Honest Money Is the Best Policy

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People the world over recognize the U.S. dollar. Above George Washington's portrait, the words "Federal Reserve Note" carry a promise in which many people trust. It's the promise of honest money that holds its value.

Some $375 billion today circulates in the United States and abroad. Not only is the U.S. dollar held more widely worldwide than any other currency, estimates indicate that more American currency is held abroad than in the United States. What U.S. citizen touring abroad hasn't seen U.S. currency used in exchange for goods and services? American money circulates in Mexico, Israel, Russia, virtually every foreign country. Today, the U.S. dollar is the world's currency of choice, and it has been for several decades.

This popularity does not mean, however, that the dollar faces no competition from other currencies, or that an infinite supply of U.S. currency should be made available to the world. In fact, the dollar's widespread use in foreign countries raises several questions. Do foreign holdings of dollars help or hurt Americans? And what, if anything, should be done to safeguard the dollar's value? Understanding the answers to these questions lies in understanding how the government finances its spending and, in particular, the role of seignorage.

Seignorage is the volume of goods and services that governments buy with the fiat money they print. *Fiat money* is paper currency that's not backed by gold or other tangible assets. In effect, seignorage is an alternative to income taxation for financing government spending. The United States' seignorage opportunity has been somewhat unique. Because 50 percent or more of all U.S. dollars are held abroad, foreigners, as well as U.S. citizens, bear the burden of U.S. seignorage. So, seignorage not only substitutes for income taxation, it also represents a means of "taxing" foreigners. Seignorage amounts to a small gift to U.S. citizens: the "taxes" paid by foreigners holding dollars reduces the amount of income taxes that must be collected from U.S. citizens.

If U.S. taxpayers benefit from seignorage, why doesn't the Federal Reserve make the dividend even larger by printing more currency and raising more seignorage from foreigners? The answer is because people worldwide seek honest money, an attribute the U.S. dollar would quickly lose if the Fed abandoned its pursuit of low inflation. By limiting the amount of currency in circulation, the Fed can provide a stable-valued currency and keep the dollar competitive against the numerous alternative currencies available to the public, such as the German mark, the Japanese yen and the Swiss franc. Inflationary policies would undermine the dollar's value and send dollar-holders to a more honest currency.

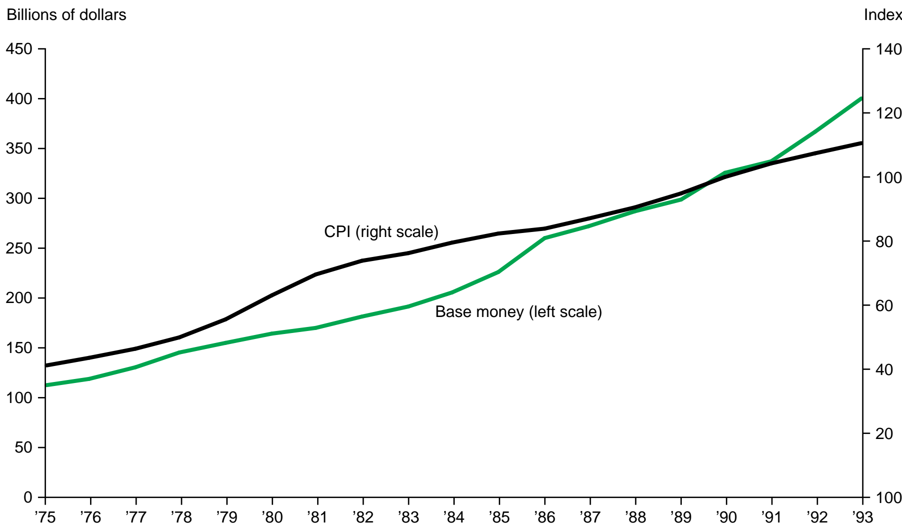
When it comes to raising revenue, honesty is the best monetary policy. The best monetary policy imposes its own internal discipline, limiting the amount of currency printed. From time to time, people call for a form of external discipline—a return to the gold standard. Americans taxpayers, however, can benefit more from a fiat money standard in which the value of currency is stable over time than from a return to the gold standard.

Fiat Money or Gold?

Until August 1971, the United States maintained the gold standard, a monetary policy that backed every bill in circulation with gold. Under the gold standard, the number of dollars circulating was determined solely by the quantity of gold held by the Fed. Consequently, a gold strike in Alaska, California or anywhere else that added to the Fed's gold reserves meant more money could be circulated. Conversely, a loss of gold reserves meant the Fed had to take an equal amount of currency out of circulation.

An attractive feature of the gold

Chart 1
Base Money and the Consumer Price Index



standard was that it imposed an external restraint on the Fed. Without additional gold, the Fed could not add money to the economy. Money was backed by gold reserves, so sustained episodes of inflation could not occur. If paper money was devalued by inflation, people traded currency for gold, which reduced the money supply and put the clamps on inflation. Hence, the value of money was dictated by the official dollar price of gold.

Today, the Fed does not back each bill with gold. Instead, the value of fiat money is maintained through the Fed's restraint in maintaining honest monetary policy. The reason a fiat money standard can make people better off than they would be under a gold standard is simple. Under the gold standard, huge quantities of precious metal had to sit in Fed warehouses to back the currency. A fiat standard lets people benefit from seignorage and releases the gold for people to enjoy, benefits that accrue as long as the Fed pursues a stable value of the dollar and refrains from excessive money creation.

Taxes or T-bills?

To understand the effects of seignorage, one needs to understand how government pays for its purchases. Government can pay for goods and services by taxing, borrowing, or printing currency. Under today's fiat money standard, budget revenue is raised through seignorage when the Federal Reserve buys U.S. Treasury securities in the form of T-bonds or T-bills. Essentially, the Fed trades currency for Treasury debt, indirectly paying for the Treasury's purchases. (If the Treasury paid off its debt, the fiat money would effectively be backed by the Treasury's taxing authority. However, historically the Fed has written off the Treasury's obligations.[1])

Seignorage is an alternative to income taxes or greater public indebtedness, not a free lunch. Overreliance on seignorage violates the honest money principle and amounts to an attempt to get something for nothing. But the economics of supply and demand prevent that from happening: if supply increases, the price falls. For money, the price is its value—how many goods and services it can buy—and the rate at which money's value falls is inflation.

Chart 1 provides evidence of the close correlation between changes in the money supply and the price level, which is used to gauge inflation. The chart plots the amount of currency in the hands of the public

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plus bank reserves (base money) and the U.S. consumer price index for 1975–93. The two lines are nearly perfectly correlated, indicating that rapid growth of the supply of fiat money lowers the dollar's value through inflation.

Between 1993 and 1994, the United States raised about $31 billion through seignorage. This sum represents about 1.6 percent of federal spending. On the surface, it might appear that a higher level of seignorage would yield greater tax savings for the U.S. taxpayer because the Fed, in effect, could export some of the seignorage "tax" to foreign countries. That policy, however, could have unintended results.

The Temptation to Tax Foreigners

Researchers have coined the term "dollarization" to describe what happens when the dollar or other foreign currency circulates along with a local currency.[2] Estimates indicate that U.S. currency circulating abroad is between 50 percent and 78 percent of the total, or between $187.5 billion to $300 billion of the $375 billion in circulation.[3]

A comparison with the German mark highlights U.S. dominance as a supplier of currency to the world. German marks in circulation today total about 250DM billion. Suppose, for example, that 33 percent of all marks were held outside Germany. Then roughly 83DM billion, or, at today's exchange rate, the equivalent of about $52 billion, would be held outside Germany. Even if *all* marks in circulation today were held outside Germany, they would be equivalent to only about $167 billion, still smaller than the most conservative estimate of U.S. dollars circulating abroad.

The volume of U.S. dollars circulating abroad means that non-U.S. citizens bear part of the seignorage burden. And while a government that overtaxes its constituents may be ousted at election time, noncitizens holding dollars in foreign countries don't vote — so why not raise the seignorage "tax"?

Such a temptation is tempered by market competition. The more inflationary monetary policy becomes, the less attractive the currency becomes as a store of value. Dollarization occurs in some countries because the public doesn't trust the local currency as a store of value, frequently because inflation in the country has been high in the past. So, the hint of inflation can cause people to exchange one foreign currency for another that seems more stable. In short, the dollar's dominance could be lost quickly if the Fed suddenly increased seignorage and caused people to question the dollar's future value.

And if the Fed reversed its monetary policy course, creating money at a much faster rate, then extensive foreign holdings of U.S. currency could exacerbate the effects of inflation fears. As foreign dollar-holders' confidence in the dollar eroded, they would trade dollars for another currency they perceived as more honest, potentially en masse. In economic terms, demand for the dollar would fall sharply, pushing inflation up even faster. If the Fed failed to reduce the supply of currency to match the lower demand, the inflationary consequences would be made worse by the volume of U.S. currency being unloaded abroad. The ensuing mass reversal of currency flows — from foreigners to the United States — could prove overwhelming.

Incentives for Honest Money

The trust people around the world are willing to place in the U.S. dollar owes largely to the United States' reputation for keeping its promises and its track record of monetary stability. Through seignorage, the dollar's popularity abroad yields a dividend for American taxpayers that was not available under the gold standard.

Proponents of the gold standard cite its low-inflation record. These

days, money's stable value during the gold standard has come to be associated with gold per se. However, the gold standard ultimately worked because of restraint, the restraint to hold gold's dollar price constant rather than make periodic revaluations. In short, it is the commitment, not the commodity, that makes paper money hold its value—then and now. The real standard is honesty, not gold.

Thus, as long as the Fed can maintain its commitment to honest money, the nation can enjoy the benefits of a stable dollar. With so much U.S. currency in circulation, the government could be tempted to cash in through inflationary money creation. But excessive seignorage hurts everyone holding the currency. And while world markets have selected the U.S. dollar as the currency of choice, that status could disappear quickly if U.S. monetary policy stirred doubts about U.S. money.

Honest money is the right policy. For both U.S. citizens and the rest of the world, honest money makes good on the promise that a dollar today will be worth a dollar tomorrow, and honest money is what the Federal Reserve works to achieve by pursuing low inflation and practicing restraint.

—Joseph H. Haslag

Notes

[1] Technically, the Treasury does pay principal and interest on these debts, but historically the Fed has returned all principal and interest payments to the Treasury. See W. Michael Cox, "Two Types of Paper: The Case for Federal Reserve Independence," *Southwest Economy*, November/December 1992, for a description of the Treasury–Fed interaction.

[2] At minimum, the country's government can ensure some demand for its currency by requiring that taxes be paid in it.

[3] See Richard D. Porter and Ruth A. Judson, "The Location of U.S. Currency: How Much Is Abroad?" unpublished mimeo, 1995. In addition, see Robert D. Laurent, "Currency in Circulation and the Real Value of Notes," *Journal of Money, Credit, and Banking* 6 (2 1974): 213–26. Laurent estimated that at most 2 percent of currency is lost, for example, by being at the bottom of rivers or privately destroyed.

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