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The Case Against Fiat Money

Under a gold standard, a crisis like the current one would be impossible.

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The global financial system has now been in intensive care for almost five years, with life support in the form of near-zero interest rates and extensive asset-price manipulations via the printing presses. Recovery remains tenuous. Some assume that most of the developed world has arrived at this same, severe predicament by sheer coincidence. But given the evidence, it might be more reasonable to suppose that there is a structural flaw in the global monetary order.

It may be time to reconsider the fundamental tenets of our fiat money system. Calls for a return to some form of gold standard no longer sound that eccentric and are becoming more frequent.

Not surprisingly, U.S. Federal Reserve Chairman Ben Bernanke has defended the present system in his recent lecture series and roundly rejected calls for a return to gold. His position reflects the view of the majority of economists today. Yet it strikes me that much of the debate revolves around history rather than economics. For the defenders of fiat money, the inflexibility of the gold standard was the reason for bank runs and panics in the late 19th and early 20th century, and policy makers were only able to fight the Great Depression effectively once they had freed themselves from their "golden shackles."

The critics of fiat money counter that politicians undermined the gold standard, in particular by setting up the U.S. Federal Reserve in 1913 as a government-sponsored backstop for credit creation on Wall Street. This encouraged the credit boom of the 1920s despite the gold standard and set up the American economy for the crash. In this view politicians and bankers destroyed the gold standard, and the fiat money system they put in its place is now in a crisis that could well prove terminal.

History can be illuminating, but it is of limited use in settling fundamental questions of economics. Human history is not a laboratory in which we can isolate various factors and straightforwardly derive cause and effect. Also, history can tell us what did happen, but never what *must* happen. The debate about fiat money versus the gold standard will have to move from history to economic theory to make any satisfying progress. And for this to happen it is paramount that we first define the problem at hand. I suggest the debate boils down to the following: For a functioning market economy, is it better to have a type of money whose supply is inelastic or one whose supply is elastic?

Defenders of the present system react to the gold standard with incomprehension precisely because of that system's inflexibility. An inelastic money supply would make "quantitative easing" and other bailout operations impossible. They suspect that, given such circumstances, the West would have experienced an even worse banking crisis and deeper deflationary correction by now.

Barbara Kelley

Advocates of inelastic money will readily concede this point, but will argue that under a gold standard, a crisis such as the present one would be impossible in the first place. Current imbalances—in particular excessive levels of debt, inflated asset prices, and overstretched and weak banks—would be inconceivable, at least on their present scale, in a system of hard and inflexible money. Only years and decades of generous monetary expansion, often for the purpose of short-term stimulus, could have accumulated dislocations of the size we see today. Furthermore, pumping more fiat money into the system addresses the symptoms but not the underlying causes. We are kicking the can down the road.

What does fundamental economic theory have to say about elastic versus inelastic money? In an inelastic system, the supply of money will not keep pace with the growth in productive capacity. The prices of goods and services will fall on trend. Such secular and moderate deflation is not a problem, however. Capitalism raises living standards by making things more affordable and nominal prices will simply reflect this.

By contrast, in our fiat money system, central banks define stability as constant, moderate inflation. This means central banks have to continuously inject money into the economy or encourage banks to expand the supply of deposit money continuously to keep chipping away at money's purchasing power and to beat capitalism's tendency to make things cheaper.

Ongoing money injections, however, necessarily dislocate credit markets. On these markets the supply of savings meets the demand for loans, usually for investment purposes.

But money injections systematically distort interest rates. Lower rates and additional credit through money creation encourage investment in excess of savings and lead to extra growth in the short term. But the mismatch between investment and true savings will undermine the expansion in the long run. The boom is artificial, leads to capital misallocations and must end in a bust.

Economists have long seen elastic money as the prime cause of the business cycle, from the British classical economists in the 19th century to Ludwig von Mises, Friedrich Hayek and the economists of the Austrian school in the 20th century. All of these economists worked, however, in periods when some form of gold standard reigned. The elasticity of money that they investigated was still strictly limited, and cycles were fairly short.

In a fully flexible fiat money system such as the one the developed world adopted after 1971, the short business cycle was replaced with the credit megacycle. Central banks routinely short-circuit or "manage" recessions with renewed injections of easy money and by repeatedly suppressing interest rates. The imbalances from the artificial boom do not get cleansed and thus compound. That is why elastic money systems can look deceptively stable for a long time—until they inevitably choke on their accumulated imbalances.

Every economist should appreciate the importance of relative prices for the allocation of resources and for guiding economic activity. A system of elastic money and persistent monetary debasement, such as the one created by our fiat money today, systematically distorts interest rates and leads to persistent capital misallocation. It is not compatible with a capitalist economy. It is unstable and, ultimately, unsustainable.

Mr. Schlichter is the author of "Paper Money Collapse: The Folly of Elastic Money and the Coming Monetary Breakdown" (John Wiley & Sons, 2011).

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