Busting Some Popular Monetary Myths

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The Globe and Mail, September 23, 2014

Last week my friend sent me a link to a short video ranting about our monetary system. I immediately recognized it as another in a large collection of videos I have seen, many of which are sent to me by students pondering the validity of the central messages – which appear quite at odds with the things I say in class.

These videos are filled with so many misconceptions that anyone studying from them would fail an exam in any respectable economics course. Two big monetary myths stand out from the rest. First, that central banks are inappropriately in the business of "giving" money to commercial banks. Second, that money is too important to be left to the banking system and instead our governments should create it and then use it to finance their expenditures.

Let me start with the second point. Centuries ago, back in the time of castles and kings, this is exactly what happened. Kings and queens created money, usually gold coins showing their names and faces, and used it to purchase a wide range of goods and services, thereby getting the money into wider circulation. It didn't take long, however, for the sovereigns to learn that they could debase the coinage by putting lead into the pot of molten gold, thereby secretly increasing the supply of money. The benefits to the sovereign were immediate and substantial, but over time this physical debasement of money led to the devaluation of the currency through rising prices – inflation.

Today, we still see this problem in many developing countries, especially those with weak financial markets and nascent tax-collection systems. The government often chooses to print money in order to finance its expenditures rather than taking the more difficult and less popular route of collecting taxes or issuing debt. If governments do enough of this – and it's very difficult to stop once you start – the result is very high inflation, sometimes even hyperinflation.

Lessons learned from modern history's great hyperinflations – from Germany's in the early 1920s to Zimbabwe's just a few years ago – have led most sensible governments to ensure that control over the monetary printing press is kept at arms length, insulated from short-run political influences. The operational independence of central banks, and the associated separation of monetary and fiscal policies, has proven to be a key factor in keeping inflation low and stable. A return to the bad old days should be unthinkable.

So central banks are sensible things. But we then need to address how they get money into the economy. They could choose to drop bundles of freshly printed cash from helicopters flying over the country, and this would surely put money into people's hands and finance their spending. Or instead they could send bundles of cash to each of us through the mail. One of the biggest problems with these methods is that they don't work well in reverse. What could the central bank do if it needed to reduce the amount of money in the economy?

Modern central banks alter what they call the “monetary base” in either direction by making transactions with participants in financial markets. If the central bank deems it appropriate to increase the monetary base, it uses freshly created money to purchase existing financial assets (usually government bonds) from financial institutions who are willing to sell. This transaction, which is exactly what “Quantitative Easing” is all about, usually raises the price of those assets and reduces interest rates. Central banks don't “give” cash to commercial banks; they exchange cash for valuable assets. The commercial banks, in turn, use their enhanced liquidity to extend more credit to households and businesses.

If the central bank chooses to reduce the monetary base, it makes the opposite market transaction. It sells some of its financial assets back to a willing buyer in the market and takes cash in return, thereby taking money out of circulation. This transaction drives down the price of assets and raises interest rates. The higher rates and reduced liquidity lead commercial banks to slow their lending to the private sector.

The topics of money and central banking unfortunately attract all manner of bizarre myths and conspiracy theories. Yet for anyone who actually reads even the most basic of economics textbooks, the mystery quickly disappears and the logic reveals itself. It’s a shame so few people do just that.

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