

A Monetary System for the Free Society: The Need For Sound Money Now

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On Monday, January 4, 2010, the front page of the New York Times ran a story entitled, *Lax Oversight Caused Crisis, Bernanke Says*. The article begins: *Regulatory failure, not low interest rates, was responsible for the housing bubble and subsequent financial crisis of the last decade, Ben S. Bernanke, the Federal Reserve chairman, said in a speech on Sunday.*ⁱ Bernanke's speech, delivered in Atlanta before a meeting of the American Economic Association, came as he sought even more far-reaching powers over the economy and awaited Senate confirmation for a second term as Fed chairman. Bernanke went on to defend the extremely low interest rates that the central bank had decreed from 2002 to 2006, claiming: *"The best response to the housing bubble would have been regulatory, not monetary. Stronger regulation and supervision aimed at problems with underwriting practices and lenders' risk management would have been a more effective and surgical approach to constraining the housing bubble than a general increase in interest rates."*ⁱⁱ

Bernanke's defense of the extremely expansionary low interest rates – even after the bursting of one of the most horrific asset bubbles this nation has ever seen – is not surprising considering he sat on the Federal Reserve's board of governors for the majority of that period. After all, government's tendency to place blame elsewhere – indeed *anywhere* else – is well-documented and quite politically expedient in a democratic system. However, before Bernanke is shooed in for a second term at the helm of perhaps the most powerful ship the world has ever known, it is worth taking a fresh, level-headed look at the crux of his argument, an argument that the vast majority of American citizens and economists alike seem to have bought in its entirety: Of course, regulatory missteps – failure to control the cold forces of capitalism – caused this crisis. Surely, our naïve and overly ideological infatuation with the Invisible Hand prevented effective government intervention and allowed the unsustainably selfish pecuniary practices of the private sector to prevail.

Thomas E. Woods Jr., in *Meltdown: A Free-Market Look at Why The Stock Market Collapsed, the Economy Tanked, and Government Bailouts Will Make Things Worse*, advances a very different view: *...even many of those who describe themselves as supporters of the free market have failed to grasp the heart of the problem... In pointing fingers at specific programs... Republicans have diverted attention to the patient's runny nose and away from his cancer. Almost nobody in Washington, and precious few elsewhere, has been willing to question the greatest single government intervention in the economy, and the institution whose fingerprints are all over our current mess: America's central bank, the Federal Reserve System.*ⁱⁱⁱ

Woods' perspective appears radical by today's standards. Yet, while Woods' propensity to blame government intervention – as opposed to free market forces – for the present meltdown stands sharply at odds with today's Washington establishment, his argument rests on the extremely solid foundation that is classical economic liberalism.

Consider, for example, the striking similarities between that quotation from Woods and this quotation from Friedrich von Hayek, Nobel laureate and one of the most important economic thinkers of the 20th century: *Those who wish to preserve freedom should recognize, however, that inflation is probably the most important single factor in that vicious circle wherein one kind of government action makes more and more government control necessary. For this reason, all those who wish to stop the drift toward increasing government control should concentrate their efforts on monetary policy. There is perhaps nothing more disheartening than the fact that there are still so many intelligent and informed people who in most other respects will defend freedom and yet are induced by the immediate benefits of an expansionist policy to support what, in the long run, must destroy the foundations of a free society.*^{iv}

Perhaps most remarkable is the fact that Woods' quotation comes from a book published in 2009 and Hayek's quotation hails from his famous 1960 work, *The Constitution of Liberty*. How little has changed over the past half century! Indeed, understanding the bleak landscape of current economic events requires looking back at the past, at developments in economic history as well as economic theory.

While central banks and government monopolies have come to dominate global monetary institutions, even a cursory glance at history reveals that the present arrangement is far from the inherent and natural state of human affairs. In the artful words of David Glasner: *The history of money virtually coincides with a history of the debasement, depreciation, and devaluation of the currency by the state.*^v In the first place, it is essential to point out that money did not spring from government. Rather, money emerged from the very natural desire to transcend the inconvenient limitations of the barter system in which goods must be exchanged for one another *directly*: A money economy displaced a barter economy because, unlike barter, goods can be exchanged *indirectly* using some accepted medium of exchange. That medium of exchange can be anything – gold or silver, paper notes or seashells – as long as it is widely desired. Rational people will willingly accept the medium in exchange for their goods – even if they have no use for the medium itself – as long as they have developed sufficient confidence that the medium can be used to make other exchanges. In this way, money emerged; and it emerged not by government decree but as a commodity whose value society has come to accept over time.

A few moments of thought will lead one to the important conclusion that government simply *cannot* create a system of money out of thin air. After all, money has value only *after* society has come to experience it and accept it: *As economist Robert Murphy puts it, only a genius could have envisioned money and its possibilities without having observed it, and he would have sounded like a crank if he tried to describe it. ("Instead of trading away your valuable pigs for horses, why not accept some smooth stones? Don't worry that you don't want them; someone else will give you those horses in exchange for the stones!")*^{vi}

Even if the state *could* create a paper money by government decree and convince its people that the money somehow held value, no one would know how much the paper

bills were worth. Woods explains: *a money has to originate on the market in this way, since only then would people know what its value was. In the process of becoming a money, it would acquire an array of prices of other goods in terms of itself. Only with this pre-existing array of barter prices could people use the money. If it were just forced on the people out of nowhere, the public would have no way of assessing its value, and it would be useless to them. A paper money, therefore, cannot originate from a simple government decree. It has to link a money that society has spontaneously adopted in the (however distant) past. Even the notorious paper monies of the American and French Revolutions were initially defined in terms of an existing commodity money, and then depreciated from there.*^{vii}

Therefore, fiat money necessarily and always piggybacks on the hip of a commodity money that society has grown to accept over time; this is why today's currencies – although they have largely left their gold anchor behind – were once redeemable for their weight in gold or other precious metal. Woods outlines a very stylized but useful generalization of the three-phased process by which spontaneously adopted commodity money becomes unhinged from its (usually) metallic origins and becomes slave to the state: *The usual pattern runs as follows: (1) society adopts a commodity money; (2) paper notes issued by banks (or by governments) that can be redeemed in a given weight of the commodity money begin to circulate as a convenient substitute for carrying precious metal coins; and (3) government confiscates the commodity to which the paper notes entitle their holders, and thereby leaves the people with an inconvertible fiat paper money.*^{viii}

The notion of government confiscating its people's valuable commodities and leaving them with mere pieces of paper should appall most Americans. Surely such a violation of individual liberties and private property rights could never happen in the United States, right? While such a totalitarian theft sounds more like communist Russia than capitalist America, one need only remember back to Executive Order 6102, signed by Franklin Roosevelt on April 5, 1933. That order, known as the Gold Confiscation Order, required all United States citizens to deliver nearly all of their gold coin, gold bullion, and gold certificates to the Federal Reserve. Yes, it can and did happen here.

If government has robbed its citizenry of its critical and natural right to protect and control the money supply, how can one explain the lack of popular clamor to reclaim that important right? Indeed, the lack of widespread opposition to the state monopoly over money – even by those who advocate property rights and free enterprise in nearly every other arena – is striking. While those in government have advanced a variety of public-good rationales that liken control over the money supply to other goods that are best provided by government monopoly (national defense, for example), the production of money actually has none of the properties of other supposed “natural monopolies.” Quite to the contrary, decentralized and competitive money-producing systems have been the norm throughout human history (Adam Smith praised such private systems for their successes in his homeland of Scotland). In fact, private money almost always works *better* than nationalized money, and for reasons that economists embrace in most other arenas: Legally enforced government monopolies are generally inefficient ways to deliver

goods and services. Examples abound, from the post office to the railroads. Both economic theory and historical evidence will suggest that a sound and stable currency is no exception to this rule.

On the level of theory, it is quite simple to understand why private currency is more reliable than public currency. The key feature that determines how well a currency works is the reliability of the issuer's redemption pledge, which is the pledge to exchange the issuer's currency for another currency at a given rate. The problem with central banks is that their redemption pledges are weak as a result of the myriad ways in which their privileged legal and political position allows them to skirt their redemption obligations. Lawrence H. White and George Selgin explain the dramatic drawbacks of central banks as currency issuers: *Their public monopoly status gives them immunity from the legal and marketplace sanctions that ordinarily prevent commercial banks from renegeing on their commitments to honor their debts in full. A central bank enjoys "sovereign immunity" from claimholder lawsuits, and legal restrictions on the public's choice in currency mean that the central bank has little fear of losing customers for bad behavior. At the same time, central bankers – especially in developing countries – face political pressure to provide the short-run benefits that surprise monetary expansion can deliver (namely extra revenue to pay the government's bills, extra stimulus to the economy, or extra liquidity for the banking system). When devaluation is relatively costless, central banks are tempted to engage in expansionary monetary policies that ultimately force devaluation.*^{ix}

Private currency issuers, on the other hand, are bound by the discipline-imposing conditions of the competitive marketplace. This competitive pressure is what makes the redemption pledges of private commercial banks far more credible, for a devaluation (paying out less than 100 cents on the dollar to customers) would send their disappointed clients looking for a more reputable bank. This prohibitively high penalty for devaluation is what encourages responsible lending; the penalty is significantly reduced both by systems of nationalized central banking and systems of "crony capitalism" in which private banks can lend recklessly and count on being bailed out by their friends in government (the so-called "Greenspan Put"). These two cases involve moral hazard and highlight the dangers of monetary manipulation, both of which will be explored later in connection with the United States' failing Federal Reserve system.

Not only do privately issued currency markets resemble the way in which healthy and competitive markets work in theory, but many examples exist of such systems functioning effectively in the real world. In present-day Scotland and Northern Ireland, for example, private banks issue and circulate notes that are redeemable for foreign currency assets (specifically, Bank of England-denominated currency). Since each note clearly displays the name of the issuing bank, it is clear which bank is liable for that note. Unlike central banks, which are immune from competition and can devalue at will, the discipline of the market ensures that such private systems function effectively. These competitive currency systems have a proven track record of providing sound money based on sound market principles, and, over time, have devalued much less frequently than their nationalized counterparts.^x

Private systems such as Scotland's dispel the myth that money production is in any way a natural monopoly. Glasner concludes: *Just as the gains from standardization did not make IBM a natural monopolist in the computer industry, they do not make the production of dollars a natural monopoly. Competing issuers can (and do) issue distinguishable moneys denominated in dollar units, thereby achieving the gains from standardization without limiting production to a single issuer. That the state asserted a legal monopoly over money cannot, therefore, be explained by any requirements implied by the technology of producing or using money. A more plausible explanation is that the monopoly was the result of the characteristic quest by the state for sources of revenue... Thus, coinage and tyranny seem to have emerged together.*^{xi}

Glasner is absolutely correct to point out that government's takeover of the money supply has more to do with the looting of the public coffers than the efficient, technocratic provision of a public good. Thus, government's control of currency is not a rightful and natural role of the state, but a tyrannical reach for economic supremacy and political control. After all, the state cannot create an infinite amount of gold to fund its wars, pet projects, and government bailouts, but it *can* print a nearly infinite amount of fiat notes. To use the imagery of Arthur Burns, a government that monopolizes the money supply is a government that has tyrannically "kicked away the ladder." *Having risen to power, the tyrant assumed the monopoly over coining. This step was probably part of a policy aimed at the enhancement of his own power and commercial success and the hindrance of his rivals. He kicked away the ladder by which he had risen lest others might attempt to use it.*^{xii}

The time has come for the people of the United States to get that ladder back. America's founding fathers were quite clear in their preference for a simple bimetallic monetary standard, yet today's system looks nothing like that vision. While the Constitution grants Congress the power "To coin Money" and to "regulate the Value thereof," in the parlance of the day these powers clearly meant the power to certify the weight and fineness of the metal in coins and *not* the power to alter the price of money itself or manipulate the money supply. (Apparently, the framers of the Constitution doubted the honesty or reliability of private coin smiths.) Consider the clause in its entirety: "The Congress shall have Power To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures." This straightforward clause is concerned with the standardization of quality and measurements; certainly it is no license for monetary manipulation.

Yet the most important reasons that America must revamp its failing monetary system is not that the present regime violates the intentions of those who wrote this nation's Constitution. No, this essay is not an exercise in originalist jurisprudence: America must change its monetary regime because the bureaucratic leviathan called the Federal Reserve, always in pursuit of the misguided Keynesian fantasy that is everlasting economic boom, has triggered the destructive series of boom-and-bust business cycles, created this decade's cataclysmic housing bubble, destroyed American savings, distorted American credit, and undermined the individual citizen's economic and political autonomy that truly constitutes the backbone of a liberal democratic state. With the

establishment of the Federal Reserve in 1913 and the 20th century's great decoupling from the global gold standard, money became fiat and fiduciary; not a commodity for markets to trade but a weapon for government alone to wield. In 1912, Ludwig von Mises wrote that a sound money supply serves as: *an instrument for the protection of civil liberties against despotic inroads on the part of governments. Ideologically it belongs in the same class with political constitutions and bills of rights.*^{xiii} How right he was. Indeed, understanding how the Fed has so damaged America's economy and society alike first requires a basic grasp of classic economic liberalism; of von Mises and Hayek; of the Austrian theory of the business cycle. Only then can one transcend today's petty political tendency to blame the market for the world's ills and associate government intervention in general and the Federal Reserve in particular with all that is good and rational and just. Only with the long-run perspective of classical economic liberalism can one see the Federal Reserve as it really is; only then can one truly ask: Does this emperor have any clothes?

Considering that the path along which America's capital markets have traveled over the past decade resembles a runaway rollercoaster more than a healthy economy, Americans have grown quite familiar with massive market fluctuations: The median home price across American cities inflated by 150 percent from August 1998 to August 2006, before tumbling 23 percent over the next two years (and the fall has not yet subsided).^{xiv} After the ecstasy-fueled boom of epic proportions that sent the Dow Jones Industrial Average to 14,164.53 on October 9, 2007 (its highest close ever), the market collapsed to close down at 7,552.29 on November 20, 2008, shedding an astonishing 46.7 percent of its value over thirteen frightful months.^{xv} Other markets including those for oil and gas have taken the American consumer on just as bumpy of a ride. What is going on here? Is there a culprit, or – as Karl Marx argued in the 19th century – is such a boom-and-bust trajectory an inherent aspect of the market system?

According to Hayek's Nobel-prize winning theory of the business cycle – which is not new but remains, to this day, the only theory that explains the current economic meltdown – the central bank's interference in the free market is what causes the boom-bust cycle. In America, that means the Federal Reserve, the institution endowed with the power to expand or contract the money supply; the power to lift or to lower interest rates. When the Fed exercises those powers, it is meddling in the market for interest rates; the market for borrowing money. This market must be understood as a market with prices that operate much like any other: Like any goods market, the supply – in this case the amount of funds being offered for loan – fluctuates. When the supply increases, there are more funds available for loan; the pool of available credit increases; and the interest rates decrease. This is a natural market response because, since credit has become less scarce, its price has decreased accordingly. Alternatively, if the amount of loanable funds decreases (or if the demand for credit autonomously increases) loans will be harder to secure and the interest rate will rise. Straightforward enough.

The more complex part of the picture emerges when one starts thinking about the business effects of fluctuating interest rates *over time*. Hayek's great insight – though it has roots in the writings of von Mises and other early Austrian theorists – is that the free,

unencumbered market for interest rates coordinates production and investment across time. How does such a mechanism work? Consider what happens, under competitive market conditions, when the rate of savings increases (which could occur for a variety of reasons, but those reasons are not important to worry about right now). As savings grow, so does the supply of capital that is available for loan. As loans become easier to access, interest rates fall, and many profit-maximizing business will seize the day and use some of its capital to invest in long-term projects that would not be profitable if interest rates had remained high. Thus, businesses take the low interest rates as a cue to focus on future, instead of present, production.

This makes perfect sense, both in terms of the individual firm's self-interest and the interest of the aggregate economy. An increase in savings (which, remember, is what set off this chain of events in the first place) indicates that consumers have relatively less desire for present consumption and therefore relatively more desire for future consumption. Thus, businesses' decisions to invest in future-oriented projects are well warranted. The market has worked smoothly and effectively. This successful coordination is the essence of Austrian business cycle theory.

Now consider what happens when the Fed (or some other central bank, for that matter) intervenes. If the Fed steps in and lowers interest rates (which it did with horrific consequences over much of the previous decade), loans will become more accessible and rational investors will undertake long-term investment projects. However, unlike the free market scenario discussed above, this artificial, government-imposed rate cut is not due to an increase in savings. It is due, instead, to self-serving and short-sided politics; to the misguided quest for expansionism at all times and all costs. The result is dislocation on a massive scale: The Fed's policy of cheap credit tricks businesses into the false conclusion that it is a profitable time to undertake long-term investments. Woods explains the consequences of this dangerous mismatch: *The coordination of production across time is disrupted. Long-term investments that will bear fruit only in the distant future are encouraged at a time when the public has shown no letup in its desire to consume in the present. Consumers have not chosen to save and release resources for use in the higher stages of production. To the contrary, the lower interest rate encourages them to save less and consume more, at a time when investors are also looking to invest more resources. The economy is being stretched in two directions at once, and resources are therefore being misallocated into lines that cannot be sustained over the long term.*^{xvi}

The horrific bubbles that have distorted both the housing market and the stock market in recent years are products of exactly such misguided monetary policy. The present state of American real estate – with half-finished gated communities sprawled around greater Las Vegas and abandoned subdivisions housing only overgrown grass and rattlesnakes blanketing much of Southern Florida – comes eerily close to an analogy that Mises drew in his magnum opus of 1949, *Human Action: A Treatise on Economics*. Mises likens an economy under artificially low interest rates to a home builder who believes that he possesses more bricks than he truly does. Of course, the builder will start constructing a house that is too large to complete given the finite amount of resources available. The sooner the builder realizes that his resources are in fact less than he had

anticipated, the fewer bricks will have been wasted, and the better off everyone will be (both the builder and the overall economy). However, economic booms are joyous times and extremely politically popular; no official or administration in a democratic regime wants to restrain the excess credit and incur the wrath of its electorate. The sad result is that the builder keeps on building; the economy continues on its unsustainable trajectory; the bubble – in housing, in stocks, in whatever the case may be – continues to inflate. Woods explains: *In the short run the result of the central bank's lowering of interest rates is the apparent prosperity of the boom period. Stocks and real estate shoot up. New construction is everywhere, businesses are expanding their capacity, and people are enjoying a high standard of living. But the economy is on a sugar high, and reality inevitably sets in.*^{xvii}

To be sure, one could delve into much greater detail about the many ways in which government intervention has distorted the housing market (and other markets, for that matter) and produced the present disaster. While the Fed's recklessly expansionary policy of flooding the market with cheap dollars is the single greatest culprit, there are other important accomplices in the commission of this crime against the American people, the American economy, against sound monetary principles, against the free market itself: Fannie Mae, Freddie Mac, the Community Reinvestment Act, as well as the (however well-intentioned) political, affirmative action pressures to include underrepresented minorities and members of the working class in the "surefire investment" that was home ownership all played a role in inflating the great bubble of this early century.

Yet the important moral of this story can be learned not by looking backward, but by looking forward; not by studying the specific ways in which government has manipulated the marketplace, but by grasping this grave trend: Unsound monetary policy tends to lead to more unsound monetary policy. Once bubbles form and dollars begin to lose value, the only way out that does not involve pain and sacrifice (always unpopular among voters, even when absolutely necessary) is the way of more bubbles, more inflation, more dollars, more government. A vicious circle ensues. In *The Constitution of Liberty*, Hayek recognized this self-perpetuating spiral: *There are two points which cannot be stressed enough: first, it seems certain that we shall not stop the drift toward more and more state control unless we stop the inflationary trend; and, second, any continued rise in prices is dangerous because, once we begin to rely on its stimulating effect, we shall be committed to a course that will leave us no choice but that between more inflation, on the one hand, and paying for our mistake by a recession or depression, on the other. Even a very moderate degree of inflation is dangerous because it ties the hands of those responsible for policy by creating a situation in which, every time a problem arises, a little more inflation seems the only easy way out.*^{xviii}

Thus, unsound monetary policy begets unsound monetary policy. A housing bubble brought on by artificially expanding the money supply has led to a string of government bailouts that (you guessed it!) further artificially expands the money supply. At each point in this downward totalitarian spiral, government intervenes in the market to correct the wreckage wrought by its previous intervention, dollars lose their value and

Americans lose their freedom as they become more and more dependent on the Washington bureaucracy, more and more dependent on the Federal Reserve to pick them up and bail them out. Crony capitalism in which select firms are “too big to fail” is not capitalism at all, and citizens that have become addicted to a constantly growing money supply and dependent for their lifeblood on a state-controlled tap of dollars can never be truly free from government manipulation. Is there any end in sight? The only hope is to dismantle the bureaucracy and restore sound, free-market principles to this nation’s money supply. Not only *can* money exist outside of the state, money *must* exist outside of the state if the New Colossus that is the American experiment is to endure; if Americans are ever again to breathe free.

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ⁱ Rampell, Catherine. (2010, January 4). Lax Oversight Caused Crisis, Bernanke Says. *The New York Times*, p A1.

ⁱⁱ <http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm>.

ⁱⁱⁱ Woods, 2-3.

^{iv} Hayek (1960), 338-339.

^v Dowd & Timberlake, 21.

^{vi} Woods, 111-112

^{vii} Woods, 112.

^{viii} Woods, 112-113.

^{ix} White & Selgin. <http://www.econlib.org/library/Features/feature3.html>.

^x White & Selgin, <http://www.econlib.org/library/Features/feature3.html>.

^{xi} Dowd & Timberlake, 23-24.

^{xii} Dowd & Timberlake, 24.

^{xiii} Dowd & Timberlake, 179.

^{xiv} Woods, 63.

^{xv} Woods, 63.

^{xvi} Woods, 68.

^{xvii} Woods, 69-70.

^{xviii} Hayek (1960), 338.