Mitchell's Musings 2-18-13: Money Illusion

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Irving Fisher (1867-1947), the famed Yale economist, is usually viewed as the man who coined (pun intended) the phrase "money illusion." In his case, the phrase referred to the stickiness of the nominal currency unit (such as the dollar) in the face of inflation. That is, even when general price changes cause the purchasing power of the currency unit to change, people tend to "think in" the currency unit. One result is that in the face of inflation, wages or government benefits may be eroded since they are set in nominal dollars, not purchasing power. [1]

There are some exceptions, for example Social Security payments are indexed to the Consumer Price Index (CPI). But the fundamental point remains. The fact that there is nominal stickiness ultimately is why changes in exchange rates have effects on the volume of exports and imports. If money were simply a veil over a world of barter, changing the value of the dollar against, say, the euro or the yen, would have no real effects on international trade. But we know that such changes do have effects. I point to this fact because of a recent item about the lower house in the Virginia legislature voting to study issuing state gold coins, just in case the U.S. monetary system collapses into hyperinflation.[2]

The fact that people "think in" their own currency is a reflection of a reality – something that has long characterized modern economies – which Americans in particular have long had a problem in understanding.[3] I am at this moment looking at a dollar bill I pulled from my wallet. Why do I accept that this piece of paper has special value? There is a statement on it that "this note is legal tender for all debts, public and private." Is that why I accept it? It has the signature of Timothy Geithner on it. Should I continue to accept it? Didn't he resign as Treasury Secretary? It also has the signature of the "Treasurer of the United States." Did you know we had a Treasurer (as opposed to the Secretary of the Treasury)? What exactly does the Treasurer do? Do you need both signatures to make the bill valid?

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[1] Behavioral economic evidence suggests that people think nominal wage cuts are unfair, but if the same *de facto* cuts arise from inflation, they are more likely to view them as fair. If I cut your nominal wage by 10%, it is unfair. If prices rise by 10% but your nominal wage is unchanged, that is fair.

[2] You can hear a radio broadcast on this development at http://www.wbur.org/npr/171310937/virginia-proposes-alternative-currency-in-case-of-federal-reserve-collapse/player or just read the transcript of the broadcast at http://www.wbur.org/npr/171310937/virginia-proposes-alternative-currency-in-case-of-federal-reserve-collapse. A newspaper report can be found at http://www.washingtonpost.com/business/economy/virginia-coin-moves-closer-to-reality/2013/02/05/9bcdd532-6fa4-11e2-ac36-3d8d9dcaa2e2_story.html

[3] An earlier musing – A Lesson from Mr. 880 – made many of these points in 2011. Apparently, they need repeating, at least in Virginia. See http://www.employmentpolicy.org/topic/10/blog/mitchell%E2%80%99s-musings-6-20-11-lesson-learned-mr-880

This particular bill has an H on it inside a set of two circles. The writing within these circles says the H means it is from the Federal Reserve Bank of St. Louis, Mo. But I don't live anywhere near St. Louis and in fact am in the Federal Reserve district overseen by the Federal Reserve Bank of San Francisco. So is this bill worth the same as one that came from the San Francisco Fed?

The fact is that I accepted this bill without really looking closely at it and certainly without asking any of these questions. Basically, I accepted it because I knew that if I wanted to pay somebody else with it, that person would accept it. On the other hand, if I went to my local grocery and attempted to pay in euros, the clerk probably wouldn't accept them, even though the euro is as valid a currency as the dollar.

People work hard for their dollars. Some steal and murder to get dollars. It is hard to accept the fact that the dollar is a social convention, akin to shaking hands, given these life experiences. When I greet someone, I extend my right hand. The other party reciprocates. We don't typically rub noses to show affection as Eskimos reportedly do. In business settings, I am likely to wear a jacket and tie. In other settings, I probably won't. If I didn't wear a jacket and tie in a setting where I am expected to do so, I would stand out – because I am not doing something that is expected. Yet shaking hands, rubbing noses, or wearing ties are all arbitrary social conventions. Somehow, however, it is harder to deal with the concept of the dollar as a convention than it is a tie.

There may be an historical explanation. Currencies emerged as a way of easing transactions which otherwise would have to be done entirely through barter. Gold and silver – which had value because of their physical properties which appeal to humans – were widely used. The gold standard evolved from this long history. Bank notes issued by private banks represented units of gold or silver. Eventually, central banks evolved and were given special powers. Gradually, the nominal currency unit came to have significance independent of the gold or silver quantity it was supposed to represent. Through an historical process that varied from country to country, the "backing" of currencies with metals disappeared.

Despite the common thread of this story among various countries, Americans in particular – or at least some subset of them - seem hung up on the idea that money should be "real." It's not clear exactly what makes gold or silver real, however. I suspect a chimpanzee would prefer a banana to a gold coin. Human beings like to appearance of gold or silver (and more recently such characteristics as being good electrical conductors). There is an arbitrary element even to what is meant by "real" or valuable. Some survivalists seem to think that when society collapses from (pick your favorite explanation/cause), gold will have value. If society collapsed – presumably triggering mass starvation – would survivors have a special interest in making jewelry? Or would they, like the chimpanzee, prefer the banana?

Over the years, the U.S. has had various monetary movements (some based on conspiracy theories) that ultimately are linked to disquiet over the concept of money as a social convention. Central banks that create money are seen as suspicious because if money has to be "real," how can it be just created? During the era of the Great Recession, the Fed has been under attack because it appears to be "bailing out" the financial system – unpopular in itself for obvious reasons – and doing so by creating money out of nothing.

The Fed has vastly increased its holding of various securities simply by writing checks. (Figure 1) Some folks see that activity as deviant because, unlike the Fed, as individuals we are not allowed to write checks unless there are "dollars" (what are those, again?) in our account to cover those checks. And when the Fed buys securities, it also increases the money supply. Let's put aside the conundrum of exactly what is meant by "money supply" in a world in which there are many liquid assets that can easily be converted into dollars. Whatever it means, someone in a college economics course probably said that increasing the money supply could cause inflation and used some neat phrase such as "too much money chasing too few goods" to make the point. (Figure 2 shows the monetary base.)

Figure 1

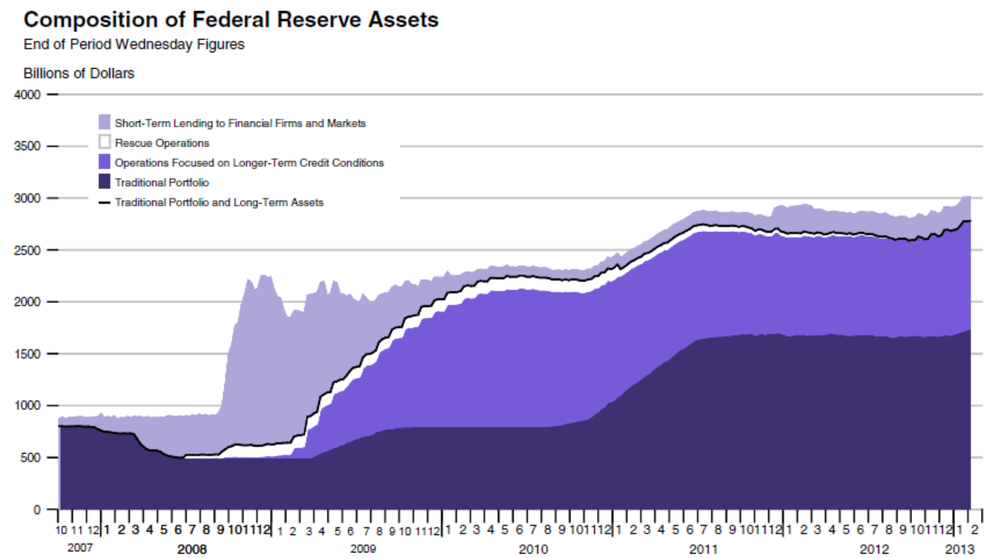
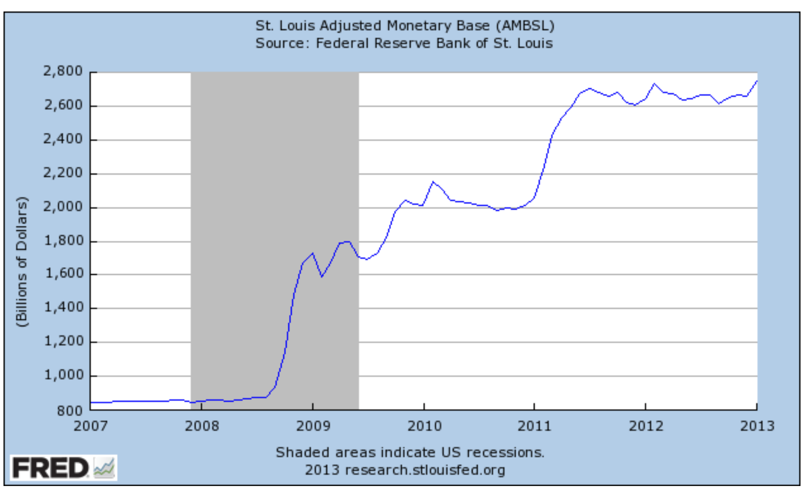
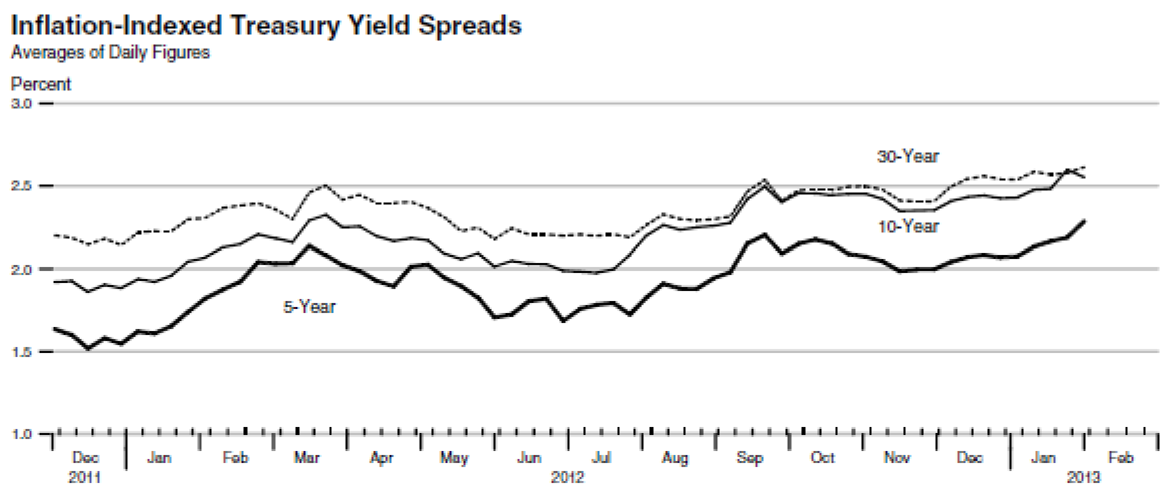


Figure 2



If you are schooled in the idea that there inevitably will be hyperinflation, then you will likely assume that some kind of monetary collapse or crisis is coming. But, as we have noted in prior musings, when you look at what the financial markets are predicting (as measured by the difference in yields between conventional Treasury securities and CPI-inflation adjusted Treasury securities), the expectation remains well below 3% per annum, even over 30 years. Part of the reason for this view that a crisis is not coming is due to the short run fact of a soft economy and high unemployment – conditions not conducive to wild price raising. Part of the reason is the assumption is that what the Fed has wrought in terms of security purchases, it can undo by security sales.

Figure 3



Nonetheless, what about gold – to be coined by the State of Virginia – as an alternative currency? Note that it is perfectly legal right now to hold, purchase or sell gold coins. You can buy South African Krugerrands, Canadian Maple Leafs, American Gold Eagles, etc. You can mint your own coins, if you have the equipment, and sell them, based on their weight. (You probably can't call them "dollars" but you could make up some other name or simply put the weight on the coin.) So if Virginia wants to get into the act and issue a coin with some name on it – Virgins or maybe Virginia Reels? - it can do so. But why would a gold buyer/holder – other things equal – prefer Virginia coins to any of the others?

Let's assume that Virginia issued its Virgins and defined them in terms of weight. Let's suppose further than somehow people stopped using the dollar, took the Virgins to heart, and began to "think in" Virgins the way they currently think in dollars. In effect, the new currency would bounce up and down relative to other currencies depending on the price of gold in world markets.

That price is quite volatile as Figure 4 shows. Since 2000, the price of gold in dollars has risen over five fold. During the past year or so, the price has varied from close to $1,800 per ounce to well below $1,600 per ounce. The new currency would be rising and falling relative to other currencies with these fluctuations. In fact, what is being proposed is not the old 19th century gold standard since other currencies would not be defined in terms of gold. The essence of the old gold standard was fixed exchange rates derived from "backing" major world currencies by gold. A unilateral gold currency is not a return to the past – even if you think that the past was some kind of (pun intended) Golden Age. Figure 5 shows how a hypothetical gold currency would have performed relative to the euro. Would anyone think that a tripling of the Virgin relative to the euro since 2000 would be good for exports that were priced in Virgins?

Figure 4

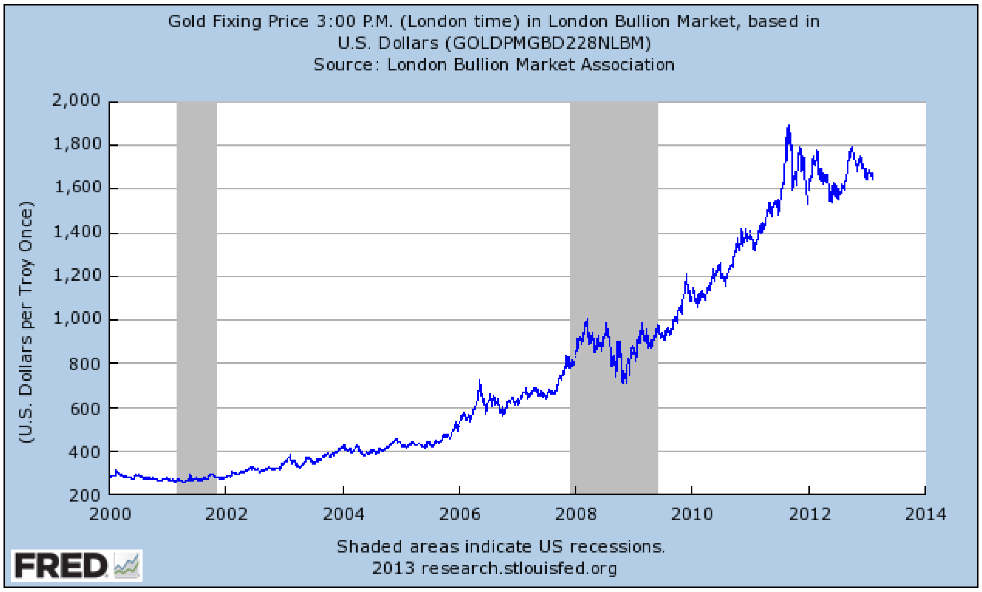
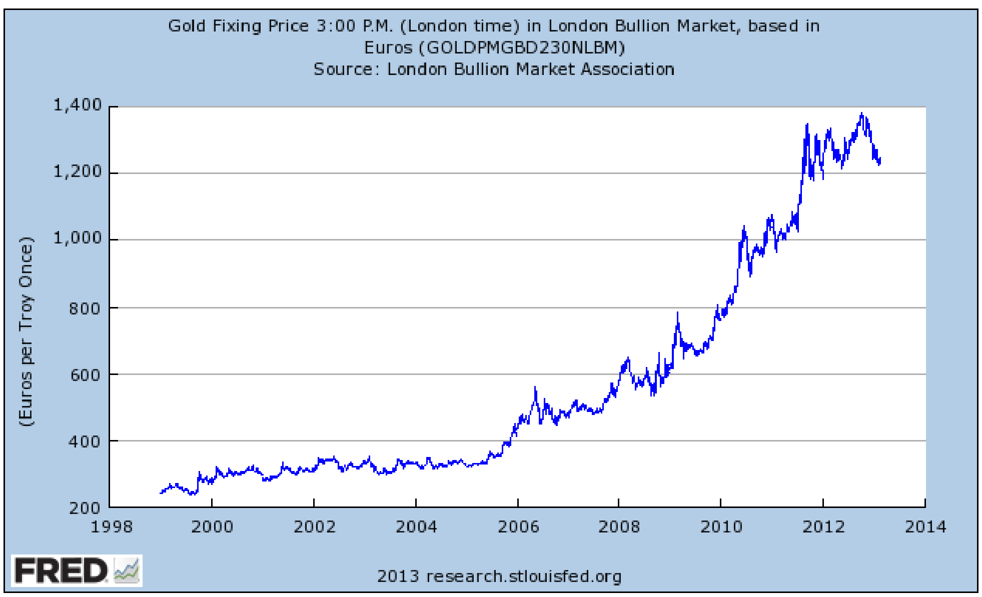


Figure 5



Of course, there isn't going to be any conversion from the dollar to the Virgin, whatever the State of Virginia decides to do. So is there any harm to Virginia issuing its own gold coins? The main harm is that it fosters ignorance, ignorance of how a modern economy works and how a modern central bank works. It fosters erroneous understandings about the economy and monetary policy which are already widespread. Back in the early 1980s, President Reagan was facing demands from his party for some kind of return to gold. He formed a Gold Commission ostensibly to consider the idea. But he stacked it with folks who recognized the foolishness of the idea but who went through the motions of studying the issue to placate those who longed, then as now, for a gold-based currency. The Commission then issued a report saying it wasn't a good idea. It's not clear the Virginia legislature will be that wise.