Money, Government and Market

by Fred Foldvary

The question of money and banking has been controversial among followers of Henry George. Some geoists believe a free-market can handle money and banking best, just as it does for other services, while others think only a central government can or should provide money. Some favor local currencies, LETS (local-exchange trading systems), or warehouse banking with 100% reserves, banks not loaning out more than is deposited. Some think fiat money is fine, while others favor commodity based money, the latter split among those who think one commodity such as gold would suffice, and others thinking that a basket of commodities is better.

Steven Zarlenga's article on "Henry George's Concept of Money" in the Fall 2002 *Georgist Journal* #96 is an example of those who think that money needs to be a government service, so I will respond to that in analyzing what kind of money and banking is most compatible with a healthy economy and the principles we share as adherents of the thought of Henry George.

Zarlenga (p. 26) correctly makes a distinction between money as a draft or claim on wealth, versus real wealth, as Henry George described. Zarlenga adds that this "requires abandoning a... view of money as a tangible physical thing," but historically, money evolved from exactly such tangible things. The difficulty with barter is finding partners for trading specific goods, so an indirect exchange developed with widely-used commodities such as salt, shells, cattle, or gold.

If you offered carrots and wanted shoes, but the shoe seller did not want carrots at the time, you could exchange the carrots for salt, and then exchange the salt for the shoes. The shoemaker accepted the salt, because most folks used salt, and the shoemaker could either use the salt himself or find someone who wanted salt. In that trading area, salt became money, and was both a claim or draft on wealth as well as also being real wealth as a commodity that was consumed. Historically, metals such as copper, silver, and gold became widely used for money because they were durable and could be cut into small convenient uniform pieces.

Zarlenga writes that money is "an abstract social power embedded in law," but originally, the commodities that became money evolved in a spontaneous market process rather than being commanded by governmental law. Only after metals came to be used as money did governments monopolize the issuing, and in many places, private money existed along side government money. A government monopoly on money is like a state monopoly on schooling; just because education is legally a government monopoly does not make this necessary or even desirable. Market-based money, including local currencies, has worked well in many places over the centuries.

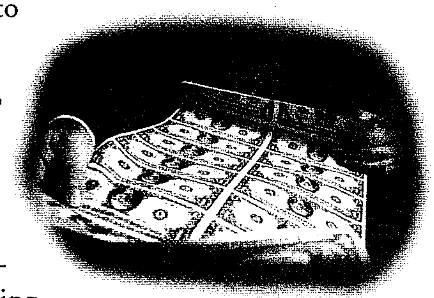
The use of commodities for money does not confuse money with wealth, but recognizes that a sound basis for money is indeed its use also as real wealth. For example, suppose copper is used for coins, and a pound of copper is equal to one dollar. A one-cent copper coin thus contains 1/100 of a pound of copper. The copper in a coin is used as a medium of exchange rather than directly as an input into production. The coin is thus not a capital-good input used as real wealth, but rather used as a claim on wealth. But that copper penny can be melted into copper that can then be used as real wealth. Its use as an input into the production of pots and pans and wires serves to anchor the value of the copper and thus the dollars and cents relative to that of other goods, preventing the unit of account from inflating into an arbitrary measure of wealth. Commodity money works best when it is both useful as real wealth and can be carried around as currency. This is why bricks, for example, are not a good commodity for money.

Zarlenga (p. 27) then cites George as distinguishing credit from money. This distinction is correct. Credit could be extended with barter as well as with money, and beneath the veil of money, credit is really the exchange of goods in the present for goods in the future. But Zarlenga also claims that George distinguished between private credit for profit and governmental credit "for the common good." But when government borrows or lends money, is this necessarily for the common good? We know that governments have created such common evils as genocide, wars, environmental destruction, and labor prison camps.

Henry George is cited in *Social Problems* (pp. 178-9) as stating that "it is the business of government to issue money... To leave it to every one who chose to do so to issue money would be to entail general inconvenience and loss ..." Here, Henry George was just plain incorrect. If we heed George's prime directive to "think for yourself," George himself would have to agree that if logic and the facts show that George was incorrect, we should frankly say so.

In a competitive free market, if a product does not provide good service, it will be rejected by customers. A barber doing bad haircuts will find himself out of business. Thus, if I am selling goods and a customer offers me his own personal money, I will not accept it. Money is by definition a medium of exchange, which implies it is widely accepted for exchange. In a free market, there would not be hundreds of different types of money, but only a few, since that is what is convenient and safe. In a truly free market, good money drives out bad money. So while anyone could legally try to issue money, if folks don't accept it, it does not become money.

George speaks of the evils of the "wildcat banking" that afflicted the USA before the Civil War, which resulted in "swindling and corruption." But these problems were caused by government intervention into banking. The states tightly regulated banking before the Civil War. Branch banking was prohibited in many states. So in the frontier states, small independent banks were set up. The states forced these banks to accept state bonds. The frontier banks then issued their own currency based on the state bonds. So the states were spending money by issuing bonds covered by the money created by the banks. This money then fueled land speculation. During the 1830s, land speculation drove land prices to absurd levels, and there followed the panic of 1837 and the subsequent depression.



The fault was the intervention into money and banking by the states. If a customer in Indiana had a choice between a branch of a big, safe New York City bank and a small, unsafe wildcat Indiana bank, he would choose the NYC branch bank. But the pioneers had no choice. The frontier states prohibited the big eastern banks from operating there and made the local banks more risky by getting them to issue money based on the state bonds. It was government that created the evils of wildcat banking, not the non-existing free market.

In fractional reserve banking, a bank lends out more money than was originally deposited, because a loan consists of a created bank account. If Joe has $100 in an account, the bank lends $80 of it to Susan by creating an account for her for $80. The money supply is now $180 rather than $100. But in a free market, this is not a privilege of banks. Anyone may open a bank and practice fractional-reserve loaning. A true privilege is something granted to some persons and not others by law. With free-market banking, fractional-reserve banking would be legal but limited because customers would prefer safer banks that either have 100% reserves or else have insurance and mutual-aid agreements with other banks.

Zarlenga (p. 29) refers to an "attack on government" that started with Adam Smith and furthered in the 20th century by the Austrian economist Friedrich Hayek. But Adam Smith was not an anarchist and was not opposed to government as such. His attack was on mercantilism, the governmental control of an economy and restriction of free trade. Hayek too was not an anarchist, and attacked state socialism, not the proper protective functions of government. George himself, as cited by Zarlenga, stated that "it is not the business of government to direct the employment of labor and capital," and that "the power of government has been deliberately and continuously prostituted," thus making as strong an "attack" on government as any made by Smith or Hayek. If we grant to government the power to control money and banking, how then can we logically protest when that power is used to favor the moneyed interests?

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Zarlenga speaks of Adam Smith's economics as based on selfishness, and in fact Smith's invisible hand is based on self-interest. By pursuing his own self-interest, the baker benefits the public by providing bread. But self-interest is not the same as selfishness; it does not include theft. Smith also wrote the book *The Theory of Moral Sentiments*, where he noted that the other human motivation is sympathy for others, which gets people to do benevolent acts. So Smith, like George, understood that human beings have both self- and other-interested motivations.

Zarlenga (p. 31) notes the "free banking faction" of libertarians who "make the historical claim that the old free banking period was not really all that bad," and claims that they labeled as "free banking" the period of 1836 to 1864. The free banking that libertarian Austrian-school economists such as George Selgin and Lawrence White refer to was the case of Scotland and a few other countries, but not what was practiced in the US during the 1800s, since they show that, as discussed above, this was not free-market banking. Zarlenga does not cite anyone for his other claims about the "free banking faction," claims I have never heard from any free-banking economist.

Zarlenga's first reform is to "A) Nationalize the Fed," but the Federal Reserve was governmental from the beginning. The Fed was created by Congress in 1913. The members of the Federal Reserve Board are appointed by the US President and confirmed by the US Senate. The "profit" made by the Fed from the interest it gets on its holding of US bonds is transferred to the US Treasury. It is true that nominally, the Federal Reserve Banks are technically owned by the member banks, but that is just a formality, perhaps intended to circumvent constitutional restrictions. In practice, the Federal Reserve Board regulates the private banks, and the regional Federal Reserve Banks serve the central Federal Reserve Board and regularly report to it.

Zarlenga's second reform is to "B) Institute the 100% Reserve Solution" using "sound, government-issued currency." By "currency" I presume he means paper money issued by the US Treasury rather than the Federal Reserve. But such currency would still be fiat, based on no commodity, and thus subject to inflation. The Treasury would face the same problem as the Fed, deciding how rapidly the money supply should grow, and the economic fact is that there is no way a central monetary authority can know this. So there would still be too much money at times, resulting in inflation, and too little at other times, leading to a recession. Only a pure free market in money and banking can keep the quantity of money in line with what is demanded. Moreover, the US Treasury is subject to political influence, which is one reason that all major industrially advanced countries have had semi-independent central banks such as the Federal Reserve.

Zarlenga's third reform is to "C) Institute mandatory monetary expansion rules," but these have failed where tried. The Fed tried to do this, and then found that since it cannot control the demand for money and the velocity of money circulation, a fixed money-growth rule will fail to provide for stability. Only with competitive private money will there be just enough supplied to equal the quantity demanded, just as with any other goods and services.

Zarlenga's fourth reform is to make the monetary authority "a fourth branch of government — a monetary branch." Setting up the Fed as a quasi-independent agency was an attempt to make it a separate branch! So how would a "monetary branch" be different?

Rather than making money a new branch of government, it should be no branch at all. If money is an important need and want, the market will provide it, and historically has provided it, no less than other needs and wants. The true science of money and banking would study the theory and history of free banking, the free-market banking that was successful in places like Scotland. In Scotland until 1844, gold was used as money, with bank notes and bank accounts serving as private money substitutes for most transactions.

A true science of money recognizes its role in setting interest rates, an effect Zarlenga does not deal with here. The market rate of interest serves to equilibrate, or make equal, the amount of savings and the amount of investment. When too much money is issued, not only do prices rise, but the interest gets skewed, which distorts investment in capital goods, leading to bad investments that waste resources and contribute to economic depressions.

Today, with all governments using fiat money, the transition to free banking would not immediately use gold. As a transition, the supply of US Federal Reserve Notes (paper dollars) would be frozen. This would become the monetary base. The future expansion of purchasing media would be by private banks issuing notes and expanding deposits convertible into Federal Reserve Notes. The convertibility would prevent inflation.

As more countries adopt free banking, there will be a demand for a global currency. Gold would then once again become a universal currency, due to both its historic role and its large current supply, unlike silver, which has mostly been consumed. Two major reforms are need for economic prosperity and justice: public revenue from land rent, and the elimination of the excessive monetary expansions and subsequent credit contractions. Only by taking the control of money out of the hands of government and leaving that control with individuals as consumers, workers, and investors, can we eliminate the monetary distortions that help cause the boom and bust cycle, unemployment, and inflation. GJ

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governments tempted to repay creditors by issuing more currency rather than imposing new taxes at home.

And so, the shell game continues. However, there is virtually no mainstream interest in this reform. One possibility is to attract one of the large financial service companies to the idea of establishing a bank of deposit, then build a global network of members who trade with one another outside of the government-mandated system of legal tender. As more banks of deposit come into being and begin to dominate global commerce, government paper currency may eventually be discounted out of existence. Governments will then have to play by very different rules.

(The full paper can be read at the online library of the School of Cooperative Iindividualism at www.cooperativeindividualism.org.)

> Can't imagine why people would hoard gold in a free society. People might like to keep a few gold sovereigns around — in case — but it is a costly thing to do. Banks don't need to keep gold around the place — unless they have good customers who occasionally want some. I would think that if a customer wants some gold, they would ask him to wait a day or two while they got some from a source (someone in the gold business, supplying jewelers, or something). — Harry Pollard