Free Banking Explained

Free banking provides a stable and flexible supply of money, and allows the natural rate of interest to do its job of keeping out economy stable

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Free Banking is free-market banking. In pure free banking, the money supply and interest rates are handled by private enterprise, there is no restriction on peaceful and honest banking services, and there is no tax on interest, dividends, wages, goods, and entrepreneurial profits. Free banking provides a stable and flexible supply of money, and allows the natural rate of interest to do its job of allocating funds among consumption and investment, thereby preventing inflation, recessions, and financial panics.

To understand free banking, we first need to understand the relationship between capital goods and interest rates. Capital goods, having been produced but not yet consumed, have a time structure. Think of it as a stack of pancakes. The bottom pancake is circulating capital goods, which turnover in a few days, such as perishable inventory in a store. The higher levels take ever longer to turn over. The highest pancake level consists of capital goods with a period of production of many years, the most important type being real estate construction.

Lower interest rates make the pancake stack taller, while higher interest rates make it flatter. Think of trees that take 20 years to mature. Suppose the trees are growing in value at a rate of three percent per year. If bonds pay a real interest rate of four percent, and the interest rate is not expected to change, then the trees will not be planted, since savers will put their funds into bonds instead. But if bonds pay a rate of two percent, then the trees get planted. So the lower interest rate induces an investment in long-lived trees and steepens the capital-goods pancake stack.

In a pure free market, the time structure is in economic harmony, because investment comes from savings. If more folks save, the banks lower the interest rate to lend out the extra money, and the greater investment from borrowed funds is offset by the lower consumption of those folks saving their income instead of spending for consumption.

But with central banking, such as with the Federal Reserve system, an injection of money has the temporary effect of greater savings. Banks lower the interest rate to lend out the extra money. But folks have not changed their intended consumption, so the new investment battles with planned consumption for resources, and prices go up.

The fundamental problem with central banking is that the optimal money supply and rate of interest are unknowable. Another problem is that despite the technical independence of central banks from the rest of the government, in practice when the economy is down, there is political pressure for central banks to stimulate the economy with money expansion.

The key problem is that the artificially lower rate of interest induces greater investment in the higher order capital goods such as real estate construction, and also associated goods such as wood for construction and durable goods such as furniture. The pancake stack has been made steeper, but that is not sustainable. Funds that would have gone to circulating capital instead get locked up and then wasted in excessive investment in higher-order capital goods such as real estate. We have seen in 2008 a glut of empty houses, some of which get looted.

The central bank later stops the great expansion of money in order to avoid too high inflation, but that then halts the real estate investments. Workers get laid off, the firms suffer losses, and the economy goes into recession.

The expansion caused by the injection of money feels economically good for a while, but it is like a drug that wears off, causes addiction, and ruins the health of the economic body. With the artificial rate of interest below the natural free-market rate, land speculators also borrow funds. Speculators buy real estate expecting the land value to rise. The economy gets a real estate bubble caused by money expansion and land-value subsidy. Public goods such as streets, transit, schooling, security, and various subsidies all make neighborhoods more productive and attractive. These benefits boost land rent and land values.

Site values capture much of the benefit from an economic expansion because the governmental works and services are paid for mostly from taxes on labor, enterprise, and trade. This is a huge implicit redistribution of wealth from workers and entrepreneurs to landowners. During an economic boom, the demand for land by overly optimistic speculators pulls up the prices of land beyond that warranted for current use. Those who actually want to use land for residences and business stop buying, which combines with higher interest rates and higher prices to reduce investment.

Investment drives the business cycle. As investment falls, the economy follows into recession. Land values fall, companies go bankrupt, unemployment rises, and property owners can't or won't pay their mortgage interest. With mounting losses, banks fail, and the value of speculative derivatives, based on land values that are now falling, collapse. The financial waterfall brings down insurance firms, banks, hedge funds, and brokerage firms which had bad investments and failed speculations.

With free banking, all this is avoided. The rate of interest is not distorted by injections of money from a central bank or government, but is set by the market for loanable funds. The supply of funds comes from savings, and the net demand (subtracting borrowing for consumption from savings) comes from those who seek funds for investment. The natural rate of interest is based on time preference, the general preference to have goods such as cars sooner rather than later. With free banking, the natural rate does not get distorted by the manipulations of a central bank.

If the United States shifted to free banking, the current supply of paper dollars, of Federal Reserve note currency, would be frozen. The future supply of money would come from the paper currency issued by private banks and from new coins. There could be a monetary role for government in minting coins: accepting metals from the public and making coins out of them. The government could also convert its gold hoard into coins sold to the public.

If someone withdraws money from a bank's ATM, the money would be inscribed with the name of the bank rather than that of the central bank. But anyone could go to the bank and get Federal Reserve notes in exchange for the notes of the central bank. Legal tender laws, which require us to accept federal money in payment of debts, and other laws that make government currency a monopoly, would be abolished. The Federal Reserve Bank would also cease to exist.

Businesses often need to borrow funds for a short while to finance their operations. The loans are paid back from the sale of goods. With free banking, firms could also pay for labor and supplies with bills of exchange. These would be tradeable IOU notes payable within 90 days. A firm that sells wood to a f d accept payment for the wood in bills of exchange, which it could then use to buy lumber, or it could deposit the bill in a bank. The furniture maker could obtain funds from a bank in order to pay wages, using a bill of exchange which the bank would discount, e.g. it would accept a one million dollar IOU in exchange for $990,000 in cash. Within 90 days, the furniture company would repay the bill of exchange with the cash it gets from the sales of the goods. Alternatively, the firm could issue commercial paper, very short term loans that get sold to money market funds, whose liquid funds also serve as money substitutes.

Reflux, the convertibility of money substitutes into real money, would prevent a bank from an excessive issuing of its notes. The supply of private bank notes would be limited by the demand by the public to hold them. The real money would be federal reserve notes in the hands of the public, and private bank notes and funds in accounts would be money substitutes, acting like money but always convertible into real money.

With free banking, there is no governmental restriction on branches. There is no governmental deposit insurance. There is no reserve requirement, the legal requirement to have some fraction of deposits held in cash. There are no legal limits to other businesses a bank can engage in, so that a bank could also offer insurance or a retail store could also offer banking. There would be no restrictions on interest rates. There would also be no explicit or implicit governmental loan guarantees, such as for the government-sponsored enterprise Fannie Mae. Any secondary market in mortgages or other loans would be purely private.

Also, in pure free banking, there would not be any taxes on interest income. Taxation, as well as the deductibility of mortgage interest payments from taxable income, distorts the incentives of savers and borrowers, which also shifts the rates of interest away from their natural rates. But if interest is tax free while wages and profits are taxed, that also distorts the natural interest rate as resources shift to tax-free sources of income.

To have a pure natural rate of interest, government has to also avoid subsidies, which distort resources towards the subsidy. In pure free banking, public revenue must be based on sources that would otherwise be subsidized, namely pollution charges and land value. The tapping of site values for public revenue prevents the subsidy of the higher rent and site value from governmental public works and services.

With free banking, the natural rate of interest would not be obliterated, since money supply would be set by the public's demand to hold money rather than an artificial injection by a central bank. Money would not be a government monopoly, but would be provided by competing private banks. But there would be a common unit of account such as the US dollar. The currencies of the banks would all be in the same dollar units and be accepted at stores and by all banks. Only the notes of the largest banks with good reputations would circulate widely, although it would also be possible for there to be local currencies from trusted issuers.

There would also be supplements and alternatives to banking, such as LETS, Local Exchange Tracking System, where users could trade with debits and credits to accounts.

Every historic economic boom, at least in the USA, has been accompanied with excessive credit creation, and every financial crisis and depression has been plagued with excessive credit constraints. Free banking avoids the credit bubble and thus also the credit collapse. But the complete elimination of the boom-bust sequence requires the elimination of land-value subsidies, since otherwise even market-based economic expansion would induce land speculation, as that would offer higher gains from leverage than the production of goods, and rising land values would induce derivatives.

Eventually, if most of the economies of the world practiced free banking, there would be a demand for a global currency, and the most likely candidate is gold, which was the global currency bef h gold as the real money, the private bank notes as well as funds in accounts and also bills of exchange would be money substitutes. One could convert paper currency or account funds into gold coins on demand. A small amount of gold would back up the value of purchasing media, and most purchases would use electronic media, not physical gold.

In free banking, the banks and other financial institutions would join together in mutual aid organizations. If one bank ran out of gold or paper notes, it would be able to borrow from other banks. One would not need a central bank as a lender of last resort, since banks would be able to borrow from the mutual aid association.

The natural expansion of money with increasing wealth and population creates a gain called “seigniorage,” the difference between the face value of the new money and the cost of creating it. With central banking, some of the gains go to the central bank, and the rest of the gains are shared by lenders and borrowers as the gains attract more funds that then lower the natural rate of interest. The private banks do not gain if the system is competitive, since any temporary profits would induce an increase supply of lenders that would drive the gain back down.

Some would-be reformers advocate that the government directly issue currency and gain from the seigniorage, but that would involve the problems of knowledge and incentive. There would be a political incentive to issue too much currency, causing price inflation. There is also the inevitable knowledge problem: there is no way for a monetary authority to know the optimal money supply and interest rate. So any creation of money by a government as a monopoly would distort the interest rate and create instability and waste.

Free banking is not just hypothetical, as it had been practiced in many economies prior to the Great Depression. One well-researched example is the free banking practiced in Scotland until 1844, when the Bank of England took over, described in the book Free Banking in Britain, by Lawrence White. Books explaining free banking include George Selgin’s The Theory of Free Banking and Free Banking by Larry Sechrest.

Land-value taxation alone would greatly reduce but not eliminate the business cycle, since the manipulation of lower interest rates by central banks would still induce excessive real estate construction and purchase, and the interest rate would not be allowed to do its job of harmonizing investment and consumption. But without public revenue from land rent, pure free banking is impossible, since taxes and land-value subsidies would distort interest rates. We therefore need to solve both the money and the land problems. The solution is free banking combined with public revenue from land rent.

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FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org

Foldvary's commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary's areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.