

**A Basic Inquiry into the Nature and Effects of Monetary Economics**  
An Analysis of Money, Banking and Credit Theory

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To all those who struggle against the great demon that is totalitarianism,  
never give up.

## A Basic Inquiry into the Nature and Effects of Monetary Economics

An Analysis of Money, Banking, and Credit Theory  
by Alexander Villacampa

Economics is a field of study that is filled with much intrigue and insight into the functions of human action; these crucial functions form societies, civilizations, and empires. The study of economics is the study of human relationships and how these interpersonal connections lead to the existence of a complex network of transactions. Though civilizations have traditionally been ruled by political bodies, there has always been something much grander behind the scenes that has been able to outlive these institutions; this phenomenon is the market. The market is built by the voluntary transactions of individuals and exists regardless if governmental institutions deem these markets not be beneficial to society. In this study, what will be of the utmost importance to analyze is the backbone of the economic structure and the catalyst of all transactions in modern human society; this catalyst is, of course, money. The importance of this catalyst will be evaluated and its origins discovered. From understanding the primitive interpersonal relationships of humanity to the complex workings of business cycles, money is the ruler of all. To comprehend the nature of media of exchange is to understand the structure of the modern market, its failures, and its triumphs. The goal of this paper is to deliver a proper explanation of the phenomenon of money, credit, and their affects on the economy as well as explore the origins of some the woes of the modern market. It will be concluded that the old Monetarist<sup>1</sup> slogan of “money matters” is, in fact, unquestionably true.

### Section I: Direct Exchange

#### A) Involuntary Interpersonal Relationships

- I. In order to properly understand the exchanges of goods and services between individuals, familiarization with the distinctions between certain human interactions must occur as well as understanding the reasons for these interactions.

In any given society, only two mutually exclusive types of interpersonal relationships can arise between individuals; these relationships consist of *violent* and *contractual* or *voluntary* relationships.<sup>2</sup> Violent relationships arise when one party is convinced that it is profitable to engage in aggressive behavior with the other party. Such violent behavior could be

1. The analysis of this paper is not in the tradition of the Monetarists but more in line with that of the Austrian School of Economics. This was simply used as a reference to the phrase that the Monetarists hold dearly. Though they believe that money does matter, there are specific differences between the Monetarists and the Austrians. Some of these differences may not be evaluated in this paper but the distinction should be made between the two.

2. von Mises, *Human Action*, p. 196

theft, armed robbery, assault, slavery, murder or a combination of those interactions. An individual will only use violent methods to acquire goods from another being if they have predetermined that the winnings will outweigh any loss that might occur during the violent interaction; these gains do not necessarily have to be material and may simply be psychic in nature. There are a few reasons why one individual would not use force against another being as a means to satisfying a desired want.<sup>3</sup> These reasons are:

- 1 The would-be aggressor finds the act immoral and thus, refrains from the violent interaction. In this situation, the aggressor finds that refraining from violent interaction is an end in itself and desires that end higher than any gains from using violence against another being.
- 2 The individual would conclude that the costs of the conflict against the other person may outweigh any gain from the violent interaction. These costs might include bodily harm inflicted by the victim, damage to any tools of war, or the time spent waging the conflict against the other individual.
- 3 The individual may predict that the armed conflict would bring death and with it, a total psychic loss.
- 4 The would-be aggressor may conclude that using violence against the other individual would destroy any gains from maintaining a non-violent relationship with the individual.<sup>4</sup>

II. For the same motivations, yet *vice-versa*, an individual may decide to violently interact with the other human being. Another form of violent interaction is slavery in which one individual is bound in a hegemonic relationship with another individual. The slave is kept in certain conditions and is obligated by the slave master, through violent force and coercion, to accomplish whatever task the aggressor demands. The slave can never be mistakenly associated with finding pleasure in the hegemonic relationship because the individual continues to be bound but instead that being simply does not see another viable alternative. In addition, one *can*

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3. Ibid., p. 197

4. See Rothbard, *Man, Economy, and State with Power and Market*, p. 80- 81

*not* claim that the slave is receiving pleasure from the hegemonic relationship for reasons such as food, potential housing, etc. for that would be a distinctly different situation in which the individual is agreeing to work for another person in exchange for certain items or services. It is clear that in a hegemonic relationship involving a slave and a slave master, the slave is always worse off due to violent coercion. There are fundamental differences between the force and voluntary labor. In *forced labor* the individual is working for another being without what they see as satisfactory compensation and thus will only perform to the bare minimum. In *voluntary labor*, the individual has entered into a contractual agreement with another being to reach a mutually desired end; this topic will be discussed in later sections. Concerning the state of the interpersonal relationship between the slave and the slave master, the slave has only two choices:

- 1 Rebel against the slave master and thus, achieve freedom if successful.
- 2 Continue to obey the violent threats of the slave master and become a factor of production for the aggressor.

It is clear that the only choices the slave has in a hegemonic relationship is to either continue obeying the threats of the slave master or to counteract the threats of the master and rebel.<sup>5</sup> The slave is in no position of authority in a hegemonic relationship and must relieve himself of the right of self-ownership and abide by any demands the master may desire as long as the individual does not wish to rebel. In such a society, the only one who gains is the aggressor and the slave is *exploited* for his labor. The use of the term exploitation should be categorized with interpersonal relationships where one individual believes that they are not receiving just compensation in a trade or interpersonal action *ex ante*. This is due to the fact that an individual would not agree to a trade if they believed *ex ante* that they were going to be worse off; the only conclusion that can be made is that the trade was made under coercive conditions.<sup>6</sup>

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5. von Mises, *Human Action*, p. 197

6. During the course of this research paper, the author may use the Latin terms *ex ante* and *ex post*. *Ex ante* simply means *before the fact* and *ex post* is referring to *after the fact*. An individual may believe that they will receive a net gain, psychic or material, *ex ante* but that may not be the case *ex post*. Referring to a trade, *ex post* has little relevance as to the legitimacy of a trade. The importance of *ex post* has more to do with how an individual reacts in further trades.

## B) Contractual or Voluntary Interpersonal Relationships

I. Another type of interpersonal relationship, in a given society, can be labeled as *contractual* or *voluntary*. Substitution for the word “contractual” with “voluntary” originates from the idea that once an individual agrees to take part in an action with another individual, that affirms a contract between both entities. Contracts, in the modern sense, are complex documents lining the duties, rights, and privileges of the parties in question yet primitive contracts exist in all non-violent interpersonal relationships. Voluntary interpersonal relationships stem from the idea that individuals are willing to work together in non-violent interactions for mutual benefit. Acquisition of goods and services in a contractual society are done via *exchanges* or *homesteading*.<sup>7</sup> Exchanges take place when one individual concludes that they would be better off giving up an item or service to another individual so long that the receiver transfers rights to another item or service to them. This situation suggests that in order for a trade to occur, the parties in question must have differing value scales when concerning the goods or services being traded. Homesteading, on the other hand, is the acquisition of an *unused* factor of production. In such a case, the first user of the land or natural resource is considered the owner until it is sold off to another individual. In a contractual society property can be acquired various ways:

- 1 By homesteading one of the factors of production.
- 2 A gift received by another individual.<sup>8</sup>
- 3 An exchange with another individual during which one sells a certain property to buy another.<sup>9</sup>

II. It is clear that under a hegemonic or servile relationship the right to self-ownership is *obstructed* and the fruits of an individual's labor are owned by the slave master. In a society of

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7. Ibid., p. 196

8. A gift is somewhat of a different transaction than an exchange of goods. A gift comes about when one individual finds it in their favor that they give a portion of one of their items away to another person. This exchange can only occur when the individual giving away the item expects no material gain in return for the favor. In addition, when concerning a similar product, there can only be a gift exchange. Two cucumber farmers can not trade identical cucumbers, such would be pointless. The only exception to this would be that one of the cucumber farmers finds it in their best interest to relinquish the right to some of the cucumbers they have farmed to the other individual; in other words, a gift. These are the brief economics of the differentiation between gifts and exchanges. Professor Rothbard has an excellent section of this phenomenon in *Man, Economy, and State with Power and Market*.

9. Rothbard, *Man, Economy, and State with Power and Market*, p. 78- 79

voluntary interpersonal relationships each individual is owner of themselves and has the right to property designated by the underlying premises that that individual first made use of that factor, was given unto them as a gift, or acquired in an exchange. In the scenario of a free market, it is obvious that each is master of his own actions and entitled to the fruits of their own labor. In that of a hegemonic society, there can only be oppression as individuals are stripped of their right to self-ownership and have few options as to liberating themselves from such oppression. For clarification, all further discussions of interpersonal exchange will be predetermined as contractual.<sup>10</sup>

### C) Exchange of Goods and Services

- I. Formal exchange of goods between individuals in a society takes place in two different manners. The first form of exchange can be labeled as *direct exchange*. Direct exchange occurs when there is a *double coincidence of wants* between the parties of the transaction. The value scales of the parties must be structured so that one individual values their good less than the other individual's good and *vice-versa*. For example, let us assume that person A is a cucumber farmer and that person B is a chicken farmer. Person A has a craving for chicken and would like to trade with person B yet person B has no need for cucumbers; thus no exchange takes place. If person B desires cucumbers than a trade will take place. Though these incidents might happen rarely, the sheer difficulty of finding such a double coincidence of wants is obvious; this especially holds true in a society thats growing in complexity.
- II. When concerning direct exchange and the phenomenon of the double coincidence of wants, one must ponder as to the nature of the exchange rate between various goods and services. In order to properly maintain a business or trading relationship in such a society, individuals would have to compile extensive lists comparing one good to another. Such a document would be enormous and the necessity to change the document constantly would be evident as the market would shift. The need to have such a complex document and accounting system for trade is eliminated once all goods are priced against one commodity; this subject will be elaborated in subsequent sections.<sup>11</sup> The hassles of direct exchange are quite immense and the necessity of a growing society for a medium of exchange, and unit of account that all goods

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10. von Mises, *Human Action*, p. 197

11. Jevons, *Money and the Mechanism of Exchange*, p. 3- 5

can be compared against, becomes evident. Direct exchange accounts only for primitive barter and found primarily in the developing economies of history. That said, the fundamentals of direct exchange lead society to a greater method of exchange that opens the door to an expansion of the division of labor and thus, a growth of the overall economy. Such a contribution to society should not and can not be overlooked.

## **Section II: Indirect Exchange**

### A) Money as a Necessity in a Complex Economy

- I. The birth of indirect exchange in society primarily came from the inability to pay for the factors of production with specific goods; that is, with less marketable goods. Indirect exchange takes hold of the *extreme marketability* of one good in the society, a good that is desired by most individuals. This method greatly expands the scope of the division of labor in the sense that by using a medium of exchange there is an *increased* ability to bid on goods and services in the marketplace that otherwise would have not been accessible. History, when concerning media of exchange, shows a competition between the most marketable commodities of a society. As certain media of exchange became more marketable than others, those commodities were increasingly used as the primary medium of exchange. The commodities that were not able to compete against the more marketable goods simply became factors of production; as was noted earlier.<sup>12</sup>
- II. It is important to point out that in any given society, one money does not need to be artificially implemented due to the fact that the market, in time, rewards the monies that are most marketable and devalues those that are not. Throughout history there have been various exchange rates between the most marketable monies of the society and such a system of exchange rates between a handful of commodities did not serve to be much more complex than necessary. In other words, the complexity of the money mechanism, in an unhampered market, can only be decided by *the market itself* and to tone down the complexity of the workings of

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12. It is important to state here before the reader continues that throughout history, up until the central banking systems, there were various units of account internationally. The market may never tend to favor one good over another in terms of money for money may have different value uses. As will be explained in subsequent sections, silver may be beneficial for some exchanges and gold for others. What is important to note is that the market does not necessarily favor only one money ultimately. In the marketplace of money, many different scenarios could arise.

such a mechanism are ill founded and foolish as well as harmful to the economy. In later sections there will be detailed explanations and examples of how government has meddled in the market for money with the use of such ancient policies as *metallism*.<sup>13</sup>

## B) The Origin of Money

I. The fundamental difference between the societies of advanced economies and those of primitive economies is their adoption of either direct or indirect exchange. Direct exchange limits the capabilities of the division of labor while that of indirect exchange allows for the division of labor to expand indefinitely,<sup>14</sup> given that no violent coercion from exogenous forces on the economy exists. In the section concerning direct exchange, the inefficiency of attempting to acquire goods without using a medium of exchange was explained; that in order for a transaction to be made without a medium of exchange present, individuals would have to rely on the double coincidence of wants.

II. As a result humans over the span of history sought to trade their produced goods for commodities that had significant value to a large portion of the population and had certain attributes that would deem them suitable for use as a money. In various regions of the world, different monies took hold. In ancient Greece, oxen were used as a unit of account for large trades. In Scotland, nails were used as a medium of exchange for sometime. The early American colonies, especially Virginia, would often use tobacco as a money. In time, metals, specifically gold and silver, won out due to *specific natural attributes* that added to their marketability. These attributes include:

1. Durability
2. Divisibility
3. Portability
4. Homogeneity

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13. von Mises, *The Theory of Money and Credit*, p. 43

14. Further commentating on the facilitation of the expansion of the division of labor thanks to indirect exchange first needs clarification. The fundamental idea behind the ability of the division of labor to expand because of indirect exchange has to do with the elimination of the double coincidence of wants, per se. Under a market where a medium of exchange is used it is much simpler to bid for the necessary factors of production because what can be offered for the goods and services is a highly marketable good. An example will be given in subsequent sections as to the easier show the connection between the expansion of the division of labor and the use of media of exchange.

## 5. Scarcity<sup>15</sup>

Due to these natural attributes, metals were often times desired as media of exchange over other monies that did not have such characteristics. It is clear that there is superiority in the existence of metals as money and such explains why in time societies began to value such commodities as media of exchange and units of account.

### C) Gold and Silver as Media of Exchange

- I. These natural attributes of metals allowed for their use as media of exchange. That said, not all metals were used as media of exchange indefinitely. Iron, for instance, was used in Scotland for quite some time but slowly began to shift out of the monetary marketplace as certain metals that were more valuable or useful as media of exchange were introduced into the society. In addition, certain media of exchange had the ability to be easily mined or produced which is another reason why the end result in international monies was an emphasis on a handful of rare precious metals; these metals primarily consisted of gold, silver, and copper. Gold was often used for *larger exchanges* while silver was predominate for *smaller exchanges*; this is mostly due to their differing values and usefulness as media of exchange. The introduction of these metals as media of exchange and units of accounts greatly expanded the horizons of the division of labor and allowed for civilized economies to grow in complexity. Gold and silver as a medium of exchange were predominately used in ancient civilizations by international traders. These metals, in particular, were recognized by the various cultures as more internationally recognizable than the media of exchange in their native lands. Gold and silver started off as simple bars measured in mass and fineness yet official coinage and stamping did not come until much later during the Mesopotamian, Greek, and Roman eras.<sup>16</sup>
- II. In time, the origin of the coinage and stampings became the *primary* signature of quality and citizens began valuing money according to the institutions that minted them. This focus on the minter rather than the dimensions of the metal has its origins in the nationalization of the minting business and the use of nationalism in the acceptance of the medium of exchange which led to a transfer from weight to name. Professor Rothbard describes:

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15. Smith, *The Wealth of Nations*, p. 25-26

16. *Ibid.*, p. 28-29

The royal stamp on coins also gradually shifted the emphasis from weight to tale by wrapping coinage in the trappings of the mystique of state “sovereignty.” For many centuries it was considered no disgrace for foreign gold and silver coins to circulate in any area; monetary nationalism was yet in its infancy. The United States used foreign coins almost exclusively through the first quarter of the nineteenth century. But gradually foreign coins were outlawed, and the name of the national state's unit became enormously more significant.<sup>17</sup>

III. The fall in emphasis of valuing money according to its weight than to its name systematically led to the adoption of central banking and a nationalized monetary policy. In addition, this concentration on name later eased the transition from partially backed gold monies to fiat currency. The arguments for and against fiat money will be evaluated in later sections as will the historical transition from commodity money to paper money. What is important to comprehend in this section is the transition of direct exchange in goods, to a use of a widely accepted good as a medium of exchange, the winning out of metals as a unit of account and money, as well as the subsequent fall of money from weight to name.<sup>18</sup>

### **Section III: The Nature of Prices**

#### A) Prices as an Outcome of Supply and Demand Schedules

The importance of monetary prices are quite evident in modern economies yet few understand the mechanisms behind the origin of these prices. Monetary prices, in a given market, represent the amount of one good or service valued against a given medium of exchange. Prices are the mere *exchange rate* between the medium of exchange and the vast array factors available on the marketplace. The nature of the market is that the supply and demand schedules of all individuals in a society constantly work towards one equilibrium price

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17. Rothbard, *The Case For A 100 Percent Gold Dollar*, p. 37

18. *Ibid.*, p. 41

value for each good or service. This is evident in the truth that buyers will always want to buy items at the lowest possible price and sellers will always want to give up their supply at the highest possible price. This gives the implication that both buyers and sellers are going to constantly *bid each other out* of the marketplace and work towards to an equilibrium value. This is understood using the law of marginal utility which derives the law of supply and demand; such a law implies the existence of an equilibrium level when one good or service is valued against another good or service.<sup>19</sup>

## B) Value of Prices in Both Direct and Indirect Exchange

- I. Prices in direct exchange are limited to the rates of value of one factor against another factor. In essence, the exchange rate of a good is only equal and applicable to the specific good it is being valued against. For instance, an exchange rate can not be discovered between horses and cows using an exchange rate between cows and pigs. The specificity of the goods does not allow for their exchange rate to apply to other goods without using one of them as a medium of exchange. This is returning to the phenomenon explained in the previous sections, that exchange rates would be far too complex and unnecessary in a direct exchange society; the need for a highly marketable medium of exchange would be unquestionably necessary.<sup>20</sup> In indirect exchange, the value of goods and services on the market are equal to the amount of money those factors can purchase on the market. Indirect exchange allows for exchange rates between a wide array of factors of production to be valued against a highly marketable good that has become the medium of exchange.

This allows for simple *divisibility* of the value of each factor on the market relative to the amount of money it can purchase. In a society that has adopted a highly marketable good as the medium of exchange, divisibility between values of certain goods is much more feasible and the complexity of the market is allowed to expand because of it. For instance, we may take the example of the chicken farmer and the shoe maker. It is impossible for the shoe maker to acquire a chicken from a chicken farmer that does not require shoes. Under direct exchange, such a transaction would not occur if that were the case. That said, if the shoe maker was acquainted with another individual that was willing to buy shoes yet produced goods that the

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19. Rothbard, *Man, Economy, and State with Power and Market*, p. 233- 235

20. Jevons, *Money and the Mechanism of Exchange*, p. 4-5

shoe maker could not directly use, what could arise is the use of a medium exchange in the process to make all transactions possible. The other individual, lets say, farms coconuts which the shoemaker has no immediate use for. That said, the shoemaker may decide to trade his shoes for the other individual's coconuts if he is aware that the chicken farmer is in desire of coconuts. If this is true, and the medium of exchange is the *coconuts* in this transaction, then in the latter example, all transactions were completed and all individuals are better off. In the example where only direct exchange was used, no transaction was initiated and no one was *better off*.

II. It is important to state that value of a good or service is equal to the amount of money it can purchase on the market. Likewise, the value of a certain quantity of a medium of exchange is equal to the vast amounts of factors on the market that quantity of money can buy. In order to understand the realization of prices we must examine the fundamentals of the law of marginal utility. The price of purchasing a good or service to an individual, when concerning the value scales of a specific individual, is the maximum amount of a medium of exchange that individual is willing to part with in order to obtain that desired factor. In addition, the price of giving up a factor, to an individual, is equal to the lowest amount of a given medium of exchange that individual is willing to receive. The law of marginal utility allows us to understand and lay the foundation to the law of supply and demand when relating factors on the market against a medium of exchange.

III. When concerning the demand of sellers to hold their product, there are two main reasons for such behavior:

1. Anticipation of a higher price at a later date for sale.
2. Direct use by that seller.

When concerning the demand of buyers to buy goods at the current price, there are two main reasons for such behavior:

1. Anticipation of a higher price at a later date for sale.
2. Direct use by that buyer.<sup>21</sup>

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21. Rothbard, *Man, Economy, and State with Power and Market*, p. 238- 253

### C) The Phenomenon of Speculation on the Free Market

These are fundamental concepts in order to relate the prices of factors on a market with the demand to hold or demand to buy an item for speculative purposes. Speculation is the act of an individual entrepreneur deciding to buy a good at a low price and selling at a higher price.<sup>22</sup> The benefits of free market speculation is the ability of individuals to properly estimate a later date at which there will be a greater shortage of that item in the market than at the current date. If the individuals estimate correctly, then they are rewarded by that given profit margin. If their speculations are inaccurate, then they receive a net loss. Speculation, in essence, allows for the allocation of a *relative surplus* in a given time period to the *relative shortage* of another time period. This brilliant mechanism, using the profit motive inherent in Capitalism which is responsible for proper resource allocation, works to further bring the market closer to the equilibrium price for the speculative goods.<sup>23</sup>

### D) Pricing and Resource Allocation

- I. In essence, the pricing of factors on the market allow for the proper allocation of given factors to the most urgently needed productions. Prices also allow for the efficient allocation of resources so far as they are not wasted on incorrect calculations; such calculations may arise on the market but the penalty to the entrepreneur is a *net loss on their investment*.<sup>24</sup> In addition, it must be noted that in a free market, the prices that are evident on the market at not due to reasons concerning the seller as much as they are reasons concerning the buyer.<sup>25</sup> In other words, the amount of money needed to buy a good or service greatly has to do with the bidding

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22. This idea is often associated to the stock market but should not be limited to. The same understanding also applies to the stock market and equity markets in the sense that the most profitable companies are obtaining the largest amount of capital from shareholders. Speculation has often been looked down upon by society because of the ability to make large profits in such an activity. In reality, the phenomenon of speculation is what allows for proper resource allocation. Buying low signifies a relative surplus and thus, one buys at that price assuming that a shortage will occur in the future where they can then sell their goods at higher prices.

23. von Mises, *Human Action*, p. 325

24. Leftwich, *The Price System and Resource Allocation*, p. 201

25. The market is never “perfect” at what it accomplishes but it nears “perfection” relative to central planning. There have been cases where companies, for example Ford, have built a vast amount of cars but then did not sell enough to gain a net profit. In this case a lot of steel, plastic, leather, etc. was misallocated yet because of such miscalculation the executives of Ford incurred a cost. As will be shown later on, the role of entrepreneurs in the production process is to gather all the risk of the operation and handle it themselves. In the production process all the laborers are paid, the factors of production are bought, and capital is accumulated. The only individuals that suffer due to the misallocation of resources are those shareholders and entrepreneurs that take the burden of risk.

of individuals on the market to gain those factors. These buyers that acquire the factors used those factors to the most urgently need production processes or uses due to the fact that they bid the highest for those factors. It must also be noted that the ability to outbid other consumers on the market is not exclusive to the *wealthier of society* but is also a useful tool for the lower income brackets. The poor take advantage of the decrease in the marginal utility of the rich when concerning large quantities of goods and services. Professor Reisman explains,

Even the very poorest outbid and the other whom they outbid can include people who are far wealthier than themselves...it is true in a case such as rental space, or in housing in general, where everyone succeeds in obtaining some supply.<sup>26</sup>

- II. It is now evident that the basic role of prices on the free market are to facilitate the transactions of individuals in addition to the added ability of properly allocating resources as a result of the bidding of various beings on given factors. The phenomenon of prices is only conceivable in a society of indirect exchange and helps to expand the ability of individuals to allocate factors to their proper positions in society. Prices, in indirect exchange, have been shown to increase the size and scope of the division of labor, properly allocate resources to the most urgently needed production processes or consumption uses, and provide an arena for all actors in a given society to bid against each other for given amounts of supply regardless of their income bracket.<sup>27</sup>

#### E) The Relationship Between Monetary Prices and Inventories

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26. Reisman, *Capitalism*, p. 204

27. One must associate any opposition to price controls with the theme of this paper. Price controls simply inhibit the market mechanism from working properly. Such government inflation has been known to create unemployment, shortages, surpluses, and the like. The fallacy that price controls work are still quite embedded in our society. For instance, if a hurricane blows through a given region and destroys a lot of the water then the price of water may rise. People may cry that this is an outrage but this is a blessing of the market in two ways. First, the new pricing allows for the proper allocation of water to the most urgently needed functions. There may be some person who needs water more than others and are willing to bid a higher price for that water and thus, purchases the gallon. As described earlier, it is absurd to think a rich man would just buy up all the water simply to keep it for themselves. At some point, the other individuals in a society can bid those items away from the rich. Secondly, the high price of water encourages entrepreneurs to feed additional water to the are with the shortage. This is due to the profit margin the companies would gain from such an action. If you place price controls in this situation, the water would soon disappear and it would take much longer for additional shipments of water to enter the region.

I. Few laymen understand the connection between supply, demand, money prices, and store inventories. It is important to show, in this analysis, the relationship between these phenomena. Monetary prices, as discussed earlier, are a method for entrepreneurs to calculate what consumers may want at a future or present time. Prices, specifically when concerning the supply and demand functions of a given market, are constantly tending towards *equilibrium value*. That said, how can a store feel the effects of malinvestment if it does not have the same equilibrium price for their items as compared to the overall market? Several different scenarios could be occurring in this case. First off, the region where the store is located may be surrounded by individuals who are willing to give a different amount of money for the goods being offered than the average are giving in the market as a whole. Equilibrium prices on the market simply show the overall demand and supply of the goods; such prices can never be exact in every region as preferences and exogenous factors might alter the values of goods. Even such stores are affected by any change in the demand and supply of the market, regardless of the price differential between the overall market and that region. It is simply to be made clear that all factors in a given market are priced in a way where they are in accordance with the supply and demand schedules of the individuals in that given region.<sup>28</sup> Now when focusing on inventories of stores overall, there can be assumed two principle rules concerning the pricing of the goods and services of the store. These rules are:

1. If the price of the goods or services are below equilibrium price in the given region, then the inventories will be gone quickly due to the greater advantage in pricing the consumers enjoy. This implies that the store owner is not speculating properly and is not earning as much of a profit as would otherwise. In this case, the store owner must raise the price in order to set it closer to the equilibrium price and receive a greater profit due to increased speculation on the goods that are being sold.

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28. What is trying to be emphasized is that there might be areas where the prices of a good or service might be very different than that of the overall market. That said, those markets are also governed by their individuals supply and demand functions. For instance, a gallon of water may cost 2 ounces of silver on the global market but to an individual in the Sahara desert it might be worth 1 ounce of gold (given that gold is valued higher than silver on the market). Now there are differing prices but that is not to say that if the individual finds another being willing to sell at 2 gold ounces that that individual will still buy. The being may simply find it too expensive and refuse the transaction. What is being described is simply that prices may not be equal in all regions but that they are still quite affected by demand and supply schedules.

2. Second, if the price of the goods or services are above equilibrium price in the given region, then the inventories will stack up due a fall in the amount consumers are willing to purchase at that price. This also implies that the store owner is not speculating properly and is not earning as much of a profit as would otherwise yet in a different manner. The store owner in this case needs to lower the price in order to increase their profit but not so much as to lose profit, as would be the case if the price was set below equilibrium price.

II. In addition, inventory malinvestment may also arise due to the inflation of the money supply as a result of a fractional-reserve central banking system. When the central bank begins to print out excess bank notes or issue inflated credit, these notes are primarily diffused into the economy by way of select businesses that then bid on certain materials for their production processes. This allows the businesses that are receiving money from the company that received a loan to increase the revenues of those they are buying from. The increase in business revenues and rising prices lead businesses to believe that they are *trends in demand* and not as a result of an *artificial inflation of the money supply*; thus, they increase their inventories to meet this rise in prices. In addition, the rise of inventories are facilitated through the loaning market by which much of fiduciary media is entered into the economy. These loans keep the interest rate artificially low and entrepreneurs have increased opportunities to fund the accumulation of their inventories. The idea of malinvestment comes in when one's ponders the origin of the rise of prices and then a rise in inventories. When businessmen see these rise in prices they believe that demand has increased in the marketplace for goods when it truly has *not*. The only thing that has increased is the output of fiduciary media by the central bank. Thus, the rise in inventories are fueled by the inflationary policies of the central bank which has led to a malinvestment in the marketplace as will soon be evident.

In addition, when the central bank introduces a *contractionary policy* after the rise in inventories, businesses will begin to sell their stock at a loss because of the malinvestments made. The central bank shifts into contractionary policy because of the fear of potential *runaway inflation*.<sup>29</sup> This malinvestment incorrectly labeled the rise in prices as an affect of an

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29. The affect of a rise in the money supply is often quite different in reality than what the central bank had previously

increase in demand and the businessmen, during contraction, begin to feel the affects of the miscalculation. Entrepreneurs also, during contractionary policy, wish to maintain a larger percentage of cash holdings because credit is not so easily attained; this also holds true for the consumers. As the contractionary policy begins to cut back the amount of credit in the marketplace, all individuals begin to hoard cash and increase the percentage of cash to earnings. This increase in the holdings of cash bring down the amount of consumption present in the economy and then as a result it is even harder for the entrepreneurs to sell off their excess inventories.

III. The effect of inflationary and contractionary policy due to the *fractional-reserve systems* of central banks clearly has a detrimental affect on the ability of entrepreneurs to correctly calculate economically. Such policies bring about malinvestment in inventories and thus, allocate resources to productions that would not otherwise be in existence. This also brings about a loss in capital for the economy as a whole due to the fall in consumption during an era of contractionary policy and as a result businesses are forced to sell their unintended inventories at a loss. Credit expansion, as will be explain in subsequent chapters, has quite a negative affect on the nature and workings of the marketplace.<sup>30</sup>

#### **Section IV: Fallacies of Socialist Economic Calculation**

##### A) The Lack of Entrepreneurial Tools

I. When assessing the state of the market in a capitalist nation, businesses tend to operate well. Entrepreneurial operations develop constantly in a free market and their existence helps those consumers who demand their goods and services as well as the laborers that the business hires. It is absurd to believe that the entrepreneur, in a market society, receives more income than is entitled to them. The entrepreneur acquires only the amount of revenue deserved to that individual as a consequence of their insight to develop that respective business to meet the needs of the market and consumers. Through the mechanism of supply and demand, the market

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determined to be. That is the reason why a central bank would put the brakes on inflation even though they supposedly created it in the first place. In essence, their predictions about the affect of increased credit on the market are all they base an inflation of the money supply on.

30. Reisman, *Capitalism*, p. 594- 599

works almost flawlessly and continuously allows for the expansion of civilized society. The reasons for this outcome of a free market has less to do with intelligence of men but of the ability of individuals to use the mechanisms of indirect exchange and media of exchange, acting as units of account, to properly calculate the demand, costs, revenue, and the potential output of a given production process.<sup>31</sup> Using monetary prices and economic calculation, an entrepreneur can understand at what point cost has outweighed profit and then begin to take measures to either:

- 1 Shut down the business.
- 2 Alter the production process so as to not incur a net cost.

II. This mechanism of economic calculation allows for the proper allocation of resources. When an entrepreneur incurs a cost, this is signifying that the resources that the individual bid on are not being put to the most urgent uses in society as deemed by the demand of individuals on the market. In other words, monetary calculation, through the profit incentive, directs entrepreneurs to make decisions in the marketplace towards the allocation of resources to their most urgent uses in society. Socialism, because of its lack of private initiative and an adequate medium of exchange, does not have the basic tools to allow entrepreneurs to use economic calculation to properly allocate resources.<sup>32</sup> Instead, Socialist societies rely on the benevolence of a central planning commission to dictate what is best for a many times larger population. How is it that Socialist central planners can acquire the knowledge of how many shoes need to be made? How many tractors must be produced to yield X amount of grain, on Z acres of farmland, for Y number of citizens? The problem lies in the ability to calculate goods in terms of other specific goods. Due to the sheer size and scope of goods used in industrial production processes, proper allocation of these resources when valued against each other is nearly impossible. Mathematical calculations based on assumptions of human order do not suffice,

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31. von Mises, *Socialism*, p. 111

32. In fact, Socialism does not allow entrepreneurs to exist at all. Socialism bases its economic growth on the intelligence and work ethic of a group of individuals. This system fails to realize the need of economic calculation to allocate resources properly. All economic calculation does is figure out how many people need a given product and how many resources are needed to create that amount of product. The problem arises when Socialism does not have the ability to see where those resources could have otherwise been allocated for more urgent uses. That is why during the Soviet Union, as given in a lecture by Professor Salerno, there were fields of wheat with tractors rusting in the fields yet there was famine. The answer to this puzzling scenario is that all the workers that should have been in the fields were at the factories making tractors. Due to a lack in economic calculation the Socialists did not have the insight to understand where the laborers should have been allocated for maximum growth.

what is necessary is the marketplace and entrepreneurial incentive for profit which guides those resources to their proper uses.<sup>33</sup>

## B) A Critique of the Labor Theory of Value

- I. When concerning the measure of value for goods and services, along with higher order goods, on the market, Socialists always equate such value with the input of labor that was used to create those factors. Socialists believe that the measure of value of an object is directly proportional to the amount of labor used to create that factor. Labor is not a measure of value; you can not measure value in *time*, nor can you measure it in *joules of energy*, which are the only manners labor can be measured in. The high value of gems on the market, which have no connection to human labor and are simply bore by the earth, brings to light the fallacy of the labor theory of value. The differing values of goods and services are solely based on the marginal utility and subjective value scales of the individuals in the marketplace. Another sector of the market where the labor theory of value comes into conflict is when assessing the differing values and monetary prices concerning art. All works of art are valued quite differently and their *value depends on various factors*, not solely on the amount of labor used to create a piece of artwork or the labor needed to make the items used to create the piece of art.<sup>34</sup> Menger explains the error in the labor theory of value,

The quantities of labor or of other means of production applied to its production cannot, therefore, be the determining factor in the value of a good. Comparison of the value of a good with the value of the means of production employed in its production does, of course, show whether and to what extent its production, an act of *past* human activity, was appropriate or economic.<sup>35</sup>

- II. In addition, the Socialist belief that because the entrepreneur gains a profit from the sale of factors due to the exploitation of the worker is a fallacy. It is in the free market that the entrepreneur takes *one-hundred percent of the risk* and incurs a cost if they were to miss

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33. Ibid., p. 116

34. Menger, *Principles of Economics*, p. 147

35. Ibid., p. 146

calculate the allocation of their factors of production. During the production process the laborers are paid for their time and effort, the capital goods are accounted for, the raw materials have been acquired, and it is only the businessman that incurs any cost from miss calculation. By the time a good or service has been sold, the laborers have been paid for their efforts, and one can not claim that it is the nature of the entrepreneur to oppress or exploit the workers for the laborers do not bare any of the risk of production and receive profit without baring risk. It is the brave entrepreneur that, by choosing to serve as such, acquires all the risk on behalf of the laborers and is to blame for any mishaps during the production process. If such problems occur then the *cost* of the mishap is taken out of the pockets of the entrepreneur.<sup>36</sup>

## **Section V: The Legacy of Banking in the United States**

### A) Evolution of Media of Exchange in Early American Colonies

- I. During the era of the early British colonies in North America, the British empire had deemed that the only gold and silver would be legal tender in England. When the British empire made these commodities legal tender, it had set a ratio between the two; this exchange rate between gold and silver was completely artificial and not an outcome of the free market. The British government had, in the ratio, overvalued gold and undervalued silver. As a result, silver was beginning to be traded out of the country or maintained in domestic hoards. There was an influx of gold into the country and soon enough only gold was being traded commonly on the British isle. This is a direct application of what has come to be known as Gresham's law. Gresham's law states that when two or more commodities are given artificial exchange rates, one will always be undervalued and another overvalued. This economic law also states that the undervalued currency will be driven out of the region and the overvalued currency will be maintained as the medium of exchange. Hence the origin of the phrase “bad money drives out the good.” Though this was the case in the British Isle, the American colonies had not experimented with such metallism yet. In fact, the North American colonies had not begun truly using metals as a medium of exchange but used other monies the could often be traded with the natives. These media of exchange included:

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36. von Bohm-Bawerk, *Capital and Interest Volumes 1- 3*

- 1 Rice in South Carolina.
- 2 Beaver pelts and wampum in New England as a means of trading with the native peoples of the region.
- 3 Tobacco in Virginia that was soon being used so widely that there were already warehouses being setup to store tobacco. In addition, 100% redeemable receipts for the tobacco were beginning to circulate as a medium of exchange.

II. As the markets of the American colonies grew, both silver and gold coins from Britain, Spain, France, and other western countries began to move into the colonies; this was seen predominately in the urban areas of the colonies due to continued trading with the Indians in most rural areas. Much of the coins in the United States until 1857, when the Congress passed a law deeming all foreign coins to no longer be legal tender, were foreign gold and silver specie.<sup>37</sup> The leading specie in the early American colonies were the Spanish silver dollars. The Spanish dollar was the finest coin and the most trust worthy specie in the Western markets and thus, were often used as the medium of exchange in the American colonies. England *did limit* export of British gold and silver coins to the colonies which directly attributed to the latter's adoption of foreign gold and silver coins as media of exchange, predominately the Spanish dollar. In an attempt to acquire Spanish silver dollars, the early American colony of Massachusetts began debasing their own schillings.<sup>38</sup> This practice led to the inflation in prices on domestic foods and a crippling of the colonial export market. The colonial schillings were debased by fixing the ratio of Spanish silver coin to the colonial schilling from four schillings and six pence per Spanish Silver dollar to five schillings per Spanish silver dollar. This increased the amount of Spanish silver dollars the Massachusetts government would taken in due to exchanges from Spanish silver dollars to Massachusetts schillings.

## B) Emergence of Paper Money in the United States

I. The first case of the use of paper money in the colonies came from a series of events that unfolded in the colony of Massachusetts. Colonial Massachusetts had often times plundered the

37. Bradford, *Money and Banking*, p. 49

38. The schilling was the official coin used in the Massachusetts colony yet was not as widely accepted as the Spanish silver dollar.

French colonies of Canada for wealth and commodities.<sup>39</sup> Usually the expeditions were successful in bringing back significant returns but one of the expeditions returned unfruitful and as a result the soldiers demanded compensation from the Massachusetts government. The colony attempted to borrow funds from local merchants but it did not have a sufficient credit rating and thus, acquired little borrowed money to finance the debt. The Massachusetts government proceeded to print up paper money and give them to the soldiers. Fearing that their paper money would not be accepted to pay off the outstanding debt, the colony promised to pay the debt in full at a later date with tax revenue. The soldiers accepted the paper money but it was not until forty years later that Massachusetts attempted to redeem only a fraction of its initial promise.

II. Then in 1691, Massachusetts proceeded, once again, to print up large amounts of paper notes to pay of its outstanding debt. The market *quickly devalued the newly issued paper money* to forty percent of its declared value. As a response, the colony declared the paper certificates as legal tender and as a result all individuals would have to accept it to pay off any debts. Soon after, a larger number of Spanish silver dollars began to move out of the colony due to a phenomenon known as Gresham's law.<sup>40</sup> After this occurrence, nearby colonies followed suit with their own paper currency. The colonies then began to inflate the amount of paper currency in the economy to finance the French and Indian War and any other debts the colonies had incurred. As a result, inflation was rampant and soon the schilling depreciated over eighty percent verses silver specie. The effects of these inflationary tactics by the governments let to the *familiar boom and bust cycles*. A boom present soon after the introduction of newly issued paper currency into the market and a bust when the money supply would contract. In 1751, the British government demanded that all American colonies halt the issue of supposedly redeemable paper currency and return to a market of totally gold and silver coinage. After a rough transition period, the market began a much more prosperous trend and stimulated the export markets of the colonies.<sup>41</sup>

### C) The Path to the Federal Reserve

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39. The reason for this phenomenon had to do with money as much as the on going French and Indian War. The colony of Massachusetts did not arbitrarily decide to attack Quebec's settlements.

40. Groseclose, *Man and Money*, p. 117- 119

41. Rothbard, *A History of Money and Banking in the United States*, p. 55

- I. The First Bank of the United States was established by Congress in 1791 and was to reign for 20 years. It was given monopoly privilege to release banknotes and credit to the populace. The First Bank inflated on two million dollars in specie. By 1796, the First Bank lent to the public in excess of \$6.2 million and had printed notes to pay off any outstanding debts the government had incurred. During the inflationary period, prices rose 72 percent in wholesale markets and by 1796, the First Bank had grown to 18 branches. Jeffersonians argued that there was no constitutional right that allowed the Federal government to print and distribute paper money. The Federalists on the other hand, predominately Hamilton, argued that the constitution implied that those powers could be used. Before the First Bank's expiration in 1811, the Democratic-Republicans failed to seriously promote a rejection of the First Bank's rechartering; this was mostly due to the presence of Federalist sympathizers within the Democratic-Republican party. The number of First Bank branches rose from 28 in 1800 to 117 in 1811. In 1804, the banking institutions had inflated twice over specie and was causing turmoil within the economic structure of the United States. The First Bank of the United States had a pyramid ratio of 2.57 to 1. A two and one-half times increase over the amount of specie available to the United States Treasury. When the date came for rechartering, the bill was rejected by a slim one vote margin both in the House of Representatives and the United States Senate.<sup>42</sup>
- II. There were many attempts to reestablish the First Bank of the United States including a petition by 150 New York citizens that made its way to the House of Representatives Ways and Means Committee. The Second Bank of the United States was signed into existence in 1816 after begin passed by both the House of Representatives and the United States Senate; immense support for the Second Bank of the United States surfaced due to the crippling conditions of the state banks and problems surrounding the National Treasury's number of specie available for redemption. Reportedly, the reason given for the establishment of the Second Bank of the United States was to ease the inflationary tendencies of state banks, not to control or manipulate their activities. During the first years of the Second Bank fraudulent activity was often being reported and claims arose that those activities were tied to the central bank administrators. William Jones, president of the Second Bank of the United States, was forced to resign and in his stead, Langdon Cheves became president. Cheves worried about the outflow of capital to the western settlements and decided to severely limit the issuance of bank notes by the western branches of the Second Bank. Cheves completed this task and shifted back most of the capital

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42. Ibid., p.68- 71

to the eastern branches but this did not serve to improve the state of the banking institution.

Cheves then retired in 1823 after completing what he had set out to accomplish. In Cheves place, Nicholas Biddle was appointed president and under his administration the Second Bank's growth would attain its peak. Biddle turned the Second Bank away from its former contractionary policies and sought to further the influence of the banks to other regions of the nation. Biddle, during his administration, is known to have been closely involved with all of the Second Bank of the United State's dealings, some of which were highly questionable . Most of the twenty-six branches of the Second Bank opened under Biddle's administration and the bank did not experience any serious administrative problems or insolvency problems until its demise in 1836. During Jackson's presidency, the Democrats motivated Congress to move the governmental deposits out of the bank and into the National Treasury. As a consequence, the Second Bank had to contract it's money supply and slowly liquidate its branches. The main reason for the disappearance of the Second Bank of the United States was due to the Jacksonian hard money mentality which viewed the Second Bank's inflationary behavior as detrimental to the welfare of the United States.<sup>43</sup>

III. The National Banking system was an institution planned out mostly by Secretary of Treasury Chase in response to the supposed “wartime necessities” of the Civil War. Chase's plan, later officially named the National Bank Act, provided a uniform paper currency that would be backed by United States government securities. The National Bank Act came into affect in 1863 under the title of “an Act to provide a national currency, secured by a pledge of United States stocks, and to provide for the circulation and redemption.” Due to the ambiguity of the Act and various problems concerning the phrasing of the document, it was repealed in 1864. Then in 1864, the the National Bank Act was revised and altered to make way for the ability to expand its branches much simpler than it previously had been able to. The revised Act of 1864 allowed for any five individuals to set up a bank under the guidance of the Comptroller of the Currency. In addition, those five individuals had to meet capital requirements and satisfy other legal issues at hand before setting up a branch. All new banks had to put down \$200,000 in capital if opened in a city of more than 50,000 residents, \$100,000 if set up in a city with less than 50,000 residents, and \$50,000 if setup up in rural areas with less than 6,000 residents. Half of the capital was to be paid immediately to the National Bank of the United States and the rest in 10% installments over a given period of time.

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43. Bradford, *Money and Banking*, p.270- 274

All bankers were liable to the insolvency of the bank and all issues concerning that insolvency had to be settled by them solely. After the creation of the bank, the members had to deposit either one-third of the capital or \$30,000, whichever was highest, with the Secretary of the Treasury. No bank was allowed to issue notes in greater amounts than capital paid to the Secretary of Treasury and the bank notes were to be issued as legal tender for all debts; exceptions were customs charges or interest on the public debt. The Act of 1864 restricted the maximum amount of aggregate bank notes that could be issued to \$300,000,000. In addition, one-half of that capital was to be held by the various banks and the other half by the Secretary of the Treasury. All banks had to keep a mandatory minimum of twenty-five percent reserves for bank notes and deposit liabilities. Rural banks outside seventeen select cities had to keep minimum of fifteen percent reserves. If the reserves fell below the required minimum, the National Bank was to halt that bank's loaning privilege. Banks in seventeen select cities had to redeem their bank notes up to their to their reserve amounts. Failure to do so brought the possibility of insolvency and a closing down of the branch. The revised Act of 1864 successfully opened hundreds of banks and had lasted longer than the Second Bank of the United States in maintaining its monopoly privileges. Throughout the late eighteenth century and the early nineteenth century, the growth of banks chartered by the National Bank was unprecedented and equally as immense were the inflationary tendencies of those banks.<sup>44</sup>

IV. There were many defects with the National Banking system. Inflationary policies were rampant during its existence and the building up of credit that only was partially redeemable in specie was detrimental to the economy, creating boom and bust cycles that will be elaborated further in subsequent sections. The inflationary tendencies of the National Banking system was evident as country banks inflated on the reserve city banks, the reserve city banks inflated on the credit from New York City banks which were only fractionally redeemable in specie or greenbacks.<sup>45</sup> The pyramiding of the bank notes was quite large during the existence of the National Banking system. After the Panic of 1893, the United States Congress eliminated required reserve ratios on all bank notes which led to further inflationary policies of the national bankers. The practice of inflationary banking by purchasing government securities allowed for monetarization of the public debt as banks bought off the debt, they could

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44. Hepburn, *A History of Currency in the United States*, p. 321- 332

45. Greenbacks were a form of fiat paper money that was deemed legal tender during the time of the Civil War. They were established in the Northern states by the Lincoln administration. There were many problems concerning greenbacks and their tendencies for inflation during their existence.

continuously inflate on their reserves. The National Banking Acts of 1863, 1864, and 1865 allowed for the monopolization of bank notes into the hands of the national banks. There was also serious inelasticity problems surrounding the national banking system which did not allow for a sufficient manipulation of credit or banks during times of high demand. There was often times not enough supply to meet the demand by citizens during the recessions caused by their inflationary policies. These were some of the most important contributions to the signing of the Federal Reserve Act that centralized all the reserves in order to better “stabilize” the nation during bank runs and recessions.<sup>46</sup>

## **Section VI: Full-Reserve Banking**

### **A) Concerning the Proper Medium of Exchange**

The role of gold and silver as media of exchange has been covered in previous sections yet in order to have a well-rounded understanding of the arguments in favor of full-reserve commodity banking, one must fully grasp the concepts behind commodities as media of exchange. Though the history of one-hundred percent commodity banking has been primarily with gold and silver specie, it is important to state that the selected commodity is virtually irrelevant as long as it is chosen by a free and unhampered market. Gold and silver are commodities that attribute certain qualities that make them optimal for use as media of exchange but that does not stop the use of other metals or commodities in their stead. An individual can contemplate areas of the world where they may want to use another, more marketable, commodity for regional transactions. Gold, silver and precious metals have been internationally recognized as media of exchange that exhibit those properties that also make them quite useful as a unit of account. One may ask, why not use any commodity in a transaction if it truly does not make a difference?

Various commodities have had a history of being media of exchange yet only gold, silver, and other precious metals have surfaced as most useful. That said, let us imagine a society that uses bananas as a medium of exchange, at current United States scarcity and value. It would take a large amount of bananas to purchase any good and an individual would have to

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46. Rothbard, *A History of Money and Banking in the United States*. p.132- 147

be able to transfer easily a large amount of bananas which may be quite difficult at times. In addition, bananas have other degrading attributes, they rot easily and can be grown very efficiently which would inflate the supply of bananas. This inflationary ability is also why many commodities that do not have sufficient scarcity fail as media of exchange relative to commodities such as precious metals. Therefore it is a lot easier to use a lighter, scarcer, more highly marketable good as a medium of exchange so that items can be bought uniformly. That is why as a market expands, different media of exchange are pushed out of the market and only those that exhibit the attributes explained in section two will be widely used. These commodities will be the only ones that are worth banking and thus, when speaking of full reserve commodity banking it is most likely, but not limited to, precious metals.<sup>47</sup>

## B) Attributes of the Full-Reserve Banking Institutions

- I. Full-reserve commodity banking can only work under *strict legal conditions*. The significance of banks in such a society is simply to store and hold media of exchange for customers. In essence, these banks work as warehouses where customers pay the banker a certain rate to protect and hold their precious goods. Receipts would be given out as a claim to the commodity but it must be redeemable one-hundred percent. In a free market there can be institutions that you may loan money to and are given a receipt for money redeemable at a later date yet this is a completely different transaction than that of banking and one should not be mistaken with the other. Such a transaction is formally referred to as a time-deposit and is much like a loan to a banking institution for payment with interest at a later date. Receipts on the free market can be used as substitutes for metal, they are often referred to as *representative money* or *token coinage*,<sup>48</sup> but what must be understood is that those receipts, regardless of what the rates of redemption are, must always be one-hundred percent redeemable on demand in the specified commodity.

In such a society, inflation of deposit receipts by banking institutions would be labeled as illegal and the bankers would be taken to a court of law for reparation damages. In full-reserve banking, an artificial inflation of the money supply is prohibited because of the one-

47. Smith, *The Wealth of Nations*, p. 25-26

48. Token coinage and representative money are virtually the same thing. Token coinage is often associated with receipts in a certain, less valuable metal that is redeemable in the printed amount of the reserve. Representative money is often tied to paper money. For an in depth discussion into the nature of token coinage refer to Jevons, *Money and the Mechanism of Exchange*, p.190- 200

hundred percent redemption rate of the receipts circulating. If the bank receipts are inflated that signifies that the circulating receipts are no longer redeemable in one-hundred percent of the specie but only in a percentage lower than specified on the deposit slip. Such a practice would also be highly unpopular and banks that practiced such fraudulent activity would be in danger of losing its clientèle due to mistrust in their ability to keep their one-hundred percent redemption promises.

- II. Another fear held by fraudulent institutions, in a full-reserve commodity requirement society, and that would be used as a true barrier to the inflationary tendencies of banks are the threat of *bank runs*. Bank runs are events where all the customers of a bank fear that their money is artificially inflated, thus that their certificates will not be one-hundred percent redeemable, and thus go to reclaim as much specie as they can. Those left without specie are victims of a crime of fraudulent activity and should proceed to take the bankers to a court of law on criminal charges.<sup>49</sup>
- III. In addition, another clear advantage to the adoption of a full-reserve commodity banking system is the inability of government to constantly and artificially inflate the supply of bank notes in order to pay off its outstanding debts. The government would have to tax the American citizens indirectly or directly as proposed in the constitution and thus the amount government can obtain from the populace will be greatly reduce compared to the amount taken through the inflation of the money supply. Many refer to the inflation of the money supply as the *silent tax* because it is equivalent to a tax that the citizen is never formally notified about. The devaluation of money in order to transfer the purchasing power to government is as much of a tax, if not worse, than any tariff or sales tax on goods and services. Another benefit of government acting in such behavior in order to gain tax revenue versus direct or indirect taxation is the ability to blame rising prices and increased cost of living on the greed of the businessmen. Thus, by limiting the issuance of bank notes to private bankers with one-hundred percent redemption, the size of government is greatly decreased due to a lack of revenue. Also, the boom and bust cycles often associated with the injection of fiat paper currency into the economy and the contraction of the money supply will stop. This because government and central banks no longer have the ability to bring about business cycles due to the issuance of *new money*<sup>50</sup> into

49. Skousen, *The 100% Gold Standard: Economics of a Pure Money Commodity*, p.127- 129

50. The usage of the term “new money” in modern economic theory is the phenomenon of one business receiving newly printed bank notes at current market value and at current monetary purchasing power. As the bank notes trickle down through the economic system then the value of the dollar diminishes and each dollar has less and less purchasing power. For more information concerning “new money” and its inflationary effects refer to *The New Palgrave Dictionary of Money and*

the economy. The clear connection between inflation, deflation, and the business cycle will be elaborate in sections to come.<sup>51</sup>

### C) Metallism

- I. The emphasis of this topic will not be much but it is important to show the role of metallism in a free market and the absence of such a practice in the one-hundred percent banking system. The institution of bimetallism, trimetallism, and multimetallism are simply governmental policies that artificially fix the ratio of two, three, and many media of exchange together, respectively. Multimetallism does not necessarily counter the idea of full-reserve commodity banking but it is an unnecessary evil that must be done away with if it were to be implemented once again. The prime example of the effects of multimetallism is Gresham's law and "bad money drives out the good." When Gresham's law states that when you fix at least two media of exchange together in an artificial ratio, the overvalued currency continues to circulate and the undervalued currency is slowly forced out of the market place by hoarding and international trade.
- II. There are several reasons as to the adoption of metallism by a government. One of the main reasons for the adoption of metallism by government has to do with the presence of special interests of business and industries that acquire the overvalued metal often. The individuals who lose because of the metallism policies are those industries, entrepreneurs, and businesses that deal often with the undervalued currency. Metallism is simply another manner for the governmental forces to dominate the financial arena and ultimately favor their special interest partners while hurt the innocent individuals that deal with the undervalued metal. In addition, metallism can also be indirectly achieved if the legal standards of coinage are not met and the fineness of the coins are not equal. If one coin of particular metal is infused with a greater fineness than another coin with a different metal, then the ratio has been indirectly fixed to value one coin above another. These principles also hold true for ratios between any medium of exchange, not simply limited to metal. If paper money an another medium of exchange, paper money or metal, are given an artificial ratio then the detrimental side effects are conclusively similar.

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*Finance*, p. 394- 399

51. Sennholz, *The Age of Inflation*, p. 156- 164

Though metallism and full-reserve banking are not mutually exclusive, such a society that embraces hard money policy can not and must not allow an atrocious governmental ratio between one metal and another. Such a policy slowly curbs the market for proper media of exchange and increases the outflow of the undervalued currency, limiting the money market.<sup>52</sup>

#### D) Problems Concerning Full-Reserve Commodity Banking

- I. One of the more common objections to full-reserve banking is the notion that banks would not be able to reap a profit because of the inability to inflate the money supply in order to provide loans to other individuals. Loaning out on on-demand reserve receipts, claim some, is the only method a bank can receive a net profit in the banking business. That said, inflationary policy by a bank is fraudulent activity. The loaning out of funds that do not exist is criminal behavior that should be, if ever found, prosecuted in a court of law. When a bank takes in ten gold ounces from depositor and gives to the individual ten receipts for one gold ounce each then turns around and loans ten more receipts to another individual at interest, there is an artificial inflation of the money supply. The end result of this scenario is that there are twenty outstanding receipts for the same ten ounces of gold specie; in realistic terms each receipt is now worth half of one ounce of gold. Obviously, the on-demand receipts are now not correctly representing the true value of the specie amount backing that receipt and such activity is fraudulent if an individual or a bank leads another individual to believe that the receipt is correct when concerning the amount of specie that has claim to. It seems quite interesting that one could argue that the only method a banking business could obtain a profit is through the fraudulent practices.<sup>53</sup>
- II. When concerning the profitability of banks on the free market under a one-hundred percent commodity standard, there are various ways that these institutions can receive a net gain. The primary method that might arise is charging individuals who request the bank to hold their specie a fee for such a service. If this service was not profitable and no supplier is willing

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52. Jevons, *Money and the Mechanism of Exchange*, p.79- 84

53. The the uses of the word criminal and fraudulent can be mutually inclusive but also different in certain respects. For instance, if bank notes are inflated over the money supply of specie, under a full-reserve system, such would be criminal behavior. The crime only becomes fraudulent when the inflated currency passes into the hands of businessmen through the purchasing of goods and services. In other words, if person A uses an inflated bank not to buy a good from person B, that transaction was fraudulent because the amount on the note did not represent its actual value. The actual act of printing excess bank notes is simply criminal behavior. The distinction is minimal but important to comprehend.

to respond to the potential demand in the market, then logically there is no reason for the institution to exist under those terms. That said, banks would most likely, under a full-reserve banking system, decide to have a large amount of *protection* and methods of securing their depositor's valuables. There is quite an advantage in storing one's valuables in a bank that has sufficient security to protect those valuables then in a place that may not be as secure for instance, like one's house. What is trying to be communicated is the potential gain banks can acquire as being a storage for money deposits on the free market.

Another method that banks can gain wealth with a full-reserve banking is the use of *time-deposits*. These deposits take hold when an individual gives a banking institution a certain amount of specie and is given a receipt for the same amount of money or more to be redeemed at a *future time*. This would be a method an individual could invest their specie that they may not use and another method for the bank to gain a return on their business. Time-deposits are a completely legal and non-fraudulent method of a bank taking specie from one depositor and loaning the specie out to another individual or investing it in equity markets. In addition, banks could easily enter equity markets as a method of attracting investors and stock-holders. This method allows the bank to gain additional funds in which they can use to increase the profitability of the business. This method of obtaining a return is not fraudulent so long as the bank only puts own capital, and not of their customers, on the equity market.

III. A popular objection that the full-reserve commodity system faces is the belief that the money supply should be expanded when there is an increased amount of transactions being made on the market. This phenomenon might be induced by such natural causes as population growth and increased productivity. What Professor Rothbard states in his *The Case for the 100 Percent Gold Dollar* is that the money supply in an economy essentially is not of importance. Professor Rothbard claimed that as the amount of transactions increases or and the society finds greater uses for the medium of exchange that the purchasing power of the specie will either rise or fall. If an individual seeks to inflate the money supply or deflate it artificially then it must be done through governmental approval and such policies have historically had detrimental affects on the state of the economy by inducing business cycles. There is no need for an increase in the money supply when concerning full-reserve banking. The only needs there may be are when addressing the issues of non-monetary uses for precious metals such as jewelry, dentistry, electronics, etc.<sup>54</sup>

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54. Rothbard, *The Case For A 100 Percent Gold Dollar*, p. 52- 55

## E) Full-Reserve Fiat Banking

I. The type of full-reserve banking that has been covered until now is a system that is backed by a given commodity. As elaborated in previous sections, this commodity must have certain attributes that make it ideal as a money, if it does not have these attributes then the use of them in order to back up warehouse receipts is useless. Under full-reserve fiat banking, the same concept applies behind the amount of reserves that the central bank or chartered banks must maintain; this, of course, is one-hundred percent reserve of standard money. In essence, the *old Chicago School* belief of one-hundred percent fiat was to make sure that the Federal Reserve does not issue more credit than it does store bank notes to cover that credit. Also, the advocates of one-hundred percent fiat banking understand the origin of the business cycle and the fluctuation of prices. These economic expansions and contractions are due to the over issue of credit that supposedly represent standard money. That said, the main factor that contributes to the reasoning behind the advocacy of the one-hundred percent fiat reserves by the old Chicago School is the supposed necessity to balance the price levels.

These advocates believed that though the origin of economic strife is a *lack of redeemability* of checking accounts and credit; that the effect is a rise in the price level which should never come to pass. This is an essential difference between the beliefs of full-reserve commodity banking and full-reserve fiat. In one instance the value of the standard money is set by the marketplace, in the other it is set by the government and exchange markets. Under full-reserve commodity banking, the price level can shift dramatically or may not shift at all but that is simply dependent on the abundance of standard money in the marketplace. If what was standard money becomes less valuable as a medium of exchange then the most likely result is a shift of social use from that money to another *vis-a-vis* the marketplace. In other words, the one-hundred percent commodity standard does not limit a change in the price level, in the contrary, it demands it if a new source of the standard money is introduced into the market. If this happens and the price of the commodity is fixed then we have a scenario metallistic policy which is quite detrimental to the monetary market.

II. The idea of full-reserve fiat banking was prompted by Irving Fisher and later advocated by Milton Friedman. Though any advocate of full-reserve commodity banking should have a some sympathy for this proposed plan, the logic behind the system seems unclear. Fiat paper money was established from fiduciary media that were created to supposedly represent a certain

amount of commodity. In essence, the very nature of fiat money came from the idea that money was backed by some valuable commodity but it was in fact backed by nothing. The issue of paper money was put into effect by a series governmental decrees that bank notes, though not backed by full-reserves of the commodity specified, must be accepted in transactions. This put into effect the first legal tender laws that mandate businesses to accept the fiduciary media. Paper, without *governmental coercion* by maintaining legal tender laws, is as valuable as the material it contains which is not much compared to the values of various precious metals. In essence, it is somewhat fallacious to believe that people on the free market would openly accept paper currency as a storage of value and a medium of exchange. These currencies have no value other than what government deems to be its value. In addition, the belief that the governmental institutions would not abuse the monopoly privilege of managing currency by issuing credit past the amount of fiat paper money in reserves is quite *unrealistic*.<sup>55</sup> The reason that government wanted to manage the money supply was to pay off outstanding debts that they had incurred and favor certain industries over others. What benefits does the government have in controlling the money supply, even if such services are paid through other means such as taxes, if it does not have the ability to abuse that privilege and pay off outstanding debt? It is clear that there is none.

III. In addition, one-hundred percent fiat banking is simply a difference in methodology and not necessarily a difference in systems. Under such a system the government can just as easily print up more standard money to finance its necessities; the government can inflate the money supply just as efficiently under a system of one-hundred percent fiat reserve. It is also claimed that under a system that the money supply would be more available for changes in the economy relative to the velocity of money. As should be stated, Professor Rothbard explains that the amount of money is not important in a complex economy but instead the value the society places on that standard money is what is crucial. Some advocates of one-hundred percent fiat reserves claim that a printing of standard money could raise productivity in the market. This is not true, it may increase productivity in the favored industry but only at the expense of the rest of society. The ability of government to print money is, of course, a negative affect of fiat banking. One of the factors of how media of exchange became favored in society has much to

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55. Though this seems to be the logical conclusion, there is an interesting phenomenon occurring in Somalia. Though Somalia has no central bank, the citizens do still use the paper money issued by the various warlords. It is said that because the cost of printing new notes are rising, that a halt in the issue of notes has occurred and with it a stabilization of prices. Such a phenomenon would be interesting to look into.

do with scarcity and the value placed on the media. Full-reserve fiat banking advocates also claim that there would be little incentive to start bank runs because of the knowledge that all checking accounts are backed up by an equal amount in dollars. That is very much true but that could be present in our current system. The Federal Reserve may print up as much money as it wants at any moment in time; there is not much difference between full-reserve fiat banking and fractional-reserve fiat banking when concerning the power of the state to dictate monetary policy. In addition, the control of the money supply would be in the hands of the Federal Reserve and not in the care of bankers with short-run loans that may be detrimental to the society. Those are the main arguments in favor of full-reserve fiat banking. Though there are many fallacious thought processes in their beliefs, these examples do show that full-reserve fiat banking is a nudge in the right direction.<sup>56</sup>

IV. That said, there is some amount of truth behind the old Chicago School belief that such a policy of one-hundred percent reserve fiat would stabilize the price level somewhat. The reason for such economic instability and the fluctuations of prices are the inflationary or contractionary policies that the Federal Reserve puts into effect. Even though such a policy of one-hundred percent reserve fiat banking would lend to greater economic stability and would be an acceptable alternative to the fractional-reserve fiat banking currently in existence, there are many problems surrounding the theories and application of the such a banking institution.<sup>57</sup>

## **Section VII: Fractional-Reserve Banking**

### A) Fractional-Reserve Commodity Banking and Its Attributes

I. Fractional-reserve commodity banking is quite different than full-reserve. What fractional-reserve commodity banking advocates is to allow banks to inflate over the supply of specie and bank notes to a legally designated amount. That is, if a bank has one-hundred gold ounces, under a fractional-reserve system that bank *does not* need to maintain all one-hundred ounces; the bank simply needs to hold a certain fraction of the reserves of specie versus that of

56. Tolley, *100% Reserve Banking*, p. 275- 309

57. Though this example is quite unacceptable for an empirical proof of the matter, one can explore an interesting occurrence in the last few decades in Somalia concerning the use of paper currency on the free market. Somalia does not have a centralized state and has somewhat of a free market yet they use paper currency issued by regional warlords. Further research into this area will not be found in this paper but the existence of such a case is quite intriguing.

the outstanding bank notes. In essence, such a bank can issue two, three, or four times as many bank notes as they are redeemable in specie. The limitation of this inflationary ability is usually set by the central bank that manages over the chartered banks or Congressional law.

Often times these inflationary tactics by the bank landed those institutions into *insolvency* due to an inability to pay back the amount of specie specified on the bank notes. These occurrences did not happen often yet they did appear through events called “bank runs.” Bank runs are happenings that occur when a large amount of a bank's clientèle become aware of their bank's massive inflationary policies and fear insolvency. In an attempt to reclaim their specie before they lose it, all the customers flood into the bank at once and demand payment. As a result the institutions becomes *bankrupt* and go out of business. Many times throughout the history of the United States, these bankers have plead to the the United States government to allow them to refuse payment so as to not become insolvent. In time the bankers were given this privilege and soon abused this government given right to inflate the money supply. Aside from fractional-reserve banking, that is supported by government laws, there are also forms of free market banking that is fractional-reserve commodity banking yet if any problems of insolvency arise such problems would be left to the market to sort out. This form of banking is called *free banking* that will be addressed shortly.

- II. There are few modern arguments in favor such a fractional-reserve commodity standard but the main aspect that fractional-reservists advocate is the ability of the government to increase the *elasticity* of money and manipulate the supply of media of exchange for select secular problems that might arise. Fractional-reserve advocates do not believe that gold can properly make up for rise in population or increased instances of trade and for such reasons a central bank must be implemented to give greater elasticity to gold receipts. This argument is ill-founded because the beauty of the use of commodities as media of exchange is that the market will automatically adjust for any inflation or deflation of the supply of the commodity. If certain secular factors come to be that change the purchasing power of the medium of exchange or changes what medium of exchange is used, so be it. There is no logical reason supporting a necessity of manipulating the money supply in response to secular occurrences.<sup>58</sup>

## B) Problems with the Fractional-Reserve Commodity Banking System

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58. Skousen, *The 100% Gold Standard: Economics of a Pure Money Commodity*, p.137- 143

I. Various systems have been used in the past as a method of stabilizing the monetary functions of the market economy. Undoubtedly, one of the most frequently used methods of banking has been the use of fractional-reserve commodity banking. Throughout the history of the United States there have been many eras where fractional-reserve banking reigned supreme. As explained in earlier chapters, such a system began in the United States during the inflation of bank note promises in Massachusetts given to failed expedition soldiers. Soon, the First Bank of the United States was setup that allowed fractional-reserves of commodities, inflation of the amount of bank notes in certain ratios with respect to specie available, and a small-scale pooling of reserves of many different banking institutions together. This inflationary system failed along with the Second Bank of the United States. The Second Bank experienced massive inflation and as a result there were many recessions during the late eighteenth century.

These recessions were masked in a way that convinced the populace that these were simply the workings of a laissez-faire capitalist system and that in order to stop the business cycle a central bank that could manage all the reserves had to be established. These cries were heard for many decades until in 1913 they were put into affect with the signing of the Federal Reserve Act. The Federal Reserve Act was a supposed solution to the business cycle, a method of chaining down the beast that is capitalism. What these individuals failed to see was that the very problem with banking was not that it was held down by a commodity standard or that capitalism contains these natural business fluctuations that can only be solved by a central bank manipulating the money supply, these are mythological ideas produced by the very individuals that *benefit* from institutionalized banking.<sup>59</sup> The negative aspects of the banking system in the United States stemmed from the inflationary policies of the institutions that led directly into the existence of the business cycle. Throughout the history of the United States, banks have either been tolerated by the United States and allowed to inflate on the money supply, which led to boom and bust cycles, or government agencies would sponsor these actions through the establishment of central banking. Finally in 1933, with Executive Order 6102 and the Gold Reserve Act, Franklin D. Roosevelt took the United States off the partial gold standard. This was the end of fractional-reserve commodity banking.

II. It is now evident that the United States has had an immense history when dealing with fractional-reserve commodity banking. The attributes that make this form of banking so unique

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59. Those who benefit from banking would include special interests, the banking industry, and certain companies that are favored when given loans. Wealth is simply transferred from society to these individuals when money is inflated.

from the others is the natural barrier present in holding specie of inflating the money supply beyond either legal restrictions or market restrictions. During the government sponsored fractional-reserve commodity banking systems, the central banks that were put into place were only allowed to inflate a certain amount of specie. Thus, the banking institutions could not endlessly inflate on specie, their power was cut back by the presence of specie. Fearing bank runs, these institutions did not want to become insolvent and therefore were often weary as to not inflate past the proper amount so as to not be thrown out of the marketplace. This fractional-reserve commodity banking system helped to curtail the affects of inflation, as opposed to inflation on nothing but paper, and allowed for some objective value to the money in circulation. Though there are many advantages to fractional-reserve commodity banking as opposed to fractional-reserve fiat banking, it must be made clear that the banks are still engaging in fraudulent activity by inflating and thus, virtually stealing the assets of their depositors. Aside from the legal aspects of fractional-reserve commodity banking, there are many detrimental affects of the inflationary methods of banks. Inflation, as will be elaborated in later sections, are the reason for the boom and bust cycle that the United States is so familiar with.<sup>60</sup>

### C) Free Banking

- I. Free banking is a form of fractional-reserve commodity banking that is left to the *discretion of the free market*. Many of its advocates correctly claim that this is a much sounder system than government allowed factional-reserve banking yet mistakenly hold that it is a far greater system than full-reserve commodity banking. Free bankings advocates adhere to a method of banking that allows bankers to assume risk, if desired, by inflating the money supply of bank notes in circulation. Free bankers claim that each time the bank inflates the number of bank notes over specie available that the banker is not committing fraud, per se, but engaging in *entrepreneurial risk*. Free bankers also hold that such a banking system, controlled by the supply and demand functions of the market, will tend towards a reserve ratio that does not necessarily have to be full-reserve. Free banking does not find government intervention to maintain any sort of reserve ratio acceptable but instead calls on the market to produce such information concerning reserve rations, risk management, etc. In addition, free banking allows

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60. Rothbard, *The Mystery of Banking*, p. 95-109

banks to inflate the money supply and use the fiduciary media as a source of funding, thus lessening the cost of storage to depositors as well as acquiring the ability to loan out the inflated funds.<sup>61</sup>

This is the negative aspect of free banking because it is an unprincipled statement that bankers should be able to compete on the market place for a reserve ratio, such activity regardless of what the market deems it to be is against fundamental legal principles. It is equivalent to having a market for thieves and allowing those who are not caught by their victims to go on robbing individuals. The inflation of bank notes representing a given amount of specie must be categorized as *unlawful activity* for either the new bank notes represent no backing whatsoever which is fraudulent if used in consumer exchanges or each outstanding bank note is devalued proportionally to the amount of new bank notes that were created which would be equivalent to thievery. There can not be a market for fraud, such a statement is an oxymoron. Many fail to see the legal implications of their advocacy for so called “free banking.” The essence of the market is based on few yet *crucial legal principles* which include the right to private property. If a banker is artificially devaluing the value of the property of other individuals, they have broken this basic legal code that the market must operate under. If the market does not have such basic restrictions on the actions of others then the foundations of trade are cast asunder. The bank can issue notes that are back by capital of some kind or private insurance funds in case of insolvency.

- II. One possibility on the free market concerning free banking would be that there could exist a market for *private insurance agencies* that bail out any bank who is experiencing a bank run. The private insurance agency could pay those demanding their money and thus, uphold all outstanding contracts regardless of the reserve ratio of the bank. That said, it is still somewhat fraudulent because the deposit receipts are redeemable on demand and if there is not sufficient specie in the bank when the clientèle demands payment then the contractual agreement between the holder of the deposit receipt and the bank has been broken. Even if a private insurance company bails out the bank and pays the outstanding demand for standard money to the individual, the bank has still committed unlawful activity because the customer's money was not redeemed on demand. What must also be taken into account is the possibility of the individual to disregard the on demand redeemability of the bank note if the amount owed to the

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61. Selgin, *The Theory of Free Banking*, p. 126- 139

individual is payed back within a given amount of time.<sup>62</sup>

Though this scenario might play out, it does not eliminate the fact that the bank deposit has not been redeemed on demand and thus, the contract has been not only broken but the deposit note was fraudulent. What this scenario concludes is that the redeemer has put the redemption of the bank note at any time X that isn't on demand above the fulfillment. Such an example would Mr. Niceguy who received a bank note for twenty gold ounces and tries to redeem the notes on demand. If the note says “redeemable on demand” and Mr. Niceguy was not given his gold ounces on demand then not only has that contract been fulfilled but the note is fraudulent. If Mr. DeVille, the banker, explains to the trouble Mr. Niceguy that he will be able to redeem the bank note tomorrow and Mr. Niceguy accepts then that is acceptable between those two individuals. That said, Mr. Niceguy, by receiving the funds the next, can not claim that his contract was fulfilled because it was not; the note said “redeemable on demand” and this was not the case. What Mr. Niceguy can claim is that he valued waiting a day for payment than settling the manner in court that might brought with it increased fees, disutility of labor when concerning court papers to complete, etc. Such action is acceptable but can not be masked under the completion of the contract.

III. One of the greatest restrictions to free bankings is the legendary bank run. This event is always present in the conscious of the banker and will serve as a true psychological barrier to the desire of the institution to inflate beyond what the market has deemed as acceptable.<sup>63</sup> If these banks do inflate beyond what the market has labeled satisfactory, then they are in danger of having their inflationary policies revealed and having a chain of rumors emerging concerning the insolvency of a bank. Such a wide spread growth of knowledge concerning the policies of the bank will quickly prompt a bank run.

IV. Free banking is a viable alternative to government sponsored fractional-reserve because of the ability of banks to easily become insolvent if fraudulent activity is discovered and the necessity of banks to stay maintain their promises. That said, this system also violates the right to private property. and one can not claim that such a system can be legally justifiable. Only under the conditions that all parties that are participating with the bank notes know exactly the value of those notes, adjusted for the artificial inflation, will such a system be viable yet this

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62. For a more further explanation of how free banking institutions can hold off bank runs through a series of alter native means beyond private insurance companies please refer to *Ibid.*, p. 133- 136

63. The use of the term “acceptable” in this discussion is referring to the rate of redemption that the market has deemed to be efficient. Inflation over the money supply of specie is never satisfactory because such activity would amount to fraudulence.

will never take place in reality. There will always be an individual who claims the bank note to be legitimately what the value is claimed to be on the deposit receipt.<sup>64</sup>

#### D) Fractional-Reserve Fiat Banking

Fractional-reserve banking, in any form, allows for inflation of the money supply over specie which does and should constitute as fraudulent activity under law. That said, beyond the legal aspects of fractional-reserve banking there are serious detrimental affects when concerning the boom and bust cycles that such activity produces. Fractional-reserve fiat banking is quite different from fractional-reserve commodity banking in that one system is backed by a standard money that can not be created by government and the other is backed by paper money that is easily printed by the central bank. In the section concerning the fractional-reserve commodity banking system it was pointed out that though this system is harmful to economic stability and is unlawful if private property is upheld, it still has an ultimate check on the ability of the government to over issue bank notes and credit. Under partial-reserve fiat banking there is no check on the amount of credit the government can issue and how many bank notes the government can print out; the final check on over issue of currency is removed. This allows the central bank to issue a greater amount of bank notes for its outstanding debts. As a result, the effects of recessions and depressions are more hurtful on the economy than if specie still back the bank notes even partially. In addition, the expansions or booms of the economy have a greater tendency to misallocate a larger amount of resources. The main economic reasons for business cycles as well as the cause of inflation and deflation will be evaluated in subsequent sections but what needs to be understood in this discussion is that when a government removes the commodity backing from bank notes that it will have destroyed the last restriction to inflation.<sup>65</sup>

### **Nature and Causes of Monetary Policy**

#### A) Monetary Policy

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64. Rothbard, *The Mystery of Banking*, p. 111- 124

65. LoCascio, *Special Privilege: How the Monetary Elite Benefit at Your Expense*, p. 134- 138

- I. Monetary policy, throughout history, has sought to accomplish certain tasks for governments that, without the institution of monopoly mint, could never be done. The introduction of monetary policy to the governments of Europe was quite different than the modern understanding of monetary policy yet there are still fundamental similarities. The first cases of monetary policy are reportedly the debasing of coinage by government for fiscal concerns during times of war or great struggle. This was a form of silent tax on the populace and often times was not discovered until sometime after the practice had begun. The citizenry would eventually become aware of the debasing of the currency and halt trade with individuals that carried such coinage. When the governments heard of such an occurrence, and fearing an end to their method of obtaining wealth discretely, they forced the populace, through legal tender laws, to accept the debased coins at full market value. This led to the exercise of Gresham's law and pushed many of the proper coins into domestic hoards or were shipped abroad through international trade.
- II. The true origin of inflationary banking begins during the time of goldsmiths. Goldsmiths would be hired by various individuals to store their gold for a nominal fee. The goldsmiths would then give receipts for the gold to the depositors and deemed those receipts payable on demand. As individuals came to use the goldsmith's deposit receipts more often as a form of payment for goods, society began to simply use the receipts to gold as money. That said, no individual found worth in the receipts themselves but in what the receipts were redeemable in. Soon the goldsmiths began to realize that the rate of redemption was sufficient so that they could use part of the gold reserves and lend them out on interest; this way the banker could gain a return on the amount of reserves not normally claimed in addition to receiving compensation from the depositors for storage. This was fraudulent activity because as the goldsmith would lend out the specie or print up bank notes, supposedly redeemable in gold, they were devaluing the notes of the other depositors. In essence, the banker had just committed a crime and gained wealth at the expense of their depositors. Often times their operations would be revealed by individuals and bank runs would occur. That said, in time governments, as discussed in previous sections, began to give these bankers special privileges and the ability to refuse specie payments. This was the true beginning of inflationary tendencies yet the market kept the bankers in check fearing bank runs and insolvency. The problem of inflation only became serious when government began allowing these fraudulent bankers to inflate the money supply to finance their public operations and gave banks the privilege to refuse specie payment. This

was the true start of government sponsored, economically detrimental inflation.

III. Thus, the ultimate goal of monetary policy, even during these scenarios, is to alter the purchasing power of money to benefit one group over another. The groups that always benefited from monetary policy and a monopolization of the mint were the government and those who traded with it. Monetary policy also tends to limit the free market choice of what medium of exchange shall be used.<sup>66</sup> Under metallic monetary policy, the goal is to favor specific metals over others in order to more simply manipulate the money supply over time for the purposes of the government. Inflationary policy is also adhered to in order to further the export industries and discourage importation of goods and services. Also, in order to maintain exportation, inflation must be constantly stimulated in order to further devalue the currency. Exporters may gain wealth in the short-run but in the long-run inflation causes a rise in prices and thus lowering the real wages of exporters. In addition, a vast amount of economists claim that through inflation businesses and production are stimulated and thus, may stimulate overall economic expansion. This has been proven to be untrue and in fact, in the long run, the economy as a whole is damaged by malinvestment and credit expansion.

IV. It is also unlikely that a creditor gains an advantage over the debtor due to monetary expansion. Often times the creditor loses because the debtor needs to pay less wealth in order to fulfill the loan. Inflation is simply a transfer of wealth from one group to another. As a result, capital, in the form of money,<sup>67</sup> is transferred to the individuals taking out loans; these individuals are favored by government and have increased purchasing power due to the unfair advantage given to them. Also, inflation is often enacted when government does not want to levy a tax because of unpopular sentiment. Taxation is often a very unpopular method of retrieving funds from the citizenry for certain outstanding debts. In essence, inflation is a fantastic method of government gaining wealth without having to directly enlighten the populace of the such a tax. In addition, inflation comes about when government can not locate sufficient individuals whom would lend them money; it is simply another way to bypass the traditional methods of government finance. In addition, as inflation occurs, the main currency becomes less and less liquid and soon other monetary alternatives enter the market. In essence, the main purposes behind monetary policy is to alter the objective value of money in order to

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66. This is true because if a state wants to efficiently use monetary policy, it needs to monopolize the mint or create legal tender laws dictating what media of exchange may be used.

67. Richard von Strigl has an excellent chapter on monetary capital. Please see Strigl, *Capital & Production*, p. 94- 108

meet certain favored goals by government.<sup>68</sup>

## B) Inflationary Monetary Policy

I. One important aspect of economics that must be stressed in this analysis is that wealth can not be produced simply by inflating currency. Many economists write as if an inflation of the money supply automatically increases wealth for the entire nation. Without an increase in production, inflation simply transfers wealth from one individual to another and no wealth is actually created. All objects X that a being's savings can obtain is the amount of wealth that individual has. There has traditionally been much ambiguity in the use of the terms money and wealth but it must be made completely clear that they are not necessarily one in the same. Inflation is not the creation of wealth by any means, simply the transfer of wealth in society. A good indication of this is the “new money” affect which shows that as dollars diffuse through the economy, prices rise because of lower purchasing power of the dollar. This predominately hurts the poor who struggle with the rising prices and often can not obtain increases in salary in order to counteract the monetary inflation. This, of course, is not the fault of the business man but of the central bank that continuously issues fiduciary media; it especially damages those primarily who are on contractually set salaries. Governments mainly give the loans and fiduciary media to those industries it works closely with. As the industry uses the fiduciary media in bidding for goods and services on the market, demand increases for those factors and thus, prices rise. In reality, though the amount purchased may have risen in the short term, there is no true shift in demand. This shift in wealth altered prices by masking as an increase in the overall market demand for certain factors. This supposed shift in demand causes stores to increase the amount of inventories. This directly leads to malinvestment as store owners begin to notice that there is no true increase in demand for such factors. This malinvestment uses up many finite resources that would have not been used otherwise. There is no true way that inflation can accurately be controlled in the short-run, even long-run elements of inflation are quite difficult to manage. Lobbying groups also play an essential role in the continuation of inflation by central banks. It is in the favor of industries that central banks shift wealth to them in the form of fiduciary media; this lobbying keeps the practice of inflation very much alive.

II. In addition, when concerning inflation of fiat currency, money is based on the

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68. von Mises, *The Theory of Money and Credit*, p. 247- 250

confidence of the holders. If individuals begin to believe that the value of the dollar is rapidly falling, then they are more likely to move their assets into goods that are becoming more liquid as a result of the devaluation, such as gold or silver. In addition, when concerning the dollar, like all media of exchange, the value of that dollar to an individual is also based on the value other individuals give it. Media of exchange are selected by society as a highly marketable good that many individuals in a given region are willing to accept as payment. Money is always valued with the overall value of that dollar to other individuals in mind. As explained earlier, inflation is a silent tax and is as method for government to take wealth from the nation to pay off its outstanding debts. By doing this, the Federal Reserve might miss calculate how much to take from the people through a inflation of the money supply.<sup>69</sup> The Federal Reserve, often times, may overstep its bounds and issue too much credit. This may lead to a snowball effect of runaway inflation and even hyperinflation.

III. The Federal Reserve prints paper money in order for the government to use it for outstanding debt payment. Through this method the government does not request wealth from the people but strips it from the populace without any individual becoming the wiser. Once the government spends the accumulated wealth, the funds make their way back to the banking institutions who are then allowed to further inflate credit on the new Federal Reserve notes. Inflationists suggest that inflation increases capital and increases production. This is quite fallacious, real capital is simply allocated to the individual who received the new receipts first at the expense of the other individuals in the society that use the medium of exchange. It has been shown that under the domestic gold standard, wholesale prices of goods remained fairly stable. This mainly has to do with the ability of gold to be a proper storage of value that can not be simply printed up in large quantities by the Federal Reserve. The ones who profit from inflation are mostly big business whom compile an immense amount of the outstanding private debt in this country. Most corporations owe a substantial amount in debt to creditors. This signifies that they take out immense loans in order to finance their operations. In addition, real wages decrease because of inflation and thus, businesses do not have to spend as much wealth compensating their workers. In essence, the businesses that received the loans were transferred wealth by the banks which allowed for the increase in general prices in society versus increases in salary. Through the issue of fiduciary media, businesses can, in the long run, lessen the value of the wages given to their workers and thus, obtain a larger portion of wealth. Big business

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69. Hazlitt, *Economics In One Lesson*, p. 114- 124

grows because of the ability to take out loans from banking institutions and expand their capital with the current purchasing power of the dollars they acquired, not the rightful purchasing power.<sup>70</sup>

IV. As the monetary unit of a society becomes inflated, it brings about malinvestment and economic hardship. The individuals of society then call upon government to step in and intervene due to the economic strife they are experiencing as a result of inflation. The fact of the matter is that citizens naively call for government action against economic troubles when it was the government to begin with that began such problems. It is obvious that the government has done a fantastic job in convincing the populace that inflation is a rise in prices due to the greed of entrepreneurs. In reality, it is caused by the central bank in luring businesses to take up cheap loans and introduce fiduciary media into the economy. Strangely enough, modern schools of economic thought believe that government management of the money supply is necessary for a functioning economy. In addition, many individuals can not imagine a world where there is economic struggles like that of the 1930s. The central bank has convinced the populace that the Federal Reserve has done away with the supposed *laissez-faire* phenomenon of business cycles. That said, gold continues to rise in price and the value of the dollar declines by the minute. It is time for citizens to wake up to the problems of inflation and decide to shift their wealth into more stable media of exchange. Only in this manner will business cycles truly end; when the populace understands the nature and origin of inflation and rising prices.<sup>71</sup>

### C) Deflationary Monetary Policy

Deflationary monetary policy, on the other hand, limits the ability of banking institutions from increasing credit or printing new bank notes when there is a rise in demand for the standard money. Deflation also increases importation and stifles economic exportation as well as attracting capital from areas of the world where the medium of exchange is not increasing in value as rapidly. In deflationary monetary policy, creditors gain at the expense of debtors as the latter has to increase the amount of wealth paid to the creditor in order to settle the debt. Tell-tale signs of deflation are accumulation of inventory stocks and decreases in overall prices. Deflation is often apparent after a period of inflation. This is the case because as the central

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70. Katz, *The Paper Aristocracy*, p. 5- 18

71. Rueff, *The Age of Inflation*, p. 20- 30

bank begins to fear runaway inflation, it cuts the amount of credit and loans that banks can give to the populace. As a result, the value of the dollar increases because scarcity increases. Businesses, often times, do not gain enough money due to a lack of loans to pay off the necessary factors of production and thus, go out of business. This process of bankruptcy of businesses is the market's response to the misallocation of resources present during the inflationary period.<sup>72</sup>

### **Conclusion**

In summation, the most important aspects of money, credit, and banking have been looked into and evaluated. What has been concluded is that the nature and mechanisms of money are quite specific and that due to these truths, an altering of the market for money can have serious detrimental effects to the economy. Governmental intervention in the money supply and use of media of exchange has the ability to misallocate resources, hurt economic calculation, create the phenomenon of business cycles, and transfer wealth from one individual to another. The history of banking has shown that the causes of early American business cycles and recessions were directly attributed to the existence of the central banking systems. The problem behind government intervention and business cycles is clearly laid out and many schools of economic thought have stepped up to the podium with their own unique method of solving the issues. Though the advocates of full-reserve fiat banking may have some truth to their arguments, there is no doubting the superiority of full-reserve commodity banking as a method of eliminating business cycles. If nothing else, what has been achieved is a basic understanding of the functions of the catalyst of all economic activity and the importance of stable media of exchange.

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72. von Mises, *The Theory of Money and Credit*, p. 262- 268

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