The Economic Dangers of the Fiat Money System: A Conceptual Analysis

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ABSTRACT

This study presents the Conceptual Analysis of the understanding, misunderstandings and the likely dangers of fiat money acceptance and usage among general masses. An attempt is made to validate the Austrian theory of instability of fiat money system via logical analysis. The objective of this research is to argue conclusively that the ever-increasing supplies of elastic money are the threat to the very stability of it. This paper elaborates on the origin and purpose of money and the unique characteristic with respect to its demand and supply. The beneficiaries of the paper money system are revealed to demonstrate how the system with its inherent disqualifications continues to run and flourish due to the benefits extended to certain segments of the economic system. Via conceptual thought process advanced by Humes, several models of money injection from simple to more complex and realistic approaches are adopted to argue conclusively that no economy can remain stable with ever-increasing supplies of flexible money. Money is not neutral, and any new injection of money distorts the market prices, creates misallocations of resources and disorients market participants. Investigating the feasibility of the fiat money system, this research endorses the fact that such monies can never act as a stimulant in every kind of economic activity without altering the very base of it.

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Highlights of this paper

- This study presents the Conceptual Analysis of the understanding, misunderstandings and the likely dangers of fiat money acceptance and usage among general masses.
- The objective of this research is to argue conclusively that the ever-increasing supplies of elastic money are the threat to the very stability of it.

1. OVERVIEW

For most part of the history, mankind has relied on gold and silver for its exchange needs. This distinctive functionality of precious metals as monetary commodities emanated from their characteristics like homogeneity, durability, divisibility and scarcity. These metals remained essentially fixed in their supply unless additional gold and silver was mined at considerable expense. On the contrary today's money is very differently created and used. Today's money, be it in the form of paper or a binary computer entry is all immaterial. The authorities that remain in the power of legally creating this money can produce unlimited quantities of it. People accept elastic money in exchange for goods and services. It does not matter if these elastic notes or bits on computer are backed by anything or not. They serve as money because people accept these as money units. The question is why has the world moved from inelastic to elastic money? Did it come into existence due to some pressing need of the market, or market forces made the ancient commodity money evolve into the present day fiat money? How reasonable is it to assume that a growing economy needs growing supply of medium of exchange? How reasonable is it to believe that today's most of the money is created because of the growing public demand of it? How convenient is it to purport that the constantly expanding money supply is the outcome of economic conditions and not the other way round. The purpose of this paper is to find convincing answers to such questions based on a conceptual and systematic analysis.

This research investigates the feasibility of the fiat money systems. The objective is to argue conclusively that no economy can remain stable with ever increasing supplies of flexible money. Money is never neutral and any new injection of it distorts the market prices, creates misallocations of resources and disorients market participants. It can never act as a stimulant in every kind of an economic activity without altering the very base of it. This analysis is built on theory, whereby the knowledge advancements by greatest minds in economics of classical times and some others from the Austrian School of thought, have been thoroughly referred to. The theoretical argument presented in this paper is based on Ludwig Von Mises' seminal work on money and business cycles. This analysis will make Mises' contribution relevant to the present day economies, to unveil most of the misconceptions under which mainstream money machine has been thriving. This analysis will start the theoretical analysis with some basic premises, while other insights will be arrived at with a careful logical deduction.

2. MONEY BASICS AND ITS DEMAND

2.1. Origin of Money

Money originally was never a creation of the state. It came into being by virtue of the market forces. Money is a social institution that came into existence because society discerned the benefits of extended human co-operation (Menger, 1871). Such cooperation was bound to facilitate division of labor and the trade between its participants. As the exchange started with the barter of goods, its limitations of Double Coincidence of Wants and Limited Divisibility led the market and its participants to innovate the creation of another good with much more marketability than the other goods. The selection of the secondary good was the beginning of creation of money, which was exchanged by people for any other good in want of its future usability in the exchanges. Some goods tend to have better marketability than others, it is seen when people are left to their choice as to what they would

use money, and they have always used precious metals like gold and silver. This has to do with the qualities deemed fit for an ideal medium of exchange (Rothbard, 1962). As many argue that money has naturally evolved into the fiat form that we use today, this view does not go with the logical understanding of the genesis of money. As Huelsmann states in his work "Ethics of Money Production", that it is not acceptable to a logical mind that money could have come into being via an authoritative system , or private person or an institution proclaiming its issued paper stamps as money. Though such a system is conceivable to exist today, however money could have only come to its being as a commodity (Menger, 1871). For an object to be used as medium of exchange, an initial value of reference is needed which is derived from its use value or exchange value with respect to other goods and services. An object must acquire a use value as a useful good before it is used as commodity money for the first time. However once the commodity sets its foot in the market as an acceptable medium of exchange , its value no longer is determined by its use value alone but also by the demand for its functionality as money. Only a commodity that has an established market value can qualify to transform into a medium of exchange. When gold and silver met this qualification their market value was not solely determined by the use value they bore in Industries and Jewelry making, instead people demanded gold and silver as monetary assets. When people demanded more gold and silver for their money use, naturally the prices of these precious metals also went up. Money as unique in its characteristics of serviceability may not suffice more if its supply is increased. The commodities that have use-value tend to fit into this rule, a greater supply of cars, TVs, bread etc. are likely to serve greater number of people. This does not hold in case of money, the usefulness of money emanates from its marketability only, in its general acceptance as a medium of exchange. The value of a commodity chosen as medium of exchange lies in its exchange value not its use-value. When gold and silver act as money alone, the increase or decrease in their supply will change their exchange ratio with goods and services. In other words the increase or decrease in supply will not alter the merits of the medium of exchange or make the society richer but will only change the exchange ratios.

Therefore it can be drawn upon logically that an economy using fiat money that stands to have only an exchange value and no use-value becomes no worse or better by increasing the supply of money. Except the extreme cases of scarcity and abundance, any quantity of monetary good is optimal (Mises, 1998). Economies that have more paper money or binary entry money are not wealthier. Economies that have more goods and services are richer.

2.2.The Concept of a Unique Demand for Money

The demand for money is usually misunderstood, resulting to considerable confusion and misconceptions. A question like "how much money is desired?" will always be answered in "unlimited". But that is not the demand for money that would be the demand for wealth. All people desire to have limitless wealth. What this desire means is the possession and control over goods and services, but not the demand for the medium of exchange. People don't want to hold all their wealth in the form of money. Holding money is at a disadvantage to other goods and services or claims to goods and services. Money cannot be used to satisfy a consumption need nor can be employed to produce a consumption good in future just as an investment good will do. Therefore holding of money comes with an opportunity cost. The only advantage that money holds to all other goods and services is its ready acceptability as a medium of exchange. The demand for money is not the demand for wealth but for a readily usable purchasing power.

How much money any individual demands is a subjective question but it depends vitally on the purchasing power of that monetary unit. People would want to hold more gold as money when its purchasing power is lower. By the same token, nobody has demand for specific quantity of fiat money; just as when gold is money nobody has a

demand for the specific amount of gold. Demand for money is actually the demand for a readily exercisable purchasing power. It follows that every quantity of monetary asset is just sufficient.

The question is what if a society wants to increase its money holdings, would that requirement need a money producer? The answer is 'No, a money producer is not needed.' The demand of money always gets satisfied by a change in its purchasing power. This may not be a case with the demand for consumption goods like Cell Phones and cars. Additional demand for Cell Phones and cars can only be satisfied with additional production of the same. But this is not true for Monetary assets, as money has exchange value and no use value, the extra demand for money is tantamount to extra demand for its exchange value which can be met by an instant drop of prices, i.e. the rise in the purchasing power of the monetary unit. A wonderful feature of the demand for and supply of a medium of exchange is that it is harmonized by the changes in purchasing power, and not by the tunings of physical supply of monetary units. Therefore one can conclude that no new money needs to be produced to serve extra demand for it or in other words a society does not need a money producer. Any quantity of money is optimal.

The logical conclusions that follow this discussion can be put as:

This precisely explains why economies can grow and function with inelastic commodity money, a counter argument to the circles who believe that an institution has to meet a growing demand for money in a growing economy. This fallacy has actually stemmed from an inaccurate transfer of laws of supply and demand from the domain of goods and services that are demanded for their use- value to the domain of money, which is demanded only for its exchange value.

2.3. A Distinctive Position of the Elastic Money Producer

The reasons that warrant the distinctiveness of the monetary asset from any other good are logical enough to distinguish the position of the money producer from that of the producer of any other good. The good 'money' can be produced very inexpensively, principally at no cost. Since marketability stands as the characteristic money is desired for, it can be sold and distributed in any quantity more easily than any other good or service. The producer of money can immediately use it to exchange goods and services. Since other goods that have use – value meet certain needs of people, their salability is restricted by demand of the very characteristics that they tend to satisfy. When uninvited amounts of money are produced and distributed by the money producer, each extra monetary unit will be produced with a lower purchasing power. This is a logical extension to the argument that a higher demand for money is satisfied with an increase in purchasing power, a higher supply of money can be absorbed by way of a deterioration of the purchasing power. The reckless production of money poses no risk to the money producer as he will never have a situation of inventory pile up in the warehouse, a restriction that keeps the producers of other goods in check.

2.4. Misconceptions of Fractional Reserve Banking

2.4.1. The Demand for Money Does Not Mean Demand for Loans

Banks do not extend the money supply in response to a higher demand; the participants of the fractional reserve banking do so not in the desire to meet the need for higher cash balances. Individual do not take loans to simply hold additional cash. The demand for loans is actually the demand for wealth that the borrowers borrow to buy goods and services. They are perceived to have higher demand for goods and services and lower marginal demand for money. On the contrary the seller of goods and services has increased demand for money. Fractional reserve banking is not determined by the loan demand; instead the former regulates the later. The demand for loans is considerably determined by the level of interest rates allowed by fractional reserve banking. Banks can easily

expand their loan portfolio by altering the interest rates and can place large amounts of money in the economy irrespective of the state of its demand.

2.5. The Instability of Banks

Fractional reserve banking is a risky business, as it involves selling rights on themselves which banks know they can't honor all the time (Mishkin, 2014). If the banks stick to this stable reserve ratio and will not lower it, the money supply expansion will come under halt. Under the pure gold standard, banks may not be able to reap unlimited benefits and add to their instability as the aggregate money supply though larger than under 100 percent reserve banking will only be a multiple of the fixed reserve the banking system can acquire. The reserves can only increase due to an increase in the mined gold brought into circulation. Central banks would not be able to create extra reserves under gold standard (Schlichter, 2011). This leads us to a conclusion that under commodity money standard banks may not be able to increase continuously the money supply by way of fractional reserve banking unless they change their required reserve ratio.

2.5.1. Cheap Credit Means More Prosperity

Most of the intellectuals and commons in the nineteenth century believed and propagated the idea that the cheap credit, sourced from the fractional reserve banking backed by the state support, is crucial for a nation's prosperity. Even today in the 21st century, this comes as a strong argument in favor of the elastic money. The booms created by fiat money expansion are seen independently and in separation from the inevitable busts they bring forth (explained in greater detailed in later parts of this paper). Much of the developments in the business cycle theory from Mises and Hayek made it clear that a credit driven boom in contrast with the one driven by pure savings, was bound to meet a correction later. Viewing corrections not part of the credit expansion, booms became desirable and measures were taken to postpone the inevitable recessions.

3. MONEY INJECTIONS AND THEIR EFFECTS

This part of the paper is going to discuss elaborately the consequences of discretionary money injections via systematic analysis. The initial model is an unrealistic one with simplified assumptions; complexities are added as we move on to more advanced models of money injections.

3.1. Money Injection without the Introduction of Credit Markets

The analysis that is going to follow is actually a thought process developed by David Hume in his article "Of Interest" 250 years ago. This analysis is very simple but can help understand to a considerable extent, the effects of expanding money supply. Three different situations are analyzed to see how the extent of money injection and the information in the market can have implications on the economic parameters.

3.1.1. Uniform and transparent Money Injection

In this simplistic model of money injection, we assume that the money holdings of all economic agents are increased by the same percentage and all economic agents are aware that money holdings of others have increased by this percentage. This can be conceptualized as if the money producer by magic increases over night the money possession of all individuals in the economy by the same percentage, say 10%. And in the morning when people transact, the seller knows that the buyer's money balance has increased by 10% and buyer also knows that the seller's money balance and the money balance of all economic agents has increased by the same percentage. The

economic agents clearly understand this process of uniform money injection. They know that their economy has not become richer, they just have additional 10% of medium of exchange, corresponding to which there is no increase of goods and services to buy with it. The very rational outcome of this injection would be an increase in price level with an equal proportion. Since all people hold their desired cash balances at any point of time, this would be case even before the injection. After the money injection every body's supply of money increased by 10%, therefore prices have to increase by 10% such that everybody's demand for money increases by the same proportion. In the market scenario all sellers knowing that buyers money balance has increased by 10%, will charge extra 10% for the goods and services. Buyers having the capacity to pay extra 10% will be willing to pay according to the seller's demand. The result is a 10% rise in prices of all goods and services. Only in a model as simplistic as this we can say that an increase in money supply brings a proportionate increase in price levels. The macroeconomic parameters like Price level and Nominal GDP will change proportionately, with no change what so ever in the real GDP.

3.1.2. Uniform but Nontransparent Money Injection

In this model we assume that the money injection is not transparent, i.e. not all the economic agents know that everybody else has received the 10% increase in his money holdings. This kind of alteration will help us achieve different results, even though the rest of the scenario is exactly the same. The individuals in this case can be grouped into two classes, the one that is aware of the uniform money injection and the other that does not comprehend the situation correctly and think that they are the only ones to get this money balance rise. The first group will comprehend the situation correctly and therefore will not change its consumption and production pattern but will only adjust the nominal prices. As producers the members of this group will charge 10% more for their goods and services and as consumers they will be willing to pay 10% more for the same. The members of the other group do not interpret the situation correctly; they believe that only their cash balances have increased in comparison to other members in the society. They find themselves in a better economic position than others, with a better capacity of purchasing goods and services. With this understanding the individuals find themselves wealthier than others. So in their role as consumers, the members of this group will increase their spending. This extra spending will be done on goods that come after the goods already bought on the marginal utility scale. The members of this group will spend this extra money on that most desired good which was not in their financial reach before. This could be any consumption or investment article. Therefore the consumption demand has increased and the new money has flown to the producers who produce goods and services desired at this level. The signal that this extra demand for goods and services provided to the producers is also misinterpreted by them. They are not able to discern the difference between the demand caused by extra money floating in the economy or by the changed consumer preferences or by their better competitive position compared to other producers of similar goods and services. Producers might engage in additional investment to meet this increased demand, which they think is genuinely driven by changed consumer preferences or their improved competitive position. The consumers who did not change their consumption pattern but just demanded more of the items that came next on their value scale will soon abandon this extra consumption due to rising prices all over. As the general price level will increase, these consumers will have to increase their expenditures on the goods and services that came first in their value scale. This will cause the extra consumption demand to vanish and producers who increased their investments in response to this false demand will have to abandon their projects.

The members of the group who interpreted that they only have received extra money balances could be consumers as well as the producers in their own economic roles. As producers they again misinterpret by assuming that their customers' purchasing power has remained unchanged and a rise in prices can make their customers

switch to other producers. So such producers will not raise the prices of the goods and services initially in fear of losing customers to the competition. The consumers will prefer such producers because they are charging lower than all others and the producers will experience a rise in the demand of their goods. This customer demand will be misinterpreted as a change in the customer preference or in producers' competitive position, to an extent that producers start expanding their business and invest more. The real cause of increased demand is the lowered prices rather than a change in any genuine parameters. Producers will soon come to senses as the rising prices all over will make them pay more on their investment and consumption goods. They will have to abandon their investments and lift the prices also. Those customers who purchased temporarily from such producers, actually benefited at their expense. In this scenario the money producer has succeeded in achieving a higher GDP growth and higher inflation by expanding the money supply. He was able to achieve this by uniformly raising people's money holdings but by obscuring this information from some. This is not the only outcome of the money extension, we have seen at the end some individuals were richer (those who did not misinterpret the situation and made their purchases at lower prices from those who were adjusting slowly) and others will be poorer (those who were late in increasing the prices of their goods and services). This situation has caused the permanent changes in resource allocation and the distribution of income.

3.1.3. Non-uniform and Nontransparent Money Injection

This model depicts a more realistic scenario of money producer, producing money and not distributing it to all entities uniformly. The money producer will just print money and expend it in the purchase of goods and services in the economy. The initial recipients of this money will be the businesses or individuals the money producer buys from. The economic agents will pass this money on to other producers when they purchase their goods and services. The additional money that came to the initial recipients did not change their demand for money and hence some of this money went into their further consumption of goods and services. The money expansion reaches to the next group of people and so on. When this money transmission process kicks in, it takes a while for this money to cross from one level to another and finally gets dispersed completely throughout the economy. This model is very close to the real world money creation process. In the real world money can't be distributed uniformly to all individuals, it reaches various segments through a step by step process, which eventually alters the resource allocation and the income distribution. Since fresh money does not make its way evenly into the economy, it is unreasonable to expect that price will move up proportionately.

This model of money injection is bound to create losers and winners. The biggest winner is the money producer itself, as due to the seignorage the issuer gets to keep the difference between money's face value and cost of production, i.e. the profit on money production which the money producer reaps to the maximum. The first stage recipients at least up to a couple of levels in the money transmission chain get substantially benefited from the money expansion process. When money reaches the level of producers who have discerned the increased demand of their goods, these producers will demand relatively higher prices from the group who stand before them in the money distribution channel and have relatively higher nominal spending power. Therefore at each step additional upward pressure would be exerted on the prices of goods and services. Clearly closer the economic agent is to the money producer in the distribution chain, more advantageous his position is. As he got hold of the new money before its effects on price had materialized, the early recipient of new money is the winner. The income distribution and relocation of resources will permanently be disturbed and will depend on the location of an economic entity in the money distribution chain.

The money distribution process slows down at every level. As prices rise during the money transmission, people will tend to restore their purchasing power and hence will demand more money. So additional money would be retained as voluntary cash balance rather than distributed further. At early stages when new money has not lost its full purchasing power, people have greater incentives to spend it. But at later stages when the purchasing power of the new money has deteriorated due to higher prices, people will desire to keep it as part of their cash holdings. Therefore, steadily the money transmission process will come to stand still. Definitely the GDP figures will be boosted as this new money finds its way into the economy due to a number of additional transactions. As money distribution process comes to an end and extra money is held as part of the voluntary cash holdings, the additional transactions will come to a halt. A bunch of economic activities that emanated from the first money production will come to an end. The money injection that lifted the GDP statistics temporarily has completed its course, but has left the resource allocation permanently disturbed. Every time a money injection is made, it is bound to reallocate the resources. The GDP growth recorded is not only temporary it is of different nature. Brought about by the money expansion which was not needed and demanded, this discretionary interference will not lead to better use of resources or improved human cooperation or fair income distribution.

3.2. Money Injection via the Credit Market

Interest rates are set in an economy by the interplay of human preferences. Not only interest rates signal the time preference but also have the potency to encourage or discourage the investment activities in an economy. Higher interest rates signal that the present need of consumption goods is not satisfied and resources need to be allocated more towards production of consumption goods rather than investment goods (Bawerk, 1909). At any point of time, the productive structure of an economy reflects the status of time preference of its players. The prevailing interest rates communicate effectively whether the existing resources are allocated to the consumption or towards the production. The new money via the medium of loan market enters the economy at lower interest rates, indicating low time preference. The new money at lower interest rates will signal the producers to start new and more capital intensive projects (Mises, 1998). Entrepreneurs will be encouraged to tie up the economic resources in the production of investment goods like plant and machinery that will allow the more efficient production of consumer goods already in demand at present. In order to carry on with their investment projects, entrepreneurs will pass this new money on to other producers of intermediate goods like tools and machinery. The scarce resources like labor and other factors of production that were previously employed to produce consumption goods, will be relocated to the production of investment goods albeit at higher returns to the factors allowed by new money. The first line of relocation of resources is clear now. It needs to be noted that the new money has not seeped through the consumer goods market yet. However, at this stage the early recipients of new money have raised the labor, other factor prices and the prices of intermediate goods they employed in the production of the capital goods. This stage will witness a hike in prices of some investment goods. The GDP statistics at this stage will definitely show an upsurge as the consumption would not be lowered much and investment will have increased by a larger extent. As some of the resources have been relocated to the production of investment goods from the production of consumer goods, fewer consumer goods will arrive at the market. The shortage of consumer goods will be felt in the market, this is the point that demarcates the additional production brought about by mere money printing from the one brought about by genuine savings of the people. This demarcation begins to develop forces working opposite to what has been happening so far. If the increase in the production of investments goods was brought about by real savings instead of credit expansion by banks, people would be ready for this relocation of resources. It would not occur at the expense of reduced consumption that economic agents were not even aware of.

Since the voluntary consumption pattern is unchanged, while the consumer goods availability has shrunken, an upward pressure on consumer goods prices is likely to be developed. Can consumers pay higher prices? The answer is no as the new money has not reached all segments of the economy yet, it is still concentrated in the hands of investment good producers. On the contrary the producers of new intermediate goods and their workers have received higher incomes and are in a capacity of paying higher prices for the consumer goods. The producers and their workers benefit from the new money at the expense of workers working in other sectors who have not received the new money yet but have already faced the increased prices of their daily consumption. They start demanding higher wages to compensate for the hike in the prices of consumption goods. Another redistributive expression on money injection comes into play here. As the aggregate measures of inflation concentrate on consumer goods, the CPI or other measures will pick up at the later stages of the process. At this point, it is impossible for economic agents to tell whether the changes of increased income in certain sectors and rises in consumer and investment goods prices, are the result of voluntary savings or the money printing. The money expansion has distorted market signals which in turn have disoriented the decision making capability of economic agents making them participate in activities not based on fundamental consumer preferences. The exploited segment of the society, the consumers who are bearing the brunt of higher prices without being compensated by new money or by their employers yet, find it impossible to meet their consumption with the level of money holdings they used to hold before. They will resort to either selling of assets or to reducing their saving level to make it up for the maintenance of their current consumption. Clearly, the interest that they receive on their savings has also been artificially lowered, therefore they will have enough incentives to lower their savings and exert upward pressure on the interest rates, and hence interest rates start rising. Had the shift in resources come according to the consumer preferences, they would not alter their consumption and saving decisions in a way that counteracts the prevailing trend brought about by artificial money injection. Higher consumer prices and raised interest rates will disrupt the entire process that was put on track by the money injection. The producers who in response to the money injection, had shifted their resources from consumer goods production to the investment goods production, will find it less beneficial to do so. Since faced with higher funding costs for their new loans or roll over loans to maintain their investments, they will be discouraged to continue. The rising prices of consumer goods on the other hand, will make shifting back to the production of consumer goods look lucrative. The rising consumer prices and rising interest rates signal high time preference in an economy. Consumers need more consumer goods and they need it in present state of time. The society is not ready for the investment infrastructure that the money expansion had erroneously conveyed to the market participants. So the investment boom initiated by the money creation process is bound to be thwarted by the very outcomes of it. The above explication describes how credit cycle gets ensued, in which the period of credit expansion creates a bliss of additional growth and investment but leads to the unmaintainable production structure and distorted system of relative prices. Such readjustments, to achieve the preferred production structure and prices, will be postponed by another cycle of money injection. Whenever the money stops to flow in the economy, recession is bound to emerge. The recession is the necessary correction by which the economy is cleansed of the ill effects caused by the earlier boom, and the preceding added up mispricing and the misallocation of resources. Consequently, the adjustment will be prolonged and harsher if the artificially induced boom is larger and induces more severe dislocations of prices in the economy.

The given explication of the boom bust analysis due to elastic money expansion has been derived from the Austrian theory of Business Cycle whose foundation was laid by Carl Menger. Ludwig Von Mises (1881-1973), contributed significantly to the theory of money. This theory purely explains the boom bust cycle on the merits of

money injection process. It does not take account of arbitrary influences due to lack of animal spirits, drop in aggregate demand, lack of investment opportunities or the tendencies to save or hoard money.

4.THE BENEFICIARIES OF THE PAPER MONEY SYSTEM

Despite the inherent disqualifications paper money persists to be used and experimented by our society, the prime beneficiaries of the paper money system need to be analyzed.

4.1. Banks as the Prime Beneficiaries

Banks and wider financial industry benefit largely from the paper money infrastructure. Banks enjoy the privilege of money creation at no cost via fractional reserve banking and lend it to the non-bank public at a return called interest. This is very profitable to banks. The wider financial sector also benefits immensely from the money creation as they are the first recipients of new money, allowed to enjoy undiminished purchasing power as compared to those who receive this money later when prices are already elevated. The growth and expansion of the financial sector after introduction of fully flexible paper money in 1971 comes as no surprise to us. At its onset most of the paper money was channeled into the financial and real estate sectors, thereby allowing the owners of such asset to benefit at the expense of people engaged in other sectors of the economy.

4.2. The Benefits to the States

After the world accepted fiat money system globally, democratic governments depended heavily on borrowing from the financial markets and inflated largely the outstanding public debt figures (Hoppe, 2005). Governments not being in the business of producing goods and services, rely on sources like taxation or borrowing to meet their expenses. When the governments tend to borrow via government bonds, the state is claiming a wider control over the presently available resources than it can have by way of taxation. If the government didn't borrow from people's savings, more resources would likely get allocated to other private sectors that the society deemed profitable. The government actually crowds out any private competition for savings. The funds that states acquire from borrowing get channeled into consumption rather than into investment via redistributive programs. An economy with hefty amounts of outstanding public debt, governments fund substantial consumption, to an extent that the significant amount of accumulated savings are backed up by mere promises of the state to allow the bondholders participate in the state led future expropriation. The wealth generating capabilities of an economy get hampered by a government's higher levels of taxation and high borrowing (Hoppe, 2005). The ease available to a state with which it can borrow more heavily due to its printing abilities allows government spending beyond the levels supported by the taxation.

Another benefit that a fiat money system promises its holders i.e. State and banks is the advantage of continuous inflation. The fairly static commodity money allows a moderate return on money over time via steady appreciation of the purchasing power. The risk averse individuals in an economy would prefer to accumulate their money rather than invest in more risky ventures of debt and equity. This feature in not only absent but is just opposite in a fiat money system. Risk averse individuals who do not have expertise and relevant information to invest in other productive sectors tend to invest in government bonds to evade the disadvantage of loss of purchasing power in a fiat money based system. Therefore the system of continuous inflation is favorable for the sale of government bonds.

The Central Banks create money at zero cost and lend it to the other banks at interest or just buy interest bearing securities with the newly created money. The government pays interest to the Central bank when buying

bonds from it, and later collects profits from the Central Bank. Further the Central Banks were created to live upto their purpose of monetization of government debt. Central Banks create money by buying government bonds and paying for them by crediting the account of the seller, thus monetizing the government debt. Government bonds are considered safe and hence provide the foundation for money creation; it is however it's this feature only that makes it safer than other assets.

Another benefit of paper money creation to the state that is usually not pondered over is the ability to reap the benefits of artificial short term booms in taxation. It has become vital for the governments to harvest higher tax amounts coupled with money creation privilege to finance their ever growing expenditures.

5. THE INEVITABLE ENDGAME

Mises in his book 'Human Action' has written, "There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved" (Mises, 1998).

The view that fiat money system is more superior tool that Central Banks can use to combat the crisis, has become the zeitgeist of modern times. Recessions can be postponed by continuous money injections, however once the point of unavoidability is reached neither additional money printing nor Keynesian deficits can help attain the solution. Recessions are actually corrections that the economies need to go through to cleanse them off the effects of previous misallocations. Additional money injections can manufacture short term recoveries but will add to the unresolved dislocations rather than clearing them. The accumulated dislocations cause impediments towards self-sustained growth and make economies very sensitive to any retardation of the flow of money. Consequentially, the huge and unavoidable crisis occurs as an inevitable endpoint of the process. The phases that the state elastic money follows before it meets its endgame are given below:

5.1. The Nationalization of Money and Credit

The start point is the occurrence of new bubbles in debt, equity and real estate claims, the assets which easily function as collateral for money induced additional lending. The economic agents cannot persistently believe that the exorbitant appreciation in these asset prices is a result of strong economic fundamentals and not unlimited money creation. Secondly, the balance sheets in banking and financial sectors become hefty enough not to accommodate further leveraging. The governments via Central Banking keep extending the credit to keep contractionary and deflationary forces at bay. The state will assume completely the role of the borrower of the last resort to the Central Bank's lender of last resort action, to bring the entire lending and borrowing process under its direct control. This will be the beginning of the nationalization of money and credit. The full nationalization of money and credit is simply the system's logical end point (Schlichter, 2011). As the misallocations continue to accumulate, more urge from the market forces towards the correction process get exerted, while the money printing policies adopted by the state to protect the credit edifice go antagonistic to the market forces. The printing of additional money will be directed to other areas of state intervention, like legislation, regulation and taxation. States will actively bailout the ailing private investments like pension funds via legislative and regulatory intervention. It will act as a precursor to more state run pension schemes. Policy makers will resort to taxing heavily the financial sectors, hence the beginning of outright capital controls. Citizens will have problems in controlling or moving abroad their financial assets. States relying on the cheap credit and circumvention of deflationary correction can never let market forces interfere with government policies.

5.2. The Monetization of Debt

States transfer the solvency risk from private sector to public sector and tend to socialize the consequences of excessive borrowing as long as the society does not question the solvency of the state. The lenders to the state will demand higher risk premium in the form of higher interest rates, a condition that the state exactly cannot cope with. This is the point where state will start direct monetization of its debt by the medium of Central Bank. Eventually, the government spending has to be financed by the printing press.

The next step will entail the use of money printing not only to fund state spending but also the corporate spending and ultimately consumer spending. Politicians may not see results as significant as they expected. The aggressive expansionary policy execution will deliver only meagre results. Definitely, the impact that most of the humongous money creation shows is only absorbed by the maintenance of the overextended credit structure created in the past. The central banks will try to give momentum to the economic activity by bypassing financial markets entirely and buying corporate and consumer debt which means lending directly to corporations and consumers. This is the stage where Central Banks enter the business of retail banking. Central banks will purchase credit card loans, auto loans and other consumer loans which eventually will be followed by direct funding of retail lending e.g. lending to credit card users (Schlichter, 2011). This inevitable phase of economic policy, if continues to go in line with existing goals will lead to ever larger sections of society depending crucially on the new money coming from the central bank.

At this point the rises in general price levels would be seen considerably, as here it constitutes a more of a transparent type of the money injection, whereby economic agents are well aware of the general increase in money holdings of others. The purchasing power of money will deteriorate drastically, as people cognize that the income flows, inflated asset prices, solvency of banks and that of the state, are the result of money printing.

5.3. The Inflationary Meltdown

Historically, it has been the threat of immediate consequences that have kept those who remain in authority of printing money, from breaking this dreadful cycle. Some might have continued in a hope of finding a less painful way of coming out of the grips of the cheap credit menace than putting their printing presses on halt. One thing to know with certainty is that the paper money has to see an unavoidable and painful end to it. When immense inflationary forces build up, policy makers feel urged to change their policies to save the currency. Again it remains dilemmatic; to what extent the existing government has the courage and resolve to let the market forces unfold and to let the economy face the consequences. Interestingly all the previous policy efforts that led to the deterioration of money's purchasing power, will need to be steered towards saving every bit of it. All the previously dominant goals like saving banks from the collapse, maintaining the overextended credit edifice, preventing the state institutions from going bankrupt, will need to be subordinated to the goal of protecting the established fiat money. The first step towards saving the fiat money would be to allow higher real interest rates, with whatever consequences that follow. The controllers of the fiat money will have to accept that the economy must go through a correction and deflationary recession should be allowed to cleanse the economy of dislocations of resources and prices. The market forces will triumph over the artificial boosts that the state relied on so far. One important point remains, when will this happen, before the money is destroyed or after (Schlichter, 2011).

6. CONCLUSION

This paper has endeavored to deduce logically the economic dangers inherent to the elastic money system. The financial crisis of 2007 has exposed the instability of our financial system. Much of the debate is being carried out in

this paradigm now, however if the understanding of the mainstream is laden with misconceptions, no relevant analysis can be expected to be drawn. With this predisposition, first of all the misconceptions regarding demand and supply of money have been tackled here. It is rationally explained that the demand of money is not like the demand of any other good with use value only, when the demand of money changes it adjusts instantly the purchasing power of the monetary unit. Similarly the supplier of the money is also at a unique position, as his supply does not correspond to the demand of money but to his own willingness and benefit to supply money. Banks and States are in no position to know the demand for money; instead their creation of money goes irrespective of demand of the same. An argument on why elastic money system, whose supply is not fixed but is constantly expanding, is inherently unstable and is bound to lead to the economic disorder by the very nature of it, is conclusively put forward. A very logical explanation, derived from the Austrian School of Thought, has been used to analyze the step wise effects of money injections under various scenarios. An excursion into the sequence of events leads us to the conclusion that recessions can be postponed by continuous money injections, however once the point of unavoidability is reached neither additional money printing nor Keynesian deficits can help attain the solution. The inevitable endgame though dilemmatic yet critical, will leave those who remain in control of money with no option but to save the paper money they had established. At this point all the policy structure will be shifted to salvage the dying money and let the market forces prevail, or if the courage to attain the shift in policies is mustered after the money is destroyed then a new currency system will have to be created.

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