ECONOMIC FLAWS & FALLACIES, MONEY & BANKING

by James B. Berger

INTRODUCTION

For several years I have kept a record of some of the flawed and fallacious statements that people, particularly people in the know, make about economic topics. Instead of just keeping them for my own entertainment, I have decided to publish these statements on the Internet, along with my account of the truth.

Since I have collected so many, I will start with flaws and fallacies related to money and banking for two reasons. First, pundits have, for the most part, ignored the importance of money in the recent economic depression. Second, this provides a good set of discussion topic to accompany my presentation “Money Matters”.

This document amounts to a rough draft. I will expand my comments in another forum.

DESTRUCTIVE DEFLATION

FALLACY:

"Deflation is more destructive than inflation."

TRUTH:

Both deflation (decreasing money supply) and inflation (increasing money supply) transfer buying power from one group to another and both distort the pricing process of the market. The structure of the market determines the relative damage done by each.

If the supply of money declines, as the result of the liquidation of malinvestments and the reduction of artificially increased money supply, deflation will cause little problem.

If, on the other hand, the government artificially contracts the money supply in an otherwise healthy economy, producers may have to liquidate assets to pay obligations, which could have a detrimental effect on the economy.

The popular notion that a generalized price decline (commonly referred to as “deflation) would wreak economic destruction has no validity. Falling prices should indicate increased productivity – a positive change for the economy. In addition, having productivity increase in all segments of the economic simultaneously remains highly unlikely.

FED CONTROL OF MONEY SUPPLY

FALLACY:

"Money supply is determined entirely by the Federal Reserve."

TRUTH:

The actions of the all players within the monetary system determine the supply of money. Banks play the most important role. In our system, only banks have the ability to create money at will.

In spite of its significant ***influence*** on the money supply, the Fed cannot force the increase or decrease in the supply of money. Banks must provide credit (deposits) in exchange for assets for the creation of new money. Now, because of the ZERO reserve requirement on time deposits and deposit shifting by banks, the Fed has much less influence than it has historically.

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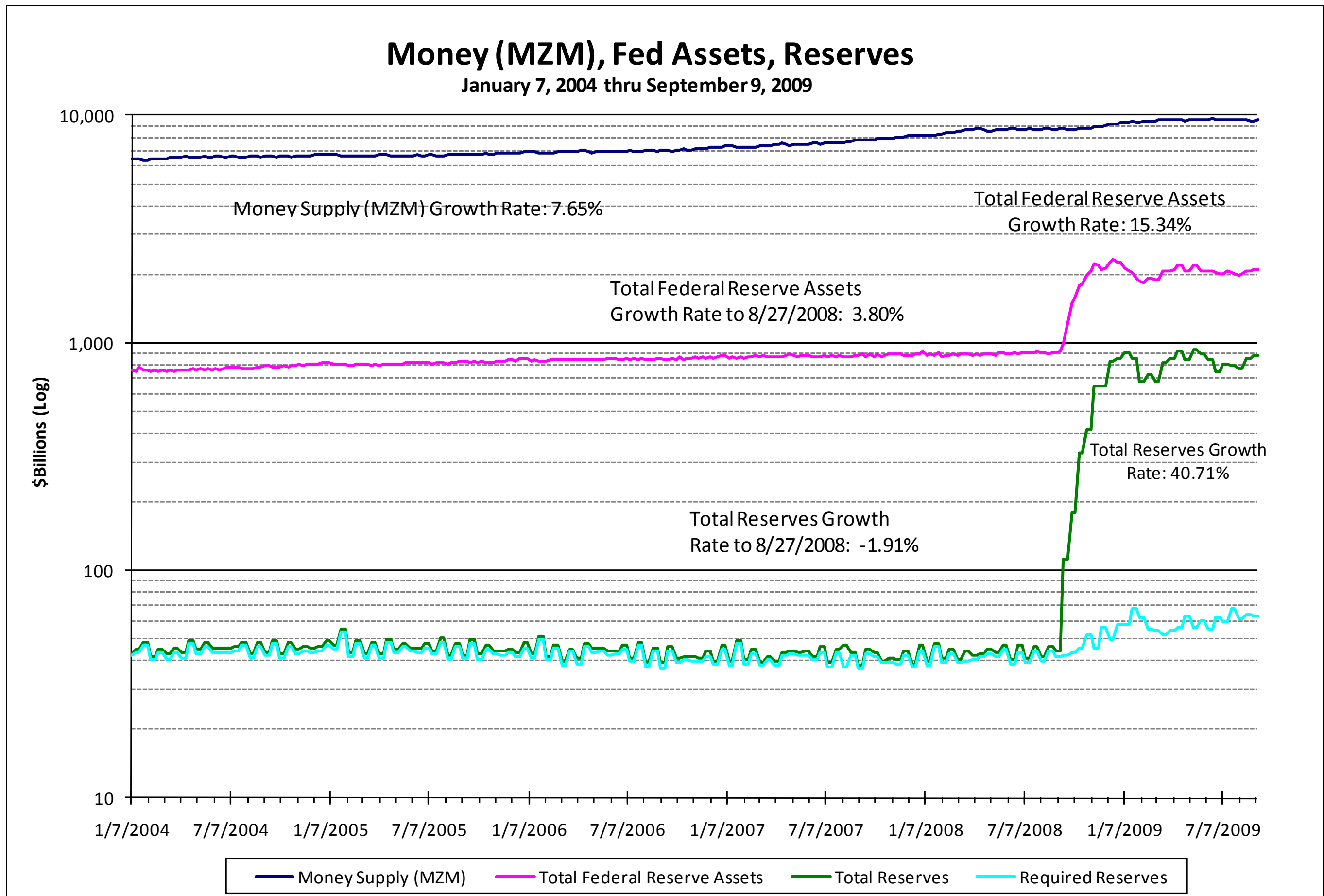
The following chart gives some evidence of this point:



From 2004 through most of 2008 the money supply and bank deposits grew while bank reserves actually declined. Since September of 2008 bank reserves while the money supply and bank deposits have flattened out.

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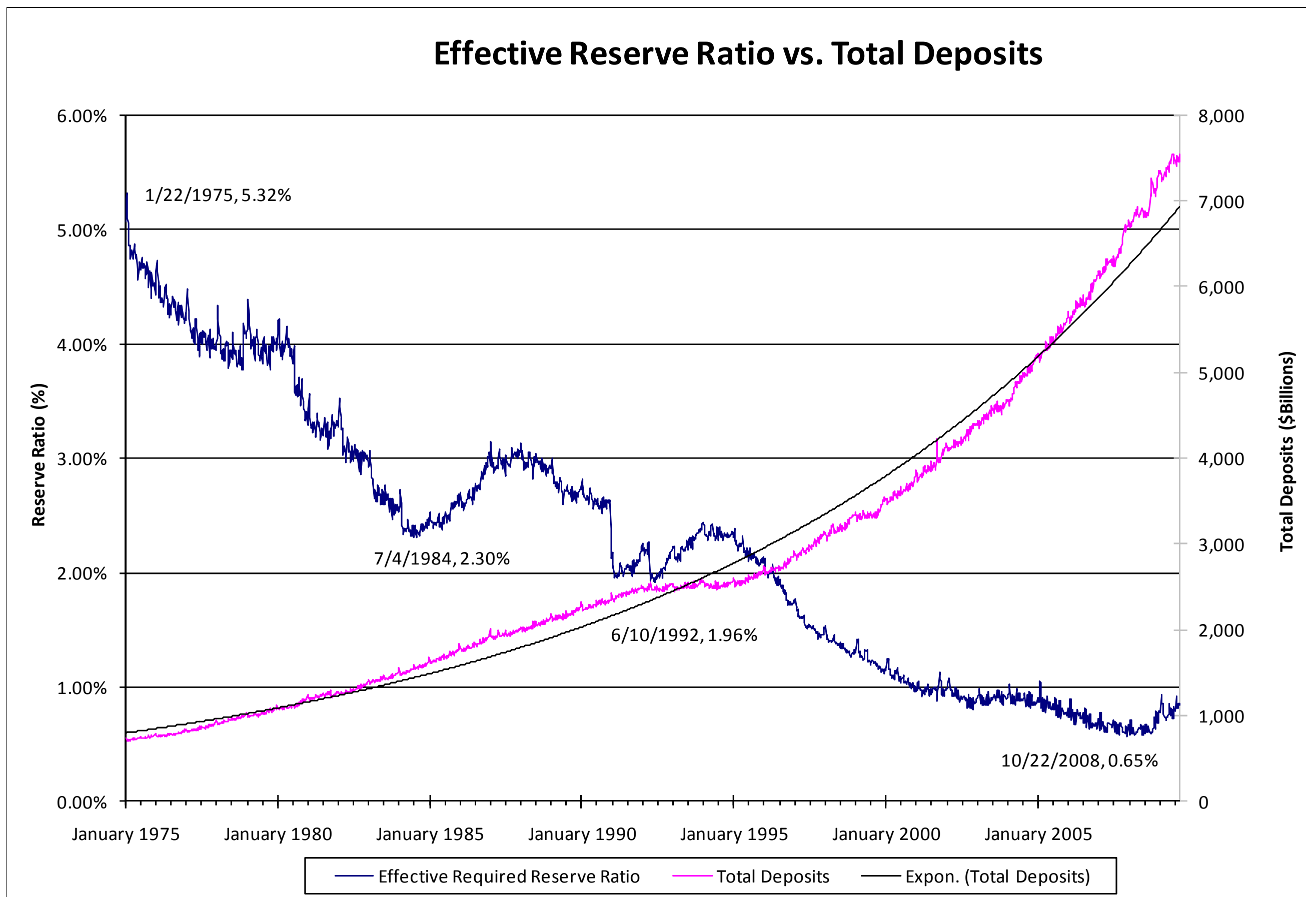
This next chart provides a somewhat different perspective on the same phenomenon:



This chart demonstrates how, since 1975, the money supply (MZM) has grown steadily, while the effective required reserve ratio has decline from 5.3% to 0.65%. (effective required reserve ratio = actual bank reserves/Total Deposits)

This distinction takes on considerable significance when looking for a solution to monetary expansion, malinvestment, and economic busts.

Fiat Value of Money

Fallacy:

“Money gets its value from the State.” Or "Fiat money derives its value, not from an underlying commodity, but from state requirement that lenders accept paper money"

Truth:

Fiat money has value simply because people use it. Just like any other form of money. The problem with fiat money lies in the state’s control of its quantity. Changes in quantity effect marginal utility, therefore value, as with any other commodity.

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Low Interest Caused by Deflation

Fallacy:

"Artificially low interest rates are caused by deflation."

Truth:

I don't know how to deal with this one.

Again, changes in supply affect interest rates not the other way round.

Money: A Medium of Exchange

Flaw:

“Money acts as a medium of exchange.”

Truth:

Partly true: Any commodity can act as a medium of exchange, e.g. marbles for yo-yos.

Money actually acts as a medium of indirect exchange. Money tends to have value in excess of its commodity value because of its acceptance as a medium of indirect exchange for commodities of greater value.

Bank Failures Erase Money

Flaw:

“When a bank fails, a quantity of money equal to the bank’s deposits disappears from the economy.”

Truth:

Even without deposit insurance, money, in the form of bank credit, would not disappear when a bank failed. Depositors, who would comprise the largest group of creditors, would take action to protect their claims. They would probably take possession of the bank's assets and sell them to another bank for new account balances.

New money would replace old money. Depositors might take some loss for the amount by which the sale of assets falls short of deposit liabilities. But no wholesale loss would occur.

With the deposit insurance the same action occurs under the direction of FDIC. In that case the FDIC would cover any shortfall.

Necessary Money Growth

Fallacy:

“Money supply must grow to accommodate economic growth.”

Truth:

An increase supply of money adds nothing the welfare of the members of an economic system. The economy can produce more food, clothing, shelter, and iPods, which add to welfare, with the same amount of money.

If an economy expands in the presents of a fixed money supply, the general price level will decline. Any growth in the supply of money, no matter how slow, distorts the information that prices carry about relative supply and demand.

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FED TOO TIGHT OR TOO LOOSE

FALLACY:

"The Fed is Too Tight." "The Fed is Too Loose."

TRUTH:

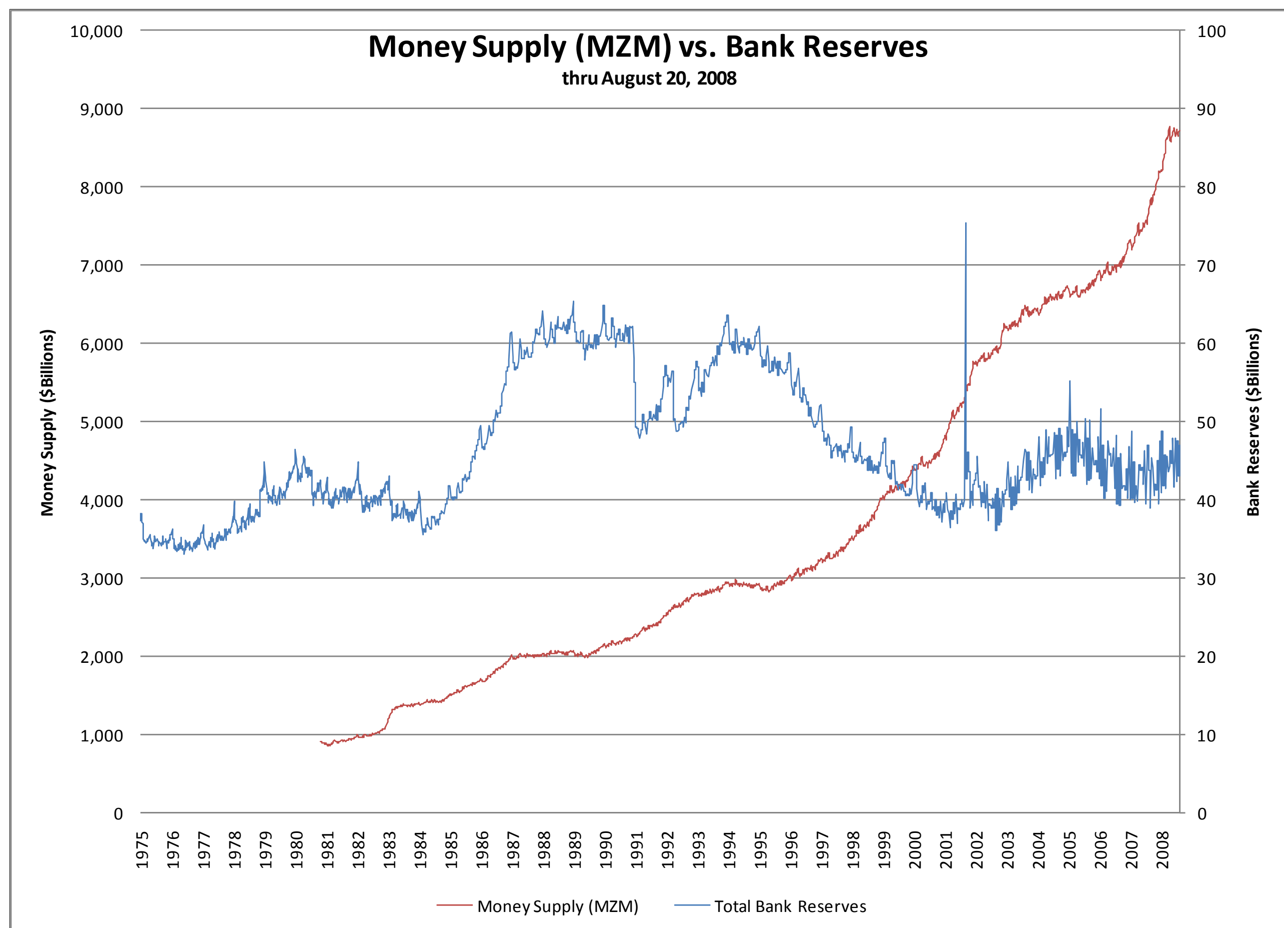
The validity of this statement collapses under the weight of the fallacious presupposition that the Fed could possibly hit the right monetary target—either money quantity or interest rates.

The right quantity of money consists of whatever exists at the close of business today, fixed at that quantity forever.

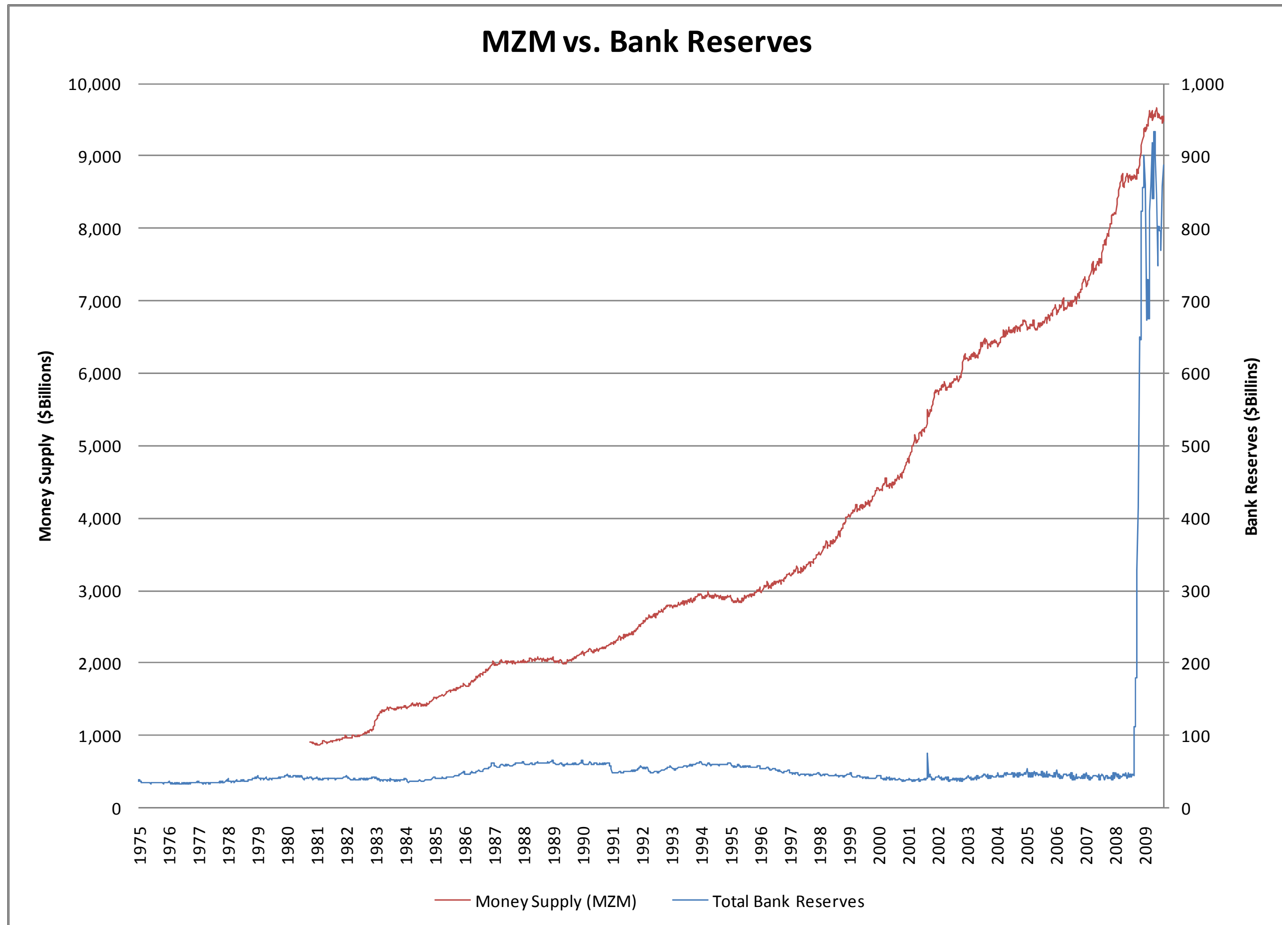
Money interest rates, on the other hand, result from the interaction of market actors supplying and demanding future money in exchange for present money.

Popular myth says, "The Fed adds to reserves; the money supply increases. The Fed subtracts from reserves; the money supply decreases." Empirical evidence neither proves nor disproves this statement. It does, however, call it into question.

Over the last 33 years–until September 2008—the money supply has steadily expanded. During that same period bank reserves have risen and fallen. See the following chart:



To put that period in perspective, relative to today's craziness, see the following chart, which includes the months since September 2008:



For those who like heroes and villains, pick your Fed Chairmen heroes or villains from the last five.

Arthur F. Burns	**February 1, 1970 – January 31, 1978**
G. William Miller	**March 8, 1978 – August 6, 1979**
Paul A. Volcker	**August 6, 1979 – August 11, 1987**
Alan Greenspan[2]	**August 11, 1987 – January 31, 2006**
Ben Bernanke	**February 1, 2006 –**

Money Interest Rates Determine Money Supply

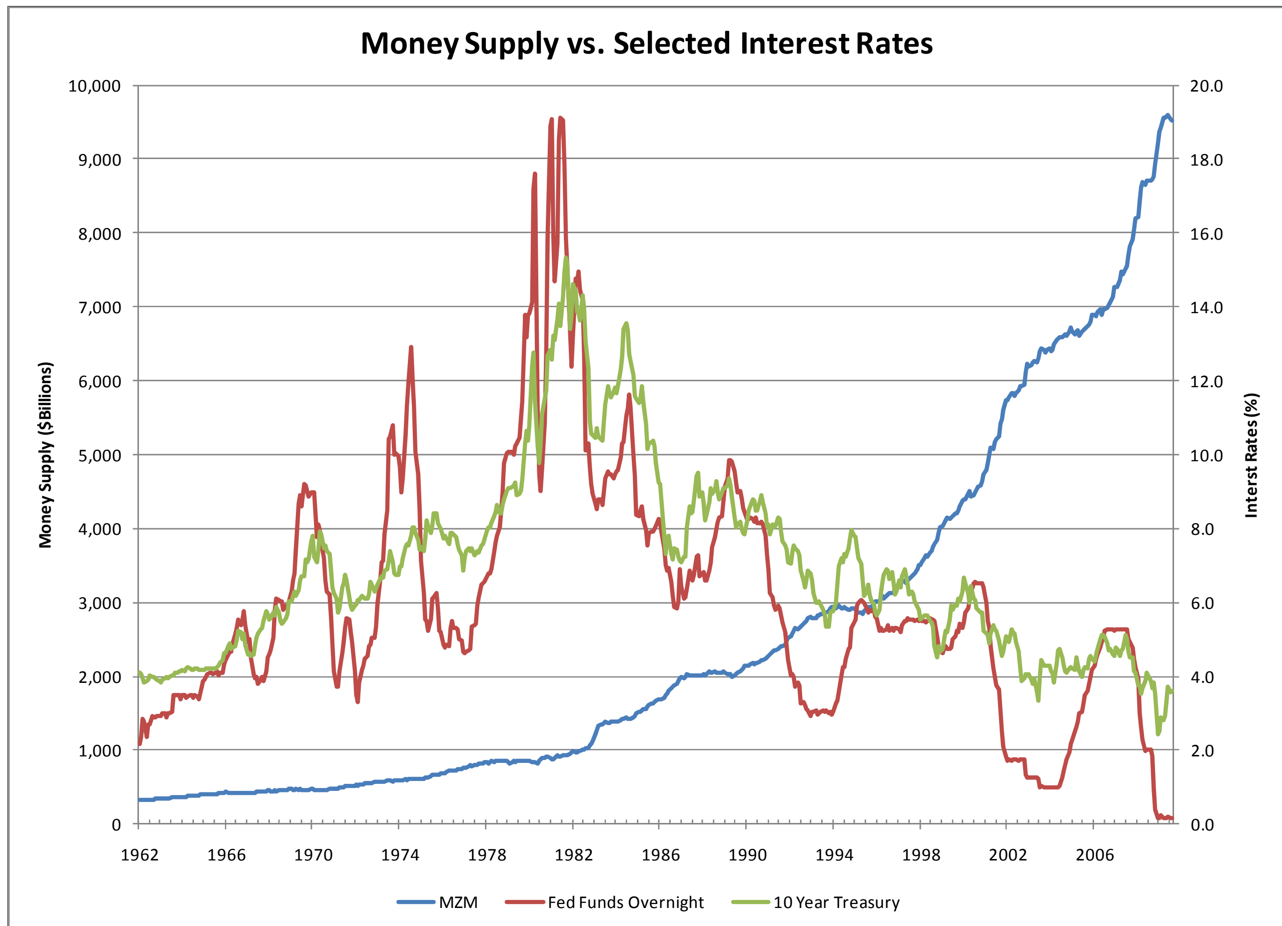
Fallacy:

"Money interest rates determine the supply of money." and "Interest rates indicate whether fed is too tight or loose."

Truth:

Interest rates, like all prices, are dependent variables. The relative demand for present money vs. future money by market actors determines interest rates. Historical interest rates influence the expectations of actors, but they do not determine rates.

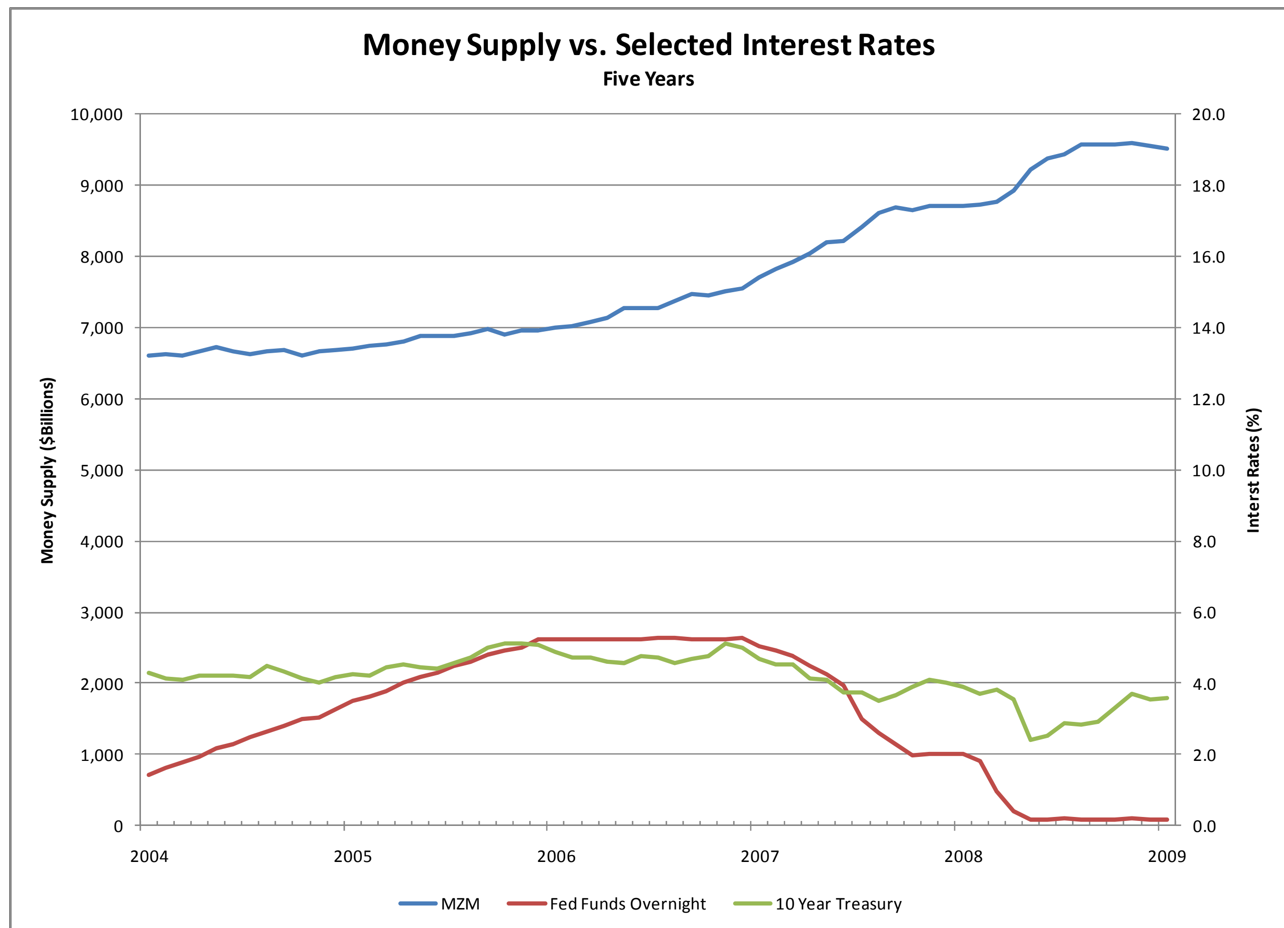
Some evidence:



This chart shows the money supply (MZM) vs. a couple of selected interests: the wildly popular fed funds rate and the 10 year Treasury rate. Correlation? What correlation?

Or

Let's shift the focus up close. How 'bout 5 years.



If low rates caused the increase in money over the last year and a half, what did they do before that?

MONEY VELOCITY & QUANTITY THEORY

FALLACY:

"The economy will get moving when the velocity of money picks up."

Quantity of money theory and money velocity based on MV=PT.

TRUTH:

For an extensive refutation of this argument see: The Velocity of Circulation by Henry Hazlitt

In the meantime, consider the logic of the basic formula.

MV=PT
M = Quantity of Money
V = Velocity of Money (Turnover)
P = General Price Level
T = Transaction Volume

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To calculate a money price you need the number (X) of units of money exchanged and the number (Y) of units of goods, i.e. P = X $ / Y units. We have the units of money: dollars. What units should we use for the goods in the general price level? What common unit of measure covers pigs, chickens, steers, and iPods?

What distinguishes V (Velocity of Money) from T (Transaction Volume)? For every money transaction, parties exchange a quantity of goods for a quantity of money. You don't have more money transactions than you have goods transactions. Doesn't T = V?

Money: A Store of Value

Flaw:

"Money acts as a store of value."

Truth:

This common statement has flaws on two levels:

1. Any commodity has an equal capacity to store value; however
2. Value lies in the subjective judgment of the acting human. A person cannot store value.

"Store of value" amounts to an oxymoron.

Supply & Demand Curves

Fallacy:

"Supply and demand curves determine value of money."

Truth:

Supply and demand curves affect the value of nothing.

The economists can only construct hypothetical curves after a transaction to depict their speculations about the preference scales of the actors in the market. No one has ever seen a supply or demand curve before a transaction. This applies as much to money as any other commodity.

> *It is possible to visualize this interaction by drawing two curves, the demand curve and the supply curve, whose intersection shows the price. It is no less possible to express it in mathematical symbols. But it is necessary to comprehend that such pictorial or mathematical modes of representation do not affect the essence of our interpretation and that they do not add a whit to our insight. Furthermore it is important to realize that we do not have any knowledge or experience concerning the shape of such curves. Always, what we know is only market prices-that is, not the curves but only a point which we interpret as the intersection of two hypothetical curves. The drawing of such curves may prove expedient in visualizing the problems for undergraduates. For the real tasks of catallactics they are mere byplay.*

Ludwig von Mises
Human Action*: A Treatise on Economics*
Page 330

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Inflation: Supply vs. Demand

Fallacy:

"Increase in money supply vs. money demand produces inflation"

Truth:

Inflation requires only a change in the quantity of money.

Refer to the principle of marginal utility.

The Private Fed

Flaw:

“Federal Reserve operates as a totally private entity, without any federal control.”

Truth:

Supposedly the member banks own the Fed. But what do they gain from it?

What private organization has their Chairman nominated by U.S. President, makes regular mandatory testimony before Congress, and pays "dividends" to the U.S. Treasury?

Conclusion

The time has come to question everything you hear about markets and economics. Discussing some flaws and fallacies about money and banking makes a good place to start.

In a recent television interview, The Chairwoman of the President’s Council of Economic Advisors said, “The public sector must keep spending until the private sector can take over.” The interviewer said nothing.

If television interviewers won’t ask, the time has come for you to ask, “Hey lady, where to you think the public sector gets its money?”

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