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Should Central Banks Accommodate Increases in Demand for Money?

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Commentary

Could an increase in the demand for money counteract the effect of an increase in the money supply? For example, if there were an increase in the *supply* of apples by ten and, simultaneously, an increase in the *demand* for ten apples, this would be completely absorbed. In other words, after individuals have satisfied their demand for ten apples, zero apples would be left.

Following this logic, it would appear that the increase in the supply of money could be nullified by an equivalent increase in the demand for money. Henceforth, for the economy to stay in stable condition, it is important that the increase in the demand for money is matched by the similar increase in the supply. Consequently, if the increase in the demand for money is not met by the increase in the corresponding supply, this is likely to produce price deflation.

According to conventional monetary policy, it seems that to prevent various economic shocks emanating from imbalances between the demand and the supply of money the central bank must make sure that supply and demand are synchronized. Whenever an increase in the demand for money occurs, to maintain economic stability the accommodation of the demand by the Fed adding to the money supply by inflation seems a necessary action.

Some commentators are of the view that the lack of a flexible mechanism that coordinates the demand versus the supply of money is the major reason why the gold standard leads to instability. It is believed that—relative to the growing demand for money because of growing economies—the supply of gold does not grow fast enough. According to a Business Insider from June 15, 2011,

“The basic problem is that the supply of gold is not related to the quantity of goods and services being produced .... As a result of this scarcity, prices decline. Individuals have less incentive to produce new goods and services. Economic growth is stifled.

“Allowing money to become scarce does the greatest harm to those who have the least. In the past, the relative inflexibility of the monetary system contributed to the chronic lack of growth in many of the world's less developed countries. Since the 1970s, we have had one of the most flexible monetary systems the world has known, and many of these countries have flourished. With a flexible monetary system, more money can be created to accommodate more growth."

The Meaning of Demand for Money

Demand for a good is not strictly demand for a particular good as such, but for the subjective service that the good provides. For instance, an individual's demand for food emerges because food provides the necessary essentials that sustain the individual's life and well-being. Likewise, the demand for money also arises because of the services that money provides. However, instead of consuming money, individuals demand money in order to exchange it for other goods and services in the future. Also note that money cannot be consumed, and it cannot be employed directly in the production of goods. According to Rothbard,

"Money, *per se*, cannot be consumed and cannot be used directly as a producers' good in the productive process. Money *per se* is therefore unproductive; it is dead stock and produces nothing."

Money's key role is simply to provide the service of a medium of exchange. Money facilitates the flow of goods and services between producers and consumers. With the help of money, various goods become more marketable—these goods can be exchanged for more goods than in the barter economy. What enables this is the fact that money is the most marketable commodity.

An increase in the general demand for money because of—let us say—a general increase in the production of goods, does not imply that individuals are going to sit on money and do nothing with it. The main reason an individual has a demand for money is ultimately in order to be able to exchange it for goods and services. Therefore, in this sense, an increase in the demand for money is not going to absorb a corresponding increase in the supply of money, as is the case with various goods.

Again, an increase in the supply of apples may be absorbed by the increase in the demand for apples (i.e., individuals want to consume more apples). Thus, the supply of apples, which increased by 5 percent, is absorbed by the increase in the demand for apples by 5 percent. The same cannot, however, be said with regard to the increase in the supply of money, which has taken place in response to the increase in the demand for money. Contrary to other goods, an increase in the demand for money implies an increase in the demand to employ money to facilitate transactions, not demand for money itself.

An increase in the supply of money by 5 percent is not going to be taken out of the economy because of the equivalent increase in the demand for money. Consequently, the increase in the supply of money to accommodate a corresponding increase in the demand for money is going to set in motion all the negatives that an artificial increase in the money supply does. The inflationary increase in the supply of money would set in motion the exchange of nothing for something. This, in turn, is going to set up for the menace of the boom-bust cycle and economic regression.

Individuals Demand Purchasing Power, Not Money Itself

Furthermore, by demand for money, what we really mean is the demand for the money's purchasing power. After all, individuals do not want a greater amount of money in their pockets, they want a greater purchasing power over goods. According to Mises,

"The services money renders are conditioned by the height of its purchasing power. Nobody wants to have in his cash holding a definite number of pieces of money or a definite weight of money; he wants to keep a cash holding of a definite amount of purchasing power."

Similar to other goods, the price of money is determined by supply and demand. Consequently, all other things being equal, if there is a decline in the quantity of money, its purchasing power will increase. Conversely, its purchasing power will decline when there is an increase in the quantity of money. Within the framework of a free market, there is no such thing as "too little" or "too much" money. As long as the market is allowed to clear, no shortage or a surplus of money can emerge. According to Mises:

"As the operation of the market tends to determine the final state of money's purchasing power at a height at which the supply of and the demand for money coincide, there can never be an excess or deficiency of money. Each individual and all individuals together always enjoy fully the advantages which they can derive from indirect exchange and the use of money, no matter whether the total quantity of money is great, or small ... the services which money renders can be neither improved nor repaired by changing the supply of money. ... The quantity of money available in the whole economy is always sufficient to secure for everybody all that money does and can do."

Hence, in an unhampered market economy, without the central bank interference, there is no need to be concerned with the "optimum" money supply growth rate. Any amount of money will do the job that is expected from money (i.e., it will fulfill the role of the medium of exchange).

Conclusion

If the Fed were to accommodate an increase in the demand for money with fresh inflation of the money supply, this "accommodation" should be regarded as an effective increase in the supply of money as such. Any "accommodation" by the Fed results in the artificial increase in money supply and leads to boom-bust cycles and economic impoverishment. In an unhampered market, without the central bank interference, any quantity of a market-selected money will correspond to the correct amount and no one is required to monitor and control this quantity.

From [Mises.org]

Views expressed in this article are opinions of the author and do not necessarily reflect the views of The Epoch Times.

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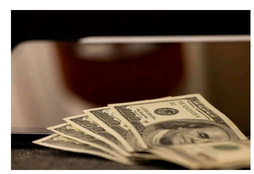

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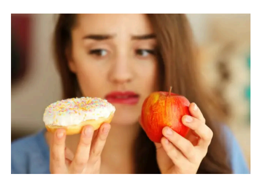

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