

Chapter 9

Global Finance, Inflation, and Local Currencies

Future students of history will be shocked and angered by the fact that in 1945 the same monetary system that had driven the world to despair and disaster (in the 1930's), and had almost destroyed the civilization it was supposed to stand for, was revived on a much wider scope.

-- Jacques Rueff[50]

Why Central Governments and Central Banks Don't Like Local Currencies

A headline in a major daily newspaper reads, **Cash-Starved Argentine Provinces Turning Out Their Own Money** (see Figure 9.1).[51] The story tells of two remote provinces which were printing their own money in the form of small denomination provincial bonds (basically, IOUs of the provincial governments), and paying their employees with it. This "to the chagrin of national and international banking authorities."

But why should the national and international authorities (namely, the International Monetary Fund) be chagrined over provincial measures to provide their own exchange media? The stated reason, according to the article, is worry that the consequent expansion of the money supply would undermine the central government's efforts to reduce the inflation rate.

This may seem rather odd considering that it is central governments and central banks themselves which are the cause of inflation. Ralph Borsodi expressed this in no uncertain terms when he presented the following "facts":

1. "The first is that inflation is *dishonest*. It is a form of embezzlement. What is worse, it is a form of legalized embezzlement. Those who ignore this fact in effect condone it. And there is no excuse whatever for condoning any form of stealing.
2. The second fact is that the inflation is *deliberate*. It was planned. It is in actuality a sort of conspiracy entered into by nations and those who represented and participated in the International Monetary Conference held in Bretton Woods, New Hampshire in 1944. It is an on-going conspiracy still being carried out by all the nations which are members of the International Monetary Fund. The dishonesty involved is therefore deliberate.
3. The third is that it is *unnecessary*. None of the so-called reasons, none of the excuses and rationalizations of those who are responsible for inflation or who condone or justify it, have any real validity.
4. The fourth and final fact is that almost without exception those leaders of the world who say they are against inflation and claim to be fighting against it, are *lying*. It is a

lie to say that you are against something which you are in truth advocating. It is a lie to say that you are against something which you are in fact deliberately doing. It is a lie to advocate doing a little of what in fact should not be done at all. It is a lie to say you are against stealing, when you are in fact saying that a little stealing is alright. It is a lie to say that a little inflation, say two or three percent, is not stealing, but that a lot of inflation, say ten or twenty or thirty percent, is all wrong."[52]



Figure 9.1: News Clip About Argentine Provincial Bonds

This story about the Argentine provincial bonds is another instance of the conflict between exploiter and exploited. We see, on the one hand, the central government, supported by the international financial hierarchy, attempting to maintain its control over the entire national economy via its control over money creation and circulation. We see, on the other hand, the provincial authorities implementing measures to ameliorate the effects of central government

and central bank policies which have been damaging to their local economies. By supplementing scarce official money with their own money issues, the provincial governments counter the stifling effects of the central government's and central bank's policies. These policies include alternating monetary expansion and contraction, mis-allocation of credit to finance privilege and to increase central power, and domestic "austerity" imposed upon the people to pay for it.

The Real Cause of Inflation

In order to understand the exploitative nature of centralized monetary control, it is first necessary to understand what inflation is, and what really causes it. Much of the problem of understanding inflation stems from the confused definition which economists use. A dictionary definition provides a good illustration of this confusion. Here is what it says: "Inflation 2. *Economics*. An abnormal increase in available currency and credit beyond the proportion of available goods, resulting in a sharp and continuing rise in price levels." [53]

In this definition we see the conventional "wisdom" reflected. We see a presumed cause, "an abnormal increase in available currency and credit," coupled with an observed effect, "a sharp and continuing rise in price levels." But this presumption stands upon shaky ground. It is more apparent than real. Let us hold in abeyance the question of cause, and define inflation as the effect -- a rise in the general level of prices of goods and services -- for this is the essence of the problem.

Since the price of something is an expression of its value relative to the money being used to value it, an increase can result in two ways. First, it can be due to people valuing the item more, or secondly, it can be due to people valuing the money less. Conditions of supply and demand can cause price adjustments of particular goods or commodities. But when the prices of most goods and services are rising simultaneously, that invariably reflects a debasement of the currency in terms of which the prices are stated. Sellers demand more money because each unit of money is worth less than it was before.

So to summarize, inflation is a rise in the general level of prices of goods and services, and its cause is the debasement of the official currency. Few economists seem willing to acknowledge official debasement as the root cause of inflation. Fewer still offer any effective remedy. Most orthodox proposals seek only to limit the rate of debasement, not to end it.

It is not the amount of money in circulation, per se, which causes inflation, but the basis upon which the money is issued. Money which is improperly issued can be viewed as counterfeit, albeit legal counterfeit. It is counterfeit, not because its issuance is unauthorized, but because its issuance violates sound principles of money and banking. The mixture of such counterfeit money with legitimate money, since they are indistinguishable from one another, causes the debasement of the entire money supply.

We have already seen how the issuance of money on the basis of interest-bearing debt causes a chronic insufficiency of money in general circulation. The primary cause of inflation is the issuance of money on the basis of ever increasing and unrepayable debt, primarily that of central governments (to finance perpetual budget deficits). This is called "monetizing the

debt." It is an abuse of power which is almost universal among governments in the modern world.[54]

Other improper bases of issue include capital investments, such as tools and machinery; speculation in land, real estate, stocks, and other securities; and consumer credit. Surely, capital investments, construction, and consumer durables need to be financed, but they ought to be financed out of savings of money already in existence. New money which is created on the basis of anything except the exchange of goods and services coming to market represents a debasement of the currency and will cause inflation of prices in the market.[55]

The irresponsible and unsound banking practices which give rise to inflation can be compared to a farmer watering his milk. The farmer who takes his milk bucket to the well can increase the volume of fluid (milk mixed with water) but the volume of real milk remains the same. The total amount of nutrients in the bucket does not change. If the farmer tries to sell the mixture as pure milk he is defrauding his customers.

Real value comes from the efforts of producers, not from debt which is never intended to be repaid. Money issued to finance goods, in or on the way to market, is legitimate; it represents the milk of the economy. Money issued to finance the government debt is valueless; it is like water, diluting the value of every legitimate dollar in circulation. It allows the government to take more value from the economy than it ever will put into it. It is for this reason that inflation has been called a "hidden tax."

It is astonishing that even the most respected economists still prescribe "massive government spending" as the medicine required to end an economic recession. Implicit in this prescription is the intention that this massive spending will be financed, not out of increased tax revenues, but by the creation of new money. This is like telling the farmer that the way to end the malnutrition of his customers is to add still more water to his milk.

To completely understand the monetary problem, we should look not only at inflation, but also at its opposite, deflation. The dictionary definition is: "Deflation 2. *Economics*. A reduction in the general price level, brought on by a decrease in the amount of money in circulation or by a decrease in the total volume of spending." [56] This time the dictionary correctly defines deflation as, "a reduction in the general price level," but the definition again includes a presumed relationship with the amount of money in circulation.

But again, it is not just a matter of the amount of money in circulation; it is more a matter of banks not lending for things they should. When banks lend for purposes they should not, while neglecting to lend for purposes they should, the result is simultaneous inflation of prices due to debasement of the currency, along with decline of economic activity (recession) due to inadequate amounts of money being issued to the private sector for productive purposes.

Given a choice between inflation and deflation, inflation is considered by many to be the lesser of evils. But that depends upon your point of view and the source from which you derive your livelihood. When there is more money sloshing around (even if some of it is counterfeit), the little guy may be more likely to get a bit of it from within the private sector. On the other hand, when banks are failing to lend enough new money into the productive

sector in a mistaken attempt to control inflation, they bring about defaults and bankruptcies, which, in turn, cause greater unemployment. Thus, many people are cut off completely, while those who are able to maintain some source of income fare well because of falling prices.[57]

Those who lose their jobs, farms, or businesses can only hope for direct government payments in the form of welfare and unemployment benefits. In either case, when government appropriates more of the nation's wealth by deficit spending, it is able to dictate the direction of economic activity. Greater numbers of citizens are required to do its bidding, either in the military, as employees in the government's bureaucracy, or by working for its corporate and academic minions (engaging in such activities as designing and building weapons, space and scientific boondoggles, and infrastructure development to benefit favored interests). Others, who lack the requisite skills, have little choice but to suffer the indignities of being "on the dole." The central economic planning for which socialist and communist countries have been so roundly criticized has, unfortunately, become the modus operandi of the "capitalist" west.

To sum up then, when the government covertly takes value out of the economy (which is evident from budget deficits and ever-increasing government debt), the people pay for it in either of two ways --recession or inflation. In a recession, some people are deprived of their share of the total product as a result of losing their jobs, their businesses, or their homes, or having social programs cut. When the debasement of money causes inflation, the dollars people get don't buy as much as they did before.

A recession is like the farmer refusing to deliver milk to some of his customers, even though they have already paid for it, so he can keep more milk for himself. Currency debasement is like the farmer adding water to the remaining quantity of milk so that, while he may continue to deliver the same amount of liquid to each of his customers, that inferior liquid (milk mixed with water) will provide them less nourishment and satisfaction.

Of course, it is possible for governments and central banks to use both strategies simultaneously, doing some of each. It has long been recognized that the existing economic structure requires a trade-off between unemployment and inflation, and public policy decisions have made this a primary focus. But economists are still scratching their heads trying to explain the more recent experience of simultaneous inflation and recession.

With that foundation laid, let us return to our story of the Argentinean provincial currencies. More up-to-date information has become available through an article by Argentine native Jose' Reissig which appeared in the English journal, *New Economics*.[58]

The province of Salta, in 1985, was the first Argentinean province to issue bonds in small denominations and to spend them into circulation. One such bond in the denomination of 100 Australes is shown in Figure 9.2. By 1986, according to Reissig's article, three neighboring provinces, La Rioja, Jujuy, and Tucuman, had followed Salta's lead in issuing bonds into circulation. As of the end of 1991, they remained in circulation and comprised an important component of the money supply in those regions. "The bonds have become an intrinsic feature of the economy of Salta. Today they are more in evidence than the national australes, amounting perhaps to 60 percent of all currency in circulation." [59] Reissig further

states that in the province of Tucuman, provincial bonds at that time provided about 43 percent of the exchange media.

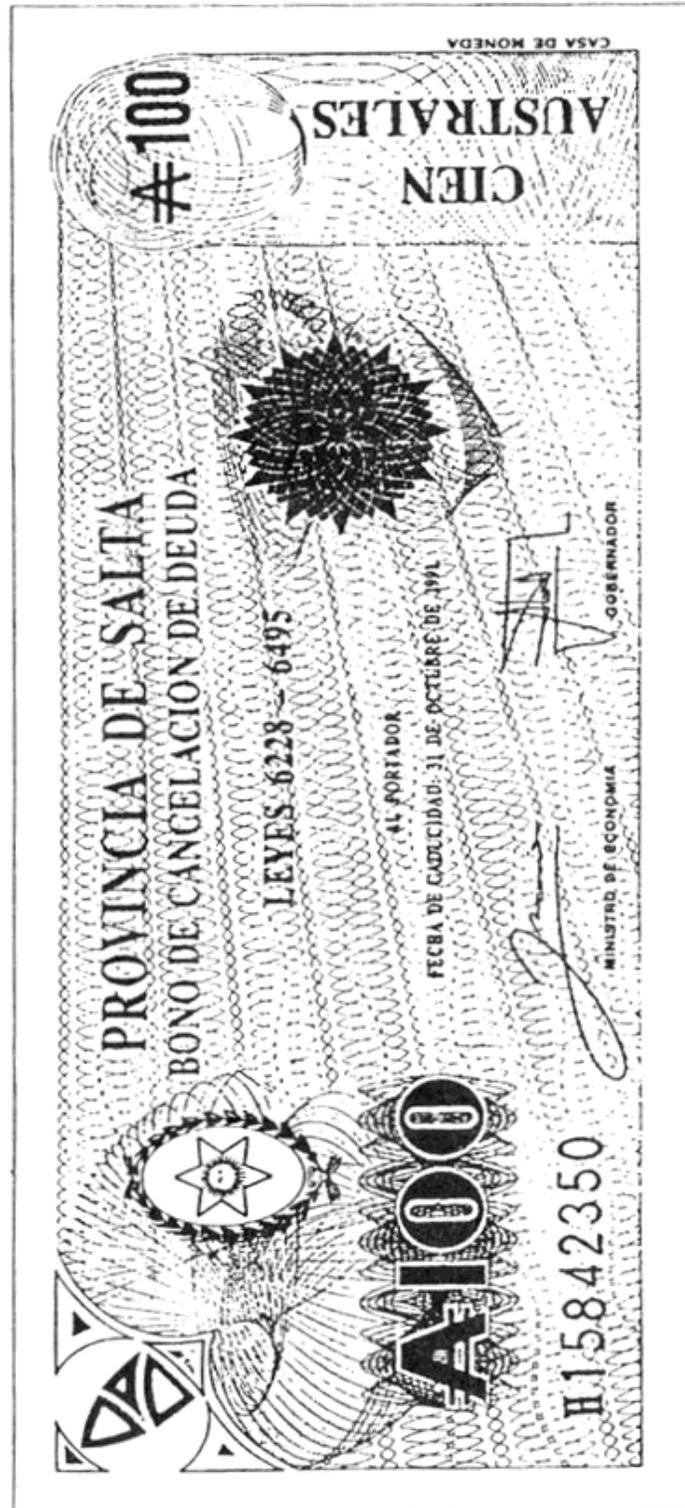


Figure 9.2: A Circulating Bond of Salta Province

It may seem surprising to find that these bonds were still circulating, and that the central government had not been willing (or able) to suppress them. Reissig speculates that it may be simply because the provincial bonds, while providing a large portion of the exchange media in the provinces that issued them, constitute a relatively insignificant portion of the total money supply nationally.

This case provides an opportunity to consider two of the critical questions which relate to local currencies. First is the question of what happens to a local currency which is denominated in the same units as the national currency which is being debased (causing inflation)? A second question is, what are the factors which make a local currency credible enough to be accepted? Let's consider these in turn.

The bonds were denominated in terms of the official unit of account, which was the official currency unit, the "austral." [60] They typically mature in about four years from the time of issuance. As the official currency is debased (inflated), the official unit of account loses more of its value. Since the provincial bonds are denominated in the official units, they will also depreciate along with the official currency. At the inflation rates typical of the recent past in Argentina (ranging from 95 percent to several hundred percent per year, except for a couple brief periods of stability), this is enough to make the bonds almost worthless in terms of purchasing power over the period of their maturity. This factor is taken into account by those accepting them. As with the official currency, no one intends to hold onto them for very long.

As Reissig says, "The bonds make it possible for the provincial government to share in the revenues of the inflationary tax." That is true enough, but it is clearly not the primary intention of a provincial government in issuing them. The dependence upon an exchange medium which must be imported from outside the region (official currency), makes the local economy dependent, to a large extent, upon the central government and/or central bank. In order to acquire official money, it must subordinate regional priorities to the demands of the central government in order to obtain a share of government spending, or it must compete for loans from the banking system, or it must earn official currency by exporting products and services out of the region. If local needs are to take first priority in the local economy, the local economy must be able of itself to mediate internal exchanges; it can do this only by using an exchange medium which is not controlled by outside agencies.

According to Reissig, a native Argentinean, prices in that country are now widely quoted in terms of U.S. dollars, and "many firms are doing their accounting in U.S. units." While the U.S. dollar has also been subject to debasement (inflation), it has provided a relatively stable unit of account compared to the *austral* and the currencies of other less developed countries.

As for the factors which may provide credibility and acceptability of the provincial bonds, Reissig mentions the following:

1. The time factor -- the provincial government was willing to pay its employees in either its provincial bonds or official Argentine currency; however, they could receive the bonds immediately, while they would have to wait a few days for the official currency.
2. The provincial bonds could be exchanged at the local banks for official currency at par.
3. For a period of time the provincial government used the bonds as the basis for a lottery, making the bonds serve also as lottery tickets (the lottery was discontinued in 1987).
4. People in the region soon realized that the circulation of a limited, local currency had the effect of stimulating local businesses.
5. The provincial government agreed to accept its bonds in payment for provincial taxes and services.
6. The Chamber of Commerce agreed to accept the bonds.[61]

It is possible that the provincial authorities might also abuse their power by over-issuing bonds, but they would pay a high price in doing so. Since there is no forced circulation of the bonds, and since they must compete in the market with the official currency, over-issuance would cause the bonds to trade below par relative to the *austral*. This would cause a loss of revenue for the provincial government, since they would still have to redeem the bonds at par. According to Reissig, there has been some abuse of this sort in the province of Salta. During one period in 1987, the Salta bonds were being discounted by as much as 20% with respect to the official Argentine currency. This situation was remedied, as one might expect, by a temporary suspension or slowing down the rate of issuance of the bonds.[62]

Recent information from Argentina indicates that the provincial government of Salta was planning, as of March 31, 1992, to redeem its bonds for official currency, using a loan obtained from the central government. Just prior to this time the bonds were again being debased as indicated by the fact that they were being traded at an approximately 15% discount from the official currency. It is not known whether the other provinces were planning to follow suit in calling in their bonds.[63] One can only speculate as to the reasons for this action, but it is not too far-fetched to consider that it might be related to the results of the 1991 elections and the provinces' changing relationships with the central government.