system then begins to emerge, whereby a horse could be worth X number of wheat bushels, a gallon of milk worth Y number of wheat bushels, and so on.

This brings forth the imperative idea that the actions of individuals in any society, no matter how diverse the goods and services they produce and no matter how diverse their individual needs and wants, are brought into harmony by the existence of a medium of exchange – whether it be bushels of wheat or metallic coins. For a good to effectively serve as currency, however, there are certain functions it must be able to perform. As stated by a standard college textbook on the subject of macroeconomics, it must function as the following: [1] a store of value [2] a unit of account and [3] a medium of exchange. The first qualification requires that the currency be able to transfer purchasing power from the present to the future, the second requires that prices of goods be stated in terms of certain quantities of the currency, and the third simply requires that the currency be used as such in the everyday trade of goods and services.² Items that have fulfilled these functions in the past include seashells, stone wheels, tobacco, fur, and

¹ Carl Menger, *Principles of Economics*, (Arlington: Institute for Humane Studies [George Mason University], 1976), 177-190

² Gregory Mankiw, *Macroeconomics*, 6th ed. (New York: Worth Publishers, 2007), 77-80

precious metals such as gold and silver. This list is but a small fraction of the countless fascinating examples of money throughout history.

While it is true that anything that performs these basic functions can be considered currency, the list provides incomplete criteria for defining *sound* money. We may rightly add further qualifications. First, the currency should be relatively scarce and costly to produce to ensure that it is of value to individuals. Dirt and sand, for example, are not likely to function as sound money. Second, and of absolute utmost importance, the supply of the currency must be relatively stable and predictable to ensure that it adequately transfers purchasing power from the present to the future.³ Though it is obviously unreasonable to expect the supply of any particular good to remain constant over time, we should expect the supply of a sound currency to be free of persistently volatile and substantial changes. The more consistent the supply of the currency, the more effectively it will transfer value from the present date to a future date, and the easier it will become for individuals and businesses to plan their future finances. There are a number of goods that adequately fit this definition and that have functioned as money throughout the world's history and within the United States. These include primarily precious metals – gold and silver in particular - which are both scarce and costly to mine.⁴

III. Currency Manipulation

Now that we have defined the qualities of sound money, we can contrast those qualities with the modern form of currency, which will prove to be unsound and subject to arbitrary manipulation. Though paper money existed in China over a thousand years ago, it was first introduced to American soil by the colony of Massachusetts when its government issued paper

³ Ludwig von Mises, *Human Action*, (Little Rock: Fox and Wilkes, 1996), 224

⁴ Murray Rothbard, *A History of Money and Banking in the United States: The Colonial Era to World War II*, (Auburn: Ludwig von Mises Institute, 2002), 47-49

currency in 1690.⁵ This is the origin of fiat money, that is, paper money not redeemable in gold or silver, in the United States. But the modern currency of the United States, the currency whose economic and social effects we will examine, was born in the Federal Reserve Act of 1913. As was expressly stated in the act, the primary responsibility of the Federal Reserve System is to “promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”⁶ This statement introduces the notion of interest rates, which are intimately related to money and will later be discussed at greater length.

In attempt to achieve the goals dictated to it by Congress, the Federal Reserve manipulates the supply of money, either directly through the creation of new money, or indirectly through adjusting reserve requirements of banks. Throughout the initial period of the Federal Reserve’s existence, its ability to affect the money supply was somewhat restricted by the U.S. dollar’s ties to gold, which were established in the Gold Standard Act of 1900. Those ties were substantially weakened by President Roosevelt in 1933, and severed altogether by President Nixon on August 15, 1971.⁷ To illustrate the impact of these two events, and the Federal Reserve’s general effect on the value of the currency, we can look at the value of gold - which can be considered a relatively sound store of value - in terms of dollars. The Gold Standard Act of 1900 defined the dollar as “twenty-five and eight-tenths grains” of gold, which is equal to about 1.67 grams. This means that only about \$9.50 USD were needed to purchase an ounce of gold in 1900. By the second half of 2009, nearly 100 years after the Federal Reserve was given control of the dollar, the price of gold hovered around \$1000 USD per ounce – the dollar had lost more than 95% of its original value. Over the same period of time, the nominal

⁵ Ibid., p. 51

⁶ Board of Governors of the Federal Reserve System, *Federal Reserve Act: Section 2a*, August 13, 2008, available from “<http://www.federalreserve.gov/aboutthefed/section2a.htm>”; accessed November 03, 2009

⁷ Lawrence White, “Is the Gold Standard Still the Gold Standard Among Monetary Systems?” *Cato Institute: Briefing Papers*, 6 (February 8, 2008): No. 100.

prices consumers pay for everyday goods have doubled many times over. At this point, it is clear that the U.S. dollar cannot by any means be considered sound money, and the Federal Reserve, which is the only entity with the power to manipulate the supply and value of U.S. dollars, is solely responsible for the devaluation of the currency.

IV. Ethical Implications

Every new dollar the Federal Reserve creates certainly has value in terms of purchasing power, but this purchasing power is not newly created value. If this were the case, a nation could achieve limitless wealth and prosperity simply by printing new currency. The value of new currency must come from a loss of value elsewhere – “elsewhere,” in this instance, is currency that already exists. This leads us to one of the primary, and arguably the most immoral, consequences of monetary manipulation. When the Federal Reserve or the central bank of any country creates new currency, it does so at the expense of the accumulated wealth of each and every citizen – rich and poor alike. In effect, money creation can be equated with a large-scale theft of personal savings.

We can construct a simple example to illustrate this point. Someone who earned \$30,000 in 1975 would have been able to buy \$30,000 worth of goods at that time. It is likely, however, is that this person would have placed a substantial portion of that income in some form of savings – say \$15,000. Now assume it is 2009, and the average annual inflation rate – which is considered to be the average annual increase in prices of goods - was 5% over the 44 intermediate years. Due to the increase in prices, the \$15,000 saved in 1975 can now only purchase \$1570.11 worth of goods.⁸ One might correctly point out that interest is earned on these savings, but the fact remains that as long as the inflation rate is above the interest rates paid on savings accounts,

⁸ $15000 \times (.95^{44}) = 1570.109321$

savings are being stripped of value. This not only has obvious moral implications - it has implications for economic efficiency as well.

By allowing a central bank to inflate the money supply, a nation is implicitly making the decision that the best use of personal savings is not achieved by allowing citizens to use their accumulated wealth as they see fit, but that the value contained in those savings is better utilized when the central bank directs where and to whom the value ultimately goes. This is analogous to saying that the best use of personal incomes is achieved when the government is allowed to tax and spend those earnings as it sees fit. In fact, since the Federal Reserve's primary avenue for creating new money is through the purchasing of government bonds, the value stripped from personal savings is often directed through the channel of government spending.⁹

It is no wonder that nations who have the ability to inflate their currencies take advantage of the opportunity to do so. Like deficit spending on the part of the government, creating new currency is a means of spending money to benefit the current government regime and its constituents at the expense of later generations. Deficit spending will plague future generations in the conspicuous form of higher taxes, but inflation of the currency, in a decidedly more insidious fashion, quietly erodes the living standards of these generations. Both of these forms of government spending are claims on the future productivity of the young and unborn, and neither policy can be voted on by those who will eventually bear the cost. Placing economic burdens on those who have no say in the matter has obvious moral implications, and one could argue that it has no place in a free society. But as long as the ability to create currency exists, there is little to stop the temptation to take advantage of the young and unborn.

While certain effects of monetary manipulation lower the living standards of generations to come, other effects have prevented some generations from being born at all. Whether or not

⁹ Gregory Mankiw, *Macroeconomics*, 6th ed. (New York: Worth Publishers, 2007), 81

one believes in the merits of one particular war or another, one fact holds true: many of the wars fought today and in modern history would not have been possible were it not for the ability of governments to create new currency. When a government decides to wage war – or spend money on anything, for that matter – it must either increase taxes on its citizens or borrow money from the public. Both of these actions have the effect of decreasing the amount that citizens are able to consume in the present. There is, however, a third option which is much more politically feasible than raising taxes or persuading the public to buy government debt: money creation. Unlike the first two options, the negative effects of inflating the money supply are not felt immediately but are subtly distributed throughout future years. A well known example of the dangers of inflation-financed war is the devastating German hyperinflation of the early 1920's, but there are countless other, less extreme examples of the concept – even in the United States.

Due to the growing unpopularity of the Vietnam War in the 1960's, President Lyndon B. Johnson's administration saw it fit to finance the government's war expenditures by issuing new currency.¹⁰ This seems to be validated when we observe the growth rate of the money supply during that decade – except for the years 1960 and 1966, the money supply grew steadily at a rate of 8-10% annually. However, these already elevated growth rates pale in comparison to those that immediately followed President Nixon's abandonment of the Bretton-Woods system in 1971. Bretton-Woods, an international monetary agreement reached at the end of World War II, represented the only remaining tie between the U.S. dollar and gold, and it was the only remaining check on the amount of money the U.S. government could create. Immediately after Nixon severed those ties under tremendous pressure due to massive war expenditures, the money supply began to grow by annual growth rates in excess of 15%, and continued to grow at rates

¹⁰ Steven Horwitz, "Free-Market Money: A Key to Peace" *The Freeman: Ideas on Liberty*, (January/February 2008)

well above 10% annually throughout most of the decade.¹¹ Without considering here the economic hardship Americans would endure throughout the late 1970's and early 1980's as a direct consequence of this inflationary environment, one can imagine how many American and Vietnamese lives would have been spared if the United States did not have the ability to simply print new currency in order to continue the war.

One of the more complicated but equally important aspects of currency manipulation is its relation to the “boom-bust cycle,” or the business cycle. Every American adult is no doubt aware of the fact that the economy goes through periods of accelerated growth followed by periods of economic stagnation – though they take part in the years of prosperity, they bear the brunt of economic downturns through job losses, declining real wages, and today, declining home equity and home foreclosures. As was stated in its charter, the Federal Reserve has responsibilities regarding interest rates, and its ability to manipulate the money supply gives it a great deal of influence over these rates. Interest rates can be considered the price of money and, like the prices of all goods, are formed by the forces of supply and demand – in this case, the supply of and demand for money. By printing new currency, the Federal Reserve increases the supply of money and thus lowers interest rates. In this way, acting no differently than an institution of central economic planning, it essentially dictates or “sets” the most important price in the economy – the price of money.

It is astounding to consider the number of economists who are usually the first to point out the obvious negative consequences of price controls, but who simultaneously justify and support the Federal Reserve's singular control over the price of money. Every investor in the economy, as they consider whether or not a potential investment will yield ample returns, is

¹¹ Federal Reserve Bank of St. Louis, *Economic Data - M3 Money Stock*, available from [http://research.stlouisfed.org/fred2/graph/?chart_type=line&s\[1\]\[id\]=M3NS&s\[1\]\[transformation\]=pc1](http://research.stlouisfed.org/fred2/graph/?chart_type=line&s[1][id]=M3NS&s[1][transformation]=pc1)

concerned with interest rates and inflation. Artificially low interest rates also have the effect of encouraging consumers and businesses to take on more debt than they could if interest rates were at their natural, higher levels. By manipulating interest rates via changing the money supply and causing the consequent distortions in prices, the Federal Reserve's expansionary policies often cause many investments - which would be conspicuously unprofitable absent artificially low interest rates and inflated prices - to appear profitable.¹² This expansion of credit creates a boom in the economy, spurred by the taking on of excess debt. But since these booms are not based on economic fundamentals like productivity, savings, and investment, they invariably lead to a crash in the economy.

There are countless historical examples of monetary manipulation causing severe economic distortions and hardships, but we need only look to the past century of United States history to find two definitive examples of the concept. As a brief illustration of the effects of monetary expansion on the economy, we can observe the Federal Reserve's monetary policies leading up to what are generally considered the two worst economic contractions in the past century of U.S. history – The Great Depression of the 1930's and the crash of late 2008.

The causes of the Great Depression have been a source of academic discussions and debates for nearly 80 years, but once this period is looked at through the lens of monetary manipulation, the causes of the depression become clearer. Between 1922 and 1929, the U.S. money supply grew by just over 60% - this substantial increase in the supply of money, combined with the fact that the U.S. economy was making dramatic technological improvements at the time, induced a "boom" in the economy which could not last.¹³ The "bust" which was to follow is extensively documented throughout all American history textbooks.

¹² Ludwig von Mises, *Human Action*, (Little Rock: Fox and Wilkes, 1996), 547

¹³ Murray Rothbard, *America's Great Depression*, (Auburn: Ludwig von Mises Institute, 2002), 47-49

To further explain the relationship between monetary manipulation and the business cycle, we can examine a much more recent example: the crash of late 2008. In 2001, in attempt to keep a looming recession at bay, the Federal Reserve under Alan Greenspan began to pump new currency into the American economy in order to lower interest rates and “stimulate” the economy. Rates sat at just under 2% throughout 2002, and in 2003 they approached 1% and remained at that level for nearly two years.¹⁴ There are few, if any, who deny that these low interest rates had a large hand in creating a speculative boom in the housing sector of the economy and pushing the economy closer to being one based entirely on credit and borrowing rather than on legitimate savings, investment, and productivity. The evidence for this is clear in the household debt levels and savings rates over the past decade.

Household debt levels in the United States had been consistently rising since the end of the recession of the early 1980’s, but, almost perfectly coinciding with the 2001 expansion of credit, they began skyrocketing in 2000. These debt levels were accompanied by a steady decline in personal savings rates. At its height in 2007, the household debt level reached 133% of personal income, and personal savings rates simultaneously reached 0%.¹⁵ As clear evidence that these trends, which were made possible only by a dramatic increase in the availability of credit, were unsustainable, the United States moved into the severe recession that began in 2007. That recession has been marked by historic levels of unemployment, record numbers of home foreclosures, and dramatic amounts of personal wealth lost. Certainly, if it is true that the central bank has a large hand in distorting the economy and creating economic downturns, it becomes a question of ethics.

¹⁴ Federal Reserve Bank of Cleveland, *Reserve Market Rates*, available from <http://www.clevelandfed.org/research/trends/2007/0107/01monpol.cfm>

¹⁵ Federal Reserve Bank of San Francisco, *U.S. Household Deleveraging and Future Consumption Growth*, FRBSF Economic Letter, May 15, 2009

V. Conclusion

For decades, monetary discussions have dealt only with whether the Federal Reserve should raise or lower interest rates and by how much, and not with whether or not a central bank with this amount of influence over the economy should exist at all. The chairman of the Federal Reserve has come to possess such power that markets often hang on his every word, and often swing one way or another if he implies a certain course in monetary policy may be pursued in the future - Americans must ask themselves if this amount of centralized power belongs in a free society. An argument often directed at those who are in favor of sound money is that the transition from the current system to sound money would be a difficult and painful one. This is true, but the only course of action more painful than that transition is the path the country is currently on, which is marked by continual debasement of the currency, erosion of citizens' wealth, and market distortions, and which can only ultimately lead to a collapse of the currency and severe economic hardship.