Pegged money is an option on base money and since options don’t reduce value of base securities pegged money doesn’t reduce value of base money.

2. "Pegged money is to credit what gold coin is to bullion—the same thing in a different form. We cannot imagine that they would affect prices."—J.S. Mill, quoted in Viner.

3. As new money pumped into system, equal quantity is taken out as govt securities—Samuelson, FRB of St. Louis Review, Sept. '73

Not true. This is actually like a firm that buys options it wrote with newly issued stock—this will raise prices. (Gov’t borrowing = writing options implies more options = pressure for more base money)

4. Issuing more bank deposits for govt bonds is like issuing more nickels for dimes. See Viner or Gregory

5. Suppose 3% of social wealth is in IBM stock. Then options are issued = 2% of social wealth. Seems that 1% of wealth is IBM stock, but extra 2% creates new liabilities = assets.

6. Suppose Argentina pegs peso. This is 1 byte of info. raises no affects on its value. Is whole idea of velocity...
7) What about McCulloch's paradox (1831) quoted in Viner, that expanding bank forces gold outflows, borne equally by all banks, expanding bank forces others out of business. (Write this out in reverse if banks contract.)

8) Option paradox might not hold for money even though it does for all other goods, if money has some unique property. And it does! "You can't satisfy an increased demand for bread by issuing bread tickets but you can satisfy increased demand for money this way." (Mises, p. 553). Also, "You can't ride a claim to a horse, but you can trade with a claim to money." (Schumpeter) It seems that to the extent that money gets its value from its monetary properties alone, its value can be affected by the issue of options. This is consistent with Ricardo's idea that pegged money replaces gold and lowers its value.

9) But suppose the unit of account is a chicken. Anyone who needs to trade only has to write out a chicken certificate — no need to suppose the price of chickens will be driven up because of their monetary properties. And the only people who will demand delivery of a chicken are the people who would have demanded a chicken anyway. Thus monetary usefulness might not increase a good's exchange value.
9) (cont.) Nobody would trade with actual chickens. Assuming complete trust, all trade would take place with chicken certificates, and there would be no increase in demand for chickens. People would use actual chickens (or gold, for that matter) only to the extent of their mistrust of others’ promises.

10) (Mises p 139) Stock of money always means an increase in the amount of money held by a number of economic agents. They are in a stronger position as buyers — not true — they borrowed the money. Might be true to the extent that discount rate gave them a wealth transfer.

11) (Mises p 259) Person with $100 to his name can lend $100. — But this is different than the usual process where bank loans out 90% of all money deposited — what’s the difference?

12) Common stock (an option on the resources of the firm) cannot be issued “unbacked” (i.e., a firm worth $10 cannot have stock worth more than $10). But options, and pegged money, can be (?) Maybe that’s the difference between pegged & base money.

13) Could consider gift certificates as money, but they are a claim to a certain dollar-amount of goods, not to money directly. This means they have no actual money backing at all.

14) IOU’s could serve as money if calculation is easy, a claim payable l.yr. from now could circulate for its discounted value. This requires (nearly) zero reserves => infinite money multiplier for (bills of exchange)?
15) If a country's money has value only because of its monetary usefulness, then if people begin to lose confidence in it, the value of the domestic money will fall. This leads to a vicious downward spiral in the value of domestic money. If monetary usefulness is the only source of its value, then there is no lower limit to its fall in value.

16) Borrowing money and spending it is just like borrowing stock and shorting it. Shorting doesn't reduce stock price. Stock lender can then sell the claim to the stock, or he can actually maintain fractional stock reserves.

17) If money has value because of its convenience for exchange, then it is only from its "marginal" convenience—how much better it is than the next-best money, such as gold. But foreign money could be even better than gold. Thus it seems nearly impossible for money's value to result from its convenience. This implies that money gets value because it is pegged to something—governments, assessments, contracts, etc.

18) An economic agent (e.g., a bank) could win a free lunch by "selling currency short"—borrow cash and sell it for real goods. There would then be both the original cash and the borrower's IOUs circulating and the money would depreciate. The borrower's real goods (purchased with borrowed money) will thus rise in cash value. This can also be viewed as selling call options on cash, buying real goods with the proceeds and thus depreciating the cash. But how to take profits? Would cash rise in value as the goods are sold back again? Maybe not if the borrower made a futures contract for the sale of the goods. Or borrower could repay debt in goods of slightly higher value than the money borrowed—but still might be a problem w/ the interest rate.

19) Schumpeter said "Can't ride a claim to a horse but can trade w/ a claim to money." He might have added that you can also trade w/ a claim to a horse. Could be that expansion of cash is offset by expansion of claims to horses (or whatever real goods secured the loan).
20) Possible that creation of pegged money goes hand-in-hand w/ a greater desire to hold cash-denominated assets (like bank deposits). In a sense, money creation is always matched by reduction in velocity (though don't like the idea of "velocity" means anything). For example, I hold much more of my wealth in the form of bank deposits (dollars) than I ever would in a world without banks.

21) (Wicksteed, p. 623) "when Italian copers were scarce their value didn't rise." The scarcity was met by other metals. Maybe popular stories of money scarcity are a result of the total value of the currency being insufficient to conduct trades. (Possibly because bank failures destroy pegged money). This could explain bi- (or tri-) mettallism. Also accounts for having several competing currencies. The idea is that scarcity of money doesn't add to its monetary value — it just creates room for other monies. (E.g., dollars circulate in Mexico because pesos are insufficient.)

Explanation for depressions: bank failures create shortage of pegged money but base money value doesn't rise as a result — instead economy is reduced to barter, and incomes drop.

22) Suppose kids at a 2-day summer camp buy things with scrip. Half of them get $20 on Saturday, and half on Sunday. They buy scrip with $10, with complete mistrust, nobody lends and the Sunday kids can't buy anything on Saturday. A Saturday kid spends $10 + $10 and a Sunday kid spends $0 + $20, for a total of $40. With complete trust, Saturday kid spends $0 + $20, for a total of $40. With complete trust, Saturday kid gives $10 to Sunday kid, Sunday kid gives $10 to Saturday kid, etc. The total spent is still $40 even though the money supply (including IOUs) is $70 on Saturday and $20 on Sunday. The IOU isn't spent since the Saturday kid wouldn't have loaned the scrip if he had intended to spend it. Loan expansion causes no change in desire to hold currency — it's just kept in banks instead of...
23) (Taussig, p. 307 ch. 4.23) Standard treatments start with depositors looking for a safe place for gold, and the goldsmith realizing that he can lend most of it. They don’t treat it as one person lending gold to another for an IOU. This is what is really happening, and banks are not a necessary part of the picture. This seems like a source of a lot of the confusion about loan expansion.

24) Might help to work out what happens if a foreigner (e.g., Englishman) lends money to someone in the U.S. Would we still have a loan expansion effect?

25) Wicksell, p. 173 “loans on absolutely sound security” — Doesn’t have to be absolutely sound. Naturally banks grant lower loans as soundness decreases. Wicksell makes Tooke sound like a real-bills doctrine advocate. Even if loans are granted on worthless security, the effect is just as if the money were stolen — no effect on value of money.

26) Wicksell p 173-q “return of the banknotes ... (un)important if banks continually reissue the notes”. This is wrong. As we see in observation #22 above, the fact that the money exists (as IOUs) is not the important thing. The key idea is that a lender wouldn’t lend if he planned to spend the money. Even though loan expansion is supposedly kept afloat by repeated loans (up to the last period) it doesn’t matter, since the money is not spent by both the borrower and the lender.

27) In a bank panic, govt. can print up cash for loan to banks suffering runs, and as long as money is loaned on adequate security there will be no inflation. It’s the same as if people who sold short or wrote calls are unable to get the stock to deliver. The corporation can actually issue new shares to these people (on adequate security) and there will be no effect on share prices since the resources of the corporation would be augmented by the loan collateral by an amount equal to the newly issued stock. Stock would be devalued if security is inadequate, and money would be devalued for the same reason — most commonly if it is loaned at far low an interest rate.
Similarly, (to #27), a firm that issues new shares to panicked investors could take advantage and raise the firm’s value (and hence stock price) by charging “hold-up” prices for newly issued shares. By the same reasoning, the govt. can charge hold-up interest rates and raise money values during a panic. This explains Friedman data showing currency constant, and prices falling seemingly in sync with M1.

Lending (like the Fed does) is ordinarily the way that pegged money enters circulation. This suggests that greenbacks are actually pegged (to U.S. govt. resources). It’s like a corporation that sells stock (or lends it—it doesn’t matter) for resources. If it gets high prices valuable resources for its stock, then stock prices rise. If it gets over-priced resources, or if it throws the resources away, then the stock price falls. Similarly, if the Fed lends at too low a rate, the value of money will fall, and if it lends at high rates, the value of money will rise.

Fallacy: “If A lends to B and B’s IOU is recognized and accepted, then A has as full use of the money as before.” This seems analogous to saying that a person who moves from P to C is just as capable of buying bundle P as before—a meaningless statement. It is confusing the point with the opportunity set. The key observation is that even though he can afford P he is not at P.

Problem: Increases in the required reserve ratio have been (I think) associated with increases in the value of money. Could this be explained analogously to a corporation that limits the number of options on short sales on its stock? Maybe higher reserves ⇒ higher interest rate on govt. loans ⇒ higher value of money as in #29 above.

Saying that taxes give money value is like saying that a firm can give its stocks value by accepting it as payment for goods it sells.
33) In the summer camp example (#22) kids have no reason to spend the IOU's. A lender will have $5 scrip each day, which is exactly what he planned to spend. The same is true of a borrower. If a Saturday kid spent his $5 IOU on Saturday then he would have nothing for Sunday and his weekend spending would still total $10.

34) Seems wrong to say paper money gets value because people have to hold it for turnover. If people had to physically exchange shares of stock to trade them that wouldn't make the stock more valuable. The effect would (I think) be like placing a tax on the stock.

35) Option experts make a big deal about "early exercise" of certain options. A call on base money, being always redeemable, has (I think) no reason to ever be exercised. Some kinds of money (e.g. bills of exchange) have a specific expiration date, and they trade at a discount. Most money has no discount, being always redeemable. Why is the non-interest-bearing money used when interest-bearing money is available? Is it just for ease of calculation?

36) With respect to #41, let A lend money to B, who uses it to buy a horse. If B can't repay the cash, A takes the horse. Thus A's claim on B is really only "a claim to a horse"—not a claim to money. The fact that the claim has a certain cash value does not mean that it constitutes so much additional cash in the economy.

37) (Regarding #29) If a company issues stock in return for resources more valuable than the shares issued, then the stock price must rise; vice-versa if the shares are more valuable than the resources. Doesn't the same thing have to be true of money? If the Fed prints a new dollar and lends it for an IOU with a present value greater than $1, the value of money must rise, and this would happen even if it were true (and it isn't) that paper money gets value because it is simultaneously scarce and useful for exchange.
38) If a firm repudiates its stock, then the stock will drop to zero, regardless of whether the firm is solvent or not. When the govt. repudiates its money, its value (I think) drops according to the expected chance of resumption.

39) Regarding #2, minting of gold obviously doesn’t affect value of coins or specie (except as the ratio between them is screwed up). The reason is as a coin is produced something (specie) of equal value is given up. Isn’t this also true when money is created by loan? If it weren’t true, wouldn’t there be a free lunch somewhere?

40) When pegged notes replace gold as money, then even if we admit that gold will fall in value (and I’m not sure of it), we still have to admit that the max fall in value is that portion of its value that the gold got from being used as money. This might amount to 20%. But when notes are issued in quantities 2 or 3 times as great as the gold replaced, then value of gold certainly can’t fall to 1/2 or 1/3 of its former level.

41) It would be easy for a corporation to reduce its stock value (or for the Fed to reduce the value of money) by making loans at low interest rates. It would be hard (impossible?) to raise stock (or money) values by lending at high rates (unless borrowers have become strapped, for example, by selling stock short or borrowing money). Thus there is a ratchet effect always tending to inflation. Deflation, on the other hand, is seen as a consequence of over-borrowing.

42) What about the shape of the yield curve? Does it give guidance as to the interest rate that would stabilize money value?
43) Friedman (Free to Choose p. 50) says U.S. accumulated gold at the start of the Great Depression. He says this shows the Depression started in the U.S. (highly questionable logic, but nevermind). However, it is exactly what my theory predicts as well. If a corporation is issuing stock to strapped short-sellers and call-sellers at “hold-up” rates, then of course the corporation’s wealth rises. If the Fed is lending notes at hold-up rates then of course its gold stock will rise and the value of the dollar will rise.

44) It seems like all it takes is to define the value of a “guinea” and from there on out people will create them by lending—no need to have them redeemable into a specific commodity. And what if all the loans are repaid? No ill effects. It’s just like dissolving a corporation and paying off shareholders.

45) What gives warn silver (or gold) coins value? Limitation of quantity? Peg to something else? Peg to new coins?

46) How about monopoly money? It gets value because it’s pegged to rents. Increase in quantity (accompanied by increased debt) will not deprecate its value but a low (negative?) interest rate on bank loans would.

3/29/91

47) Hard to reconcile idea in #29 with the seemingly proportionate relationship between money & prices. If value of money depends on backing of the Fed, then a doubling of it would double Fed’s resources & leave P unchanged. Maybe Fed is consistently getting from itself—really just a disguised way of printing money & throwing it away. Or maybe using Fed resources in a regression really would predict prices better than just using M.

48) Suppose a bank issues notes for gold at first but then begins issuing notes for other resources (e.g., bonds) so that the backing of the notes is (say) 20% gold & 80% bonds. Then the bank could suspend convertibility into gold without notes losing more than 20% of their value. If the gold isn’t actually gone the drop in value would not.
49) As a solution to depreciation of banknotes caused by over-issuing, Ricardo (in Sraffa, "Complete Wks of R. Ric.", p. 81) suggests buying back excess notes. But the bank would have to pay out resources equal in value to the notes it buys. Thus, its note-keeping resources fall, and the value of the notes is unaffected.

50) In fact, once banknotes have depreciated due to deficient backing, it is impossible to restore their value by restriction.

51) Ricardo, in Sraffa (Complete Wks of R. Ric., p. 140) talks about raising value of banknotes above that of gold. This would give a free lunch to banksters.

52) Monetarists' advocacy of limits on quantity of money is a violation of the freedom to trade—consistent with their libertarian reputation. Those saying meanwhile are not so adamant—sort of makes them libertarians.
60. The expansion of gold certificates may be matched by the expansion of iron certificates. Remember: "You can't ride a claim to a horse but you can trade with a claim to money." (But you can also trade with a claim to a horse.)

61. A corporation issues 10 shares for 10 oz of gold, then 90 shares for 90 oz worth of wheat (equal in value to 90 oz of gold), and then issues 100 shares in return for equal value of promises to return the stock (call options, e.g.). If the 10 oz. gold is stolen, then the remaining shares have a total value of 190 oz, or 9.5 oz each. The more shares issued on promises, the smaller the fall in value of each share. Thus, if a bank on a gold standard loses its gold, the banknotes will retain value to the degree of issue, in proportion to issue of notes for promises.

62. Fig. 1 shows Monetarist view of T.M. Income goes up, then down, then back to trend. But if Fed T.M by reducing r, the economy moves from p to p1 in Fig. 3. We're richer today, poorer tomorrow, just like monetarists would predict. Similarly, if Fed T.M by raising R we move from P to P1 in Fig. 2. Erk.

63. Insolvent bank that keeps operating would be an arbitrage opportunity. Sell gold claims short. Borrow all outstanding notes & present them for gold. No bank (private or gov't) can circulate notes in excess of its assets!
64) It seems like someone who finds an arbitrage opportunity (like over-valued bank notes) could make unlimited profits by making bets like: "I'll bet you a million dollars that the dollar will fall 1¢ against the pound tomorrow." There is (I think) a limit to this. An investor with a large enough bet has an incentive to manipulate the value of the dollar.

65) What about the idea that a thing's use as money raises its value? Doesn't this contradict the arbitrage rule in #63?

66) What about my former belief that money saved & not loaned out is so much less money pushing up prices?

67) A C.D. (or bill of $x) can be part of the money supply on Monday and part of money demand on Tuesday.

68) What happens to call options if a firm is legitimately liquidated? What happens to IOU's if the goldsmith liquidates?

69) Say a goldsmith gets 100 oz gold for which he issues 100 banknotes. Consider these different cases: (a) 10 oz of the gold is stolen. (b) 10 gold certificates (banknotes) are counterfeited. (c) 10 banknotes are lost (burned, let's say). (d) bank gets 10 more oz gold. Work out the effects in a world of convertibility & inconvertibility.

70) 10 oz gold stolen: with peg maintained, there is a run on the bank and 10 banknotes will be worthless. The expected value of each banknote is .9 oz. Without convertibility, its like 100 banknotes are claiming 90 oz. Value of each note must fall to .9 oz. If it didn't borrow the banknotes and short them and invest in gold to make arbitrage profit. But I'm not sure how to collect if the banknote values don't fall.
71) Common stock is inconvertible in the sense that the firm usually won't cash it in. It still has to have value ≤ firm value. Firm would be foolish to redeem since a wrong price would give arbitrage opportunities.

72) But since you can't liquidate gold bank hard (impossible?) to make arbitrage profits.

73) If 9 oz gold in vault can support $310 oz circulating banknotes why doesn't goldsmith just blow the 1 oz?