“Well, if I had a nickel, I know what I would do. I’d spend it all on candy and give it all to you. . . . Cause that’s how much I love you baby.” That wasn’t a very generous proposition even in 1946, when country singer Eddy Arnold wrote those words. But at least a nickel would buy a good-sized Baby Ruth or Clark bar. Today? A jelly bean, perhaps?

The Problem with Fiat Money

I don’t think love has been devalued: consult pop anthropologist Lionel Tiger or maybe Lady Gaga for a more expert opinion. But we all know what has happened to the nickel. That’s the problem with fiat currencies. They lose value over time, which means they fail an important requirement of money: that it serve as a reliable storehouse of wealth.

Some fiat currencies sink faster than others. I lived and worked in England in the late 1960s, at the height of the U.K.’s postwar socialist experiment. State mismanagement of the “means of production” was destroying the efficiency of British industry. At the same time the government was doling out more “free” goods, health care, for example.

This excess of consumption over production was steadily weakening the once-powerful pound sterling, forcing heavy government

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George Melloan is a former Deputy Editor of the Wall Street Journal editorial page, where he wrote a weekly op-ed column titled “Global View.” He is author of The Great Money Binge, Spending Our Way to Socialism (2009).
borrowing. The weakening pound was being abandoned as a reserve asset by central banks, even within the far-flung British Commonwealth. The result was inevitable, a sharp official devaluation (14.3 percent) of the pound in November 1967.

The End of Bretton Woods

To anyone who might think that the postwar monetary system was nirvana, recall that Bretton Woods was then still operative. Socialist Britain spent years fudging on its Bretton Woods obligations, hitting up the United States and the International Monetary Fund for money to tide it over until, as Mr. Micawber might say, “something turned up.” Bretton Woods finally went belly up when the United States followed the British example with LBJ’s “war on poverty,” a big social spending campaign conducted at the same time we were trying to combat the spread of communism with a shooting war in Vietnam. Richard Nixon performed the coup de grace on Bretton Woods in August 1971 when he closed the gold window, thus destroying the system’s central control mechanism, the exchange of gold among central banks at a fixed dollar rate.

The Politicization of Money

So there you have the problem. Fiat currencies are subject to the vagaries of politics. Highly productive countries can maintain currency stability more easily than unproductive ones because they produce broadly marketable goods. But even governments of such nations can weaken their currencies through spending and borrowing excesses.

Because of America’s vast industrial power, the U.S. dollar has remained the world’s foremost currency even after Bretton Woods, despite the political abuse the dollar has suffered these last 40 years. But lately, with trillion-dollar-plus federal deficits forcing the Treasury to borrow heavily from both the Fed and foreign central banks, the dollar’s global primacy is increasingly questioned. Were there an attractive alternative, the dollar would be even weaker than it already is in international currency markets.

America’s heavy borrowing began when Washington reached the effective political limits of its power to extract money from taxpayers. Spending nonetheless continued to grow on borrowed money. Now
we are all getting very nervous. When the Federal Reserve creates vast amounts of money to lend to the U.S. government, inflation is the likely result. The warning signals were flying last year, with the CPI rising at over 3 percent annually in a relatively flat economy. The growth rate subsided late in the year, but prices still bear watching. When the British government was destroying the pound in the 1960s, inflation expectations eventually wiped out the bond market. If you can’t borrow long, it’s pretty hard to build and rebuild permanent infrastructure. The result is stagnation.

The one bright sign in all of this is that the American public seems to have a better understanding of the government’s role in money destruction than it did during the inflation of the 1970s. The standard practice in politics is to blame private producers when prices go up, fomenting such things as the latest demonstrations against “Wall Street” in New York and elsewhere. The politicians sometimes are aided, I’m sad to say, by gullible or tendentious journalists. Our current president is playing this game and you can expect it to intensify as the 2012 election approaches.

But that old ploy isn’t working as well as it once did. Voters are more sophisticated and are increasingly distrustful of attempts by officials to shift blame. Confidence in government is at a low ebb. People look at places like Greece, where sovereign debt went sour because the sovereign was fat and lazy. They draw conclusions.

An Alternative to Fiat Money?

Does that mean the voters are ready for an alternative to fiat money? Not yet. Fiat money hasn’t been a total disaster. Financial markets have remained liquid during periods of extreme stress, as in 2008, because of the ability of the Fed to generate a flood of money to offset sharp declines in asset values. The flexibility of fiat money can be both a cause and a cure. It was a cause during the credit boom. It was a cure, or at least a stopgap, after the bust. But has the Fed reached the limit of its powers to cure, and now risks devastating inflation?

Sad to say, I don’t think there is a political chance of restoring discipline to the monetary system until we learn the answer to that question. The circumstances under which the American public will demand some new form of monetary discipline, or an old form such as a gold standard, may prove to be very unpleasant.
The speculation about alternatives is not reassuring at this point. There’s the idea of turning the IMF into a global world bank that would issue special drawing rights as the world’s reserve currency. A look at the IMF’s record in a much more limited role as the international monetary nanny hardly encourages that idea. We already have one multilateral fiat currency, the euro, and the European Central bank has had little more luck disciplining the politicians of Greece or Italy than the Fed has ever had in denying American Congresspersons free money. The Maastricht Treaty set severe restrictions on deficits and debt in the eurozone. Greek ministers decided that it was politically wiser to meet the demands of their strident, overgrown public sector than to worry about treaty commitments that the Germans and French had little means to enforce. The world’s banks, bless their hearts, were buying their euro paper, so what the heck.

So is there any alternative to the jerry-built nonsystem that circulates the world’s money today? To reestablish a gold standard, the United States would have to take the lead. There would have to be a radical, almost revolutionary change in our politics for that to happen. Even a return to the Bretton Woods gold-exchange standard doesn’t look feasible at this point, partly because of its historic failure to instill discipline. It had a mechanism for official devaluation, perhaps because some of its designers thought the political embarrassment of an official devaluation would constrain politicians. But the United States didn’t bother with an official devaluation. It just scuttled the whole system.

Are there any conditions that might actually force a change? There are but we aren’t going to like them. If the current rate of price inflation begins climbing toward double digits and we enter a period of stagflation, there will be still more anger from the voters. It will be worse than it was in the late 1970s because it will start from a higher base. Jimmy Carter hired Paul Volcker to restore order in 1979. Who will restore order the next time and how will it be done?

We are much further down the road we were traveling in the late 1970s, in terms of unrealistic deficit levels and the increasing necessity that they be financed by the central bank. If a current central banker applied the harsh medicine Volcker did in 1979 and 1980, he would bring howls from the Treasury as it struggles to finance the current deficit and refinance maturing debt, a total approaching $2 trillion annually. It also would starve the private sector, already
weakened by three years of tax and regulatory abuse, and force an even sharper recession than the one suffered in the early 1980s that resulted from monetary contraction. With federal spending at nearly 25 percent of GDP, much higher than in 1980, and some states drowning in red ink, it would be harder not only to restore the dollar but also to pull out of the resulting slump. Out of the turmoil, we might not get reformers but political demagogues.

In past such periods, people have dealt with debasement of currencies by adopting alternative means of settling debts. In Argentina during its hyperinflations, the alternative currency was the dollar. But what currency would you use in parallel to the dollar?

A creative society will invent substitutes if circumstances demand it. Gold clauses in contracts might offer some protection for traders. How about cyber-currency? There’s already something called a bitcoin in limited “peer-to-peer” circulation, partly for illicit activities, so I am told. It is a complex computer encryption that supposedly has intrinsic value because it is so hard to create. To bind their customers, local merchants in many places circulate scrip that they all agree to accept, but it is dollar based.

The problem is that improvised substitutes for fiat currencies are usually inefficient. In some sense, fiat currencies have served well, judging from the healthy expansion of world trade and an impressive rise in global GDP over the years since Bretton Woods. Millions of Chinese and Indians, not to mention other nationalities in once poor lands, have been lifted out of poverty. But keep in mind that most of that growth took place in the 20 years after 1983 when America was running a fairly stable fiscal and monetary policy.

We are right to be concerned today about the stewardship of the world’s most important fiat currency. If it goes, le déluge, peut-être.

Reference