Market Money and Free Banking*

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If we want to have money, it must be something that cannot be increased with a profit by anybody, whether government or a citizen.

The worst failures of money, the worst things done to money were not done by criminals but by governments, which very often ought to be considered, by and large, as ignoramuses but not as criminals.

LUDWIG VON MISES
Speaking at the Foundation for Economic
Education, November 8, 1969.

Most people who write about money and banking nowadays from a free-market perspective criticize the Federal Reserve-and rightly so-for contributing to uncertainty by alternating between expansion and contraction. They point to the Fed-induced monetary manipulations that have led to the boom-bust business cycle. They criticize especially the Fed's arbitrary contractions of 1929-1933 and 1936-1938, which resulted in economic downturns and were alleviated only when monetary expansion resumed. They fault the Fed for sitting on its stockpile of gold and for not using it as a basis for further expansion. They object to the Fed's inconsistency, alternating between easy credit one moment and tight credit the next. At the root of their criticism there appears to be a belief, however, that a continual expansion in the quantity of money is not only desirable but also necessary for an economy to prosper.

As an alternative to national control of the monetary system, these free-market critics of the Fed would prefer private banking. In their view, private banks would be well able to satisfy the market's "need" for currency by issuing bank notes to satisfy the demands of their clientele. Such issues of currency would hold no threat of inflation, they say, for the issues would necessarily be limited by the competition of the issues of other private banks as well as by the obligation of each bank to redeem its notes in real commodity money according to terms agreed upon.

Private banks with the freedom to issue notes are certainly consistent with free-market theory. However, by starting from the premise that the very *purpose* of free banks is to issue currency, it would seem that the advocates of private banks ignore basic economics; they fail to consider, first, what market money is and, second, the basic role of banks in a free market.

Money is not a piece of paper with a dollar sign printed on it; money is basically a *medium of exchange*, something with market value that market participants are willing to accept in exchange. Second, banks are institutions dedicated to handling, safeguarding, lending, and / or managing the funds of depositors, according to agreed-upon terms. Emphasizing the note-issuing aspect of private banking assumes that the paper currency itself is money, (2) that the economy "needs" a certain supply of readily available paper bank notes, and(3) that a less-than- "adequate" amount of currency necessarily leads to economic disaster.

Everyone wants more money-you, I, our friends, families, employers, businessmen. It is not money per se that we want, but purchasing power; we want what money can buy-food, clothing, and shelter, of course, and also automobiles, televisions, computers, medical care, travel, and entertainment. There is practically no end to the wants we can satisfy if we have more money. Government too wants more money to buy things-guns, planes, highways, and the ability to pay its employees; it wants to provide health care, to take care of the poor and the elderly, to clean up pollution, to insure bank deposits, to give humanitarian aid to foreigners, to assist some foreign governments

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militarily, and so on ad infinitum. There seems to be no limit to the amount of money people would like to have.

Some people carry over into the field of economics the idea that each of us would like more money in his own wallet or bank account. They reason that if everyone would be better off if he had more money, then it should follow that the more money in the whole economy the more prosperous the whole economy would be. Some have even carried this idea to the extreme and have recommended that the government needn't collect taxes at all but may simply print all the paper money it wants, and hand it out to people on the theory that their spending will then bring prosperity. Of course, if this idea were really put into practice, the printed money would soon be so plentiful that it wouldn't be worth anything on the market; it would no longer be serviceable as a medium of exchange, and thus, also, it would no longer be any good as money. Producers would stop producing and there wouldn't be anything to buy-at any price.

Continually Increasing Money

Fortunately, economists see through such proposals and do not recommend the unlimited issue of paper money. However, many persons, unfortunately, believe that for an economy to prosper the total quantity of money in the economy must be continually increased.[1] They point to occasional monetary contractions (deflation) in this country and claim that the economy began to pick up only after the Federal Reserve began again to inflate. Deflation, they say, must be avoided at all costs. And most people believe it is the task of government and of the banks to provide the currency, to keep prices relatively stable, and to prevent deflation.

Private banking, according to its advocates, would eliminate violent monetary fluctuations. Private banks of course should be free to issue currency, but their notes would not be legal tender. Their paper notes would represent the medium-of-exchange-commodity on deposit at the bank and would be redeemable by the bank at any time. As such, their notes could become the community's money. But their status as money would have to be earned; it would not result from the mere issue of paper currency labeled "money". A private bank's notes would have to compete with readily marketable commodities, as well as with other bank notes, for acceptance as media of exchange. The bank would have to persuade market participants that its notes had value on the market, were generally acceptable to traders, and thus were reliable media of exchange.

The method for introducing the bank's notes into circulation and the interest rate it asked of borrowers would limit the effectiveness of supply and demand in checking under- and over-issue. For instance, a below-market interest rate would invite an increased demand for loans, which the bank could satisfy only by expanding its note issue; an above-market interest rate would discourage loan applications and lead to contraction However, it is true that the bank's willingness tc redeem on demand all its notes submitted for redemption would prevent any over-issue.

The monetary problems that the advocates o free banking are trying to solve, as described b; modern monetary economists, is very complex But this complexity is not a consequence of the economics of money. Rather it is caused by governmental, not economic, factors-especially the designation of government's notes as legal tender for the payments of debts. The complexity of the monetary situation is the outcome of many regulations and controls. To analyze the problem and the views of today's advocates of free banking, on must review some basic economic principles.

Medium of Exchange

There is really nothing complex about money itself. Money is simply a medium of exchange. Money came out of barter as a result of countless purposive actions of individuals. As the development of specialization and the division of labor expanded to encompass more and more persons, it became difficult and cumbersome to exchange goods for goods, that is, to engage in direct exchange, to barter. If Jones wanted to trade his output for things to consume, he was not always able to locate a would-be trader willing to take his goods and services in exchange for the precise items he wanted. As a

1. This article was sparked by Professor Richard H. Timberlake's three articles in The Freeman (April. May, and June 1999).

result, step by step, Jones and other would-be traders discovered in time that exchanging what they had for a more widely desired commodity would bring them one step closer to a successful exchange.

Traders came to recognize, as the outcome of countless voluntary exchanges, agreements, and contracts, that some particular commodity could serve as a generally useful medium of exchange in their community. Such a readily marketable commodity might be held for a while and then used later when a suitable trading opportunity arose. Thus, over centuries, perhaps millennia, money evolved. No government conceived the idea; it came out of the market. The medium of exchange in any community must be something that has market value, purchasing power. If a commodity is easily available and free to everyone, no one will be willing to take it in trade for what he is selling. Such a "free good" will never become a medium of exchange.

The availability of a medium of exchange was a big step forward toward economic progress. The name given to it is "money". Over millennia, many commodities have been used as money-gold, silver, wampum, tobacco, cattle, and more. As a result of voluntary transactions undertaken by countless traders over years, the various commodities used as money were finally narrowed down to practically only one-gold.

Although we now talk about our paper U.S. dollars as if they were money, we should never forget that whatever we use as money must be something people will take in trade. Only its tradability, its acceptability, assures that money is something you and I can exchange for things we want. It should be "something that cannot be increased *with a profit* by anybody, whether government or a citizen", lest that government or citizen take advantage of the situation to increase its quantity until it loses its value as a medium of exchange.

However, we should not dismiss money as unimportant because it is simply a medium of exchange. In today's world, almost every interpersonal transaction depends to some extent on a reliable money. It is essential for a viable economy. It enables entrepreneurs operating in a finely specialized division of labor to estimate production costs, calculate potential income, and anticipate future markets. It makes it possible for entrepreneurs to carry out far-ranging and complex financial transactions over long periods of time and across great distances.

Strictly speaking, the government-issued currency in use today, the U.S. dollar, is not money per se, It is a transmogrification of market money foisted on the people by force through the legal-tender laws. It is a derivative of the commodity -gold-that emerged over centuries as the market's medium of exchange. Similarly, privately issued notes would have to earn their reputation as reliable media of exchange to become accepted as money.

Banks and Banking

To understand money, it is important also to analyze banks and their economic beginnings. Banks originated as market custodians for funds entrusted to them by depositors. They soon began to serve as middlemen to help arrange financial transactions for customers. A bank's assets consisted of the funds left with it for safekeeping and money entrusted to it for managing and/or lending. If banks lent funds left with them for safe keeping they did so only at the risk that their depositors, who expected their money to be kept safe and available on demand, might ask for it and find it gone. However, experience taught bankers that all depositors would not ask for all their money at the same time; so a bank could lend a portion of these funds-if it was careful. The bank knew that the rate of interest it asked could influence a person to borrow more or less. If the bank lowered its interest rate, it could expand its currency issue and lend more *for its own profit*. But lending more increased the bank's risk. It always realized that such over-lending might be discovered and it would then have to make up the shortfall from elsewhere or face bankruptcy.

It is argued that expanding credit to lend more money promotes prosperity because it puts money in the hands of businessmen who can use it to good advantage. This argument depends on considering the "seen" and ignoring the "unseen". It ignores the fact that new credit over and above the available supply of savings can ge granted only by issuing loans at below-market interest rates. This means expanding credit artificially. Those who benefit from the additional new

credit, created *for the profit* of the issuing bank, are helped; they appear on the market ahead of others, bid up prices, and walk off with their credit-financed purchases. Those who do not benefit from the new credit, the savers on whose funds the expansion was based, are hurt. But they are not seen. Not having received any of the new credit, they do not become visible spenders; they are prevented by the beneficiaries of the new credit from using their own money as they wish.

Banks are expected, of course, to lend the money that savers leave with them for that purpose, sharing part of the interest earned with those who furnished the funds. But even in such cases, banks must be cautious. They soon learned from experience that the periods for which loans are made must be coordinated with the dates when the money lent has to be repaid to depositors. In other words, deposits that its customers could claim on demand at any time must always be redeemable from funds on hands. Funds to repay short-term loans must be financed by credits that will be repaid by the end of the short term specified. And long-term loans may be financed by funds repayable to the bank over longer periods. But those funds too must be back in the bank by the date when they must be repaid to the depositors. For instance, if a bank's short-term loans are backed by long-term mortgages, the bank would be in trouble.

The role of Government

Much has changed over the centuries since money first evolved on the market and since entrepreneurs first opened banks to serve the needs of persons who engage in money transactions. But the basic economic principles remain the same. To serve as money, a commodity must still possess widespread marketability as a medium of ex-change. And to remain in business private banks must still fulfill their obligations.

Governments have become more and more involved with monetary matters. It started when they were called on the settle disputes that arose over contracts. Courts and judges were frequently asked to decide whether the two parties to an agreement had actually complied with the terms agreed upon. Suppose one person agreed to ex-change bushels of wheat for money of the realm, and the other agreed to pay a certain amount of money for wheat. When the time came for the farmer to deliver wheat and the buyer to deliver money, one or both parties might object the other hat not complied with the agreement. It was then up to the courts to decide. Was the wheat delivered actually the quantity and quality specified in the contract? Was the money paid -whether gold, silver, wampum, tobacco, dollars, or pesos- actually "money" as called for in the contract? Only that, and nothing more than that, the courts and judges had to decide.

Government's role in the field of money was soon broadened. From the idea that courts must settle disputes over what was meant by "money" in specific cases, there developed the doctrine that money was whatever the government said it was. Governments took advantage of this situation. They not only decreed what money was but they expanded *for their own profit* the quantity of whatever they decreed to be money. Then they compelled people to accept that money in trade by declaring it to be legal tender for the payment of debts.

Counterfeiters try to piggyback *for their own profit* on a community's money. A government does essentially the same thing. In ancient times, governments clipped or adulterated their coins and then compelled the people to accept them at their previous nominal value. Later, with the invention of the printing press, it became easier to debase the currency. The government could simply declare anything to be money, even a piece of paper. Then government privileged certain banks and protected them from bankruptcy if they printed bank notes *for the profit of the government* over and beyond the gold or silver deposits in their vaults. And the government gave these bank notes legal-tender status. With the establishment of the Federal Reserve system in this country in 1913, the monetary system of legal-tender paper bank notes based on reduced gold and silver backing was formalized. In time the U.S. government itself, through the Federal Reserve, assumed the responsibility for issuing this country's currency. And these paper notes enjoy legal-tender status today.

The redemption in gold or silver of legal tender was at first discouraged and then halted completely. In 1933, it became impossible for citizens to obtain gold for their paper money, and they were eventually

prohibited from owning any monetary gold at all. The U.S. government even reneged on its own promises to redeem its bonds and debts in gold. In January 1975, U.S. citizens regained the right to own gold, but they are still compelled to accept the government-issued legal-tender notes. Throughout all the years since the Federal Reserve Banks opened, the quantity of legal-tender money has continually increased. And the market value, the purchasing power, per unit of this money has continually declined, reflecting the subjective value that individual market participants place on the dollar relative to other goods and services.

Inflation: More Money or Higher Prices?

One reason for confusion over money results from the changed definition of the word "inflation." Originally and traditionally it meant an increase in the quantity of money and / or credit, and it so defined in Merriam Webster's Second International Dictionary (1954).[2] Only in recent decades has the word been widely used to refer to one consequence of a monetary increase: an increase in prices. Granted, this new definition is now widely accepted, but that does not make it correct or expedient. Not only does it leave the language without a term for a monetary increase, but it shifts the blame away from the real culprits to the victims. While the U.S. government and the government-established Federal Reserve are responsible for increasing the quantity of money *for their own profit* and hence for causing prices to rise, it is the victims-businessmen, savers, workers, investors, consumers, and so on-who are blamed for asking or paying higher prices.

Now let us consider the Federal Reserve as "an engine of inflation." Granted, it is difficult to compare the number of dollars in circulation over the years. Statisticians frequently revise their "money stock" estimates, even changing what they include. However, there can be no doubt that there has been a tremendous increase in the number of dollars since 1913 when the Fed was established. There was a Fed-inspired monetary expansion from 1021 to 1929. In 1913, the country's "money stock" (gold, coins, and notes) was estimated at $3,798 billion.[3] On June 30, 1979, at the peak of the stock market boom, this figure had more than doubled to $8,538 billion, representing a substantial inflation. If market prices did not climb to the same extent during those years, as most economists agree they didn't, it is because the effect of the monetary increase on prices was hidden by increased production, due to the initiative, innovation, and productivity of entrepreneurs, creating a downward pressure on prices.

To return to the statistics, the money stock reported on June 30, 1930, dropped slightly from 1929 to $8,306 billion, but by June 1932, it had climbed to $9,004 billion. The Fed's figures show that the country's money has been increased more or less steadily ever since, bounding up especially during war years.[4] By the end of 1998, M2 figures came to $4,288.3 billion. And they continue to climb. If U.S. prices have not risen proportionately, it is due not only to the tremendous initiative, ingenuity, adaptability, and productivity of entrepreneurs but also to the mushrooming demand by foreigners to hold dollars-as their preferred medium of exchange-for their own security and as a hedge against the potential loss in value from inflation of their own country's currencies.

Being unable to trade in gold, and having long since been compelled to accept the U.S. legal-tender dollars in payment of debts, market participants have come to accept them by default as the best available medium of exchange. Having no other realistic alternative, entrepreneurs do their best to calculate their costs and potential markets in terms of dollars. In making business plans, they try to anticipate future fluctuations in the value of the dollar. And as long as the Federal Reserve practices relative restraint, market participants worldwide adjust and adapt fairly successfully. But in the last analysis, the market value of the U.S. paper/credit dollar depends on the judgement of fallible human beings who take into consideration, among other factors the political climate, the interests and profit of the U.S. government.

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2. It defines inflation basically as a "Disproportionate and relatively sharp and sudden increase in the quantity of money and credit, or both, relative to the amount of exchange business".

3. Statistics approximate, taken from the monthly *Federal Reserve Bulletins*.

4. The Fed's monetary statisticians apparently took a holiday in 1933 along with the banks. But they returned to the task after the gold stock was revalued from $20,67 to $35,00 per ounce by FDR's diktat. The value of the money stock as of December 3, 1933 ($17,470 billion) reflected the increased value of the government's gold holding. By December 1941, when

The Effects of Inflation

Supply, demand, and competition for the medium-of-exchange commodity are determined by the subjective values of market participants. This is true whether the medium is gold, a paper substitute for gold, a paper note decreed by government to be legal tender, or a private bank's paper note. Every dollar added to the existing supply of money to which the market has adjusted has at least three inevitable consequences: (1) it confiscates some wealth from anyone who owns dollars; (2) it upsets the calculations of entrepreneurs; and (3) it reduces purchasing power.

New issues of money and/or credit withdraw or extract some value, some purchasing power, from every existing dollar asset, whether in a wallet, savings account, bond, insurance policy, or debt payable in dollars. The value of every person's dollar holdings shrinks even as he sleeps. New issues of money and/or credit upset the calculations entrepreneurs made in dollar terms, distorting production, causing malinvestment, and setting the stage for a boom/bust business cycle. Of course, holders of privately issued currency that does not enjoy legal-tender status are not helpless; they may refuse to accept it if it loses value and turn to some other medium of exchange.

When the quantity of money is increased, the new money is passed form one person to another throughout the economy. But this takes time. Every additional monetary unit created-whether by gold miner, the printing press, credit expansion, or deficit financing (monetization of debt)-goes to some individuals first. It necessarily affects their value judgements, reducing in their minds the marginal utility of each unit of money. Those who receive the new money or new credit first benefit, feel more affluent, spend more freely, and are willing to offer higher prices for goods and services. Their demand for goods and services creates pressures on the market pushing priced upward. The delayed and uneven effect on the market of an inflation helps the early recipients of the new money at the expense of others. Those who do not receive any of the new money until later are hurt; they must pay the higher prices resulting from the pressure of the increased demands of the early beneficiaries before they get any of the new money themselves.

There have been many times in history when the value of money has dropped drastically because governments have increased the quantity/or their own profit. One of the most dramatic cases is that of the German mark after World Was I. By 1923, the number of German marks was increased by billions, the market value of a single mark fell practically to zero. The marks still enjoyed legal-tender status. However, they were no longer reliable and ceased to serve as money. Creditors engaged in all kinds of subterfuges to avoid being repaid in marks, and debtors tried various tactics to trick their creditors into accepting payment in the depreciated marks. Many other national currencies have suffered similar fates in recent years-the Bolivian and Argentine pesos, the Russian ruble, the Italian lire, the Thai baht, the Indonesian rupiah, the Hungarian forint, to name a few. Such examples show clearly that there can be too much money.

How much is Enough?

Any quantity of money is adequate because prices will adjust. Individual market participants, bidding and competing with one another, will bring the purchasing power parity principle into effect. They will bid more or less for units of money, and more or less for goods and services, depending on their subjective values. The purchasing power per monetary unit will tend to decline as the number of monetary units increases. It will tend to rise as the number of monetary units drops. In the end, the purchasing power per monetary unit will shrink or stretch so that the total available quantity of money, large or small, will suffice to purchase the available goods and services. Thus, any amount of money is enough money, if it is not changed abruptly or arbitrarily and if it is not made legal tender.

World War II started, the money stock had increased to $90,435 billion. By the end of the war, it had been expanded to $113,597 billion. In the 1950s, the U.S. gold holdings began to go down as other countries started to withdraw their gold from the United States. However, money stock statistics continued to climb. At the end of the Korean war (1955) it was approximately $133,3 billion. In 1971, Federal Reserve statisticians revised their money stock figures (M2 consisted of currency outside of banks, demand deposits at commercial banks) and backtracked, calculating M2 in 1964 to have been $273,8 billion. In 1971, Nixon stopped the sale of gold to foreign governments and foreign central banks. He devalued the U.S. dollar in December 1971, to $38 an ounce, and then again in February 1973 to $42,22. In January 1975, the U.S. government resumed selling gold and U.S. citizens regained the right to own gold coins and gold bullion. The price of an ounce of gold zoomed off the charts, indicating the extent to which the effects of inflation, defined as monetary increases, had been suppressed. After the end of the Vietnam War, M2 figures came to $576,5 billion.