

The Gold Standard

Perspectives in the Austrian School

***Edited with an Introduction by
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Free Banking and the Gold Standard

Lawrence H. White

The conjunction of “free banking” with “the gold standard” in the title of this chapter suggests to me two questions: Is free banking necessary to a successful gold standard? And, conversely, is a gold standard necessary to a successful free banking system? My aim in what follows will be to see how much of a natural affinity can be found between the principles of the gold standard and the principles of a freely competitive monetary order, or to put it metaphorically, to see whether gold and free banking are really warp and woof of the fabric of a successful monetary system.

Focusing the chapter in this way admittedly may leave it with little to say to those who find neither free currency competition nor commodity money attractive or interesting. Its concerns will likely seem idle to those who find the current national systems of banking regulation *cum* fiat money part of the best of all possible worlds. There is encouraging evidence, however, that serious interest in alternative monetary systems, particularly the gold standard and various proposals for a laissez-faire approach to money, is on the rise both within academic circles and among participants in political affairs.

The Criteria for Monetary Success

Posing the question of how essential a free banking system is to the successful working of a gold-based monetary order obviously raises another question: What are the proper criteria for success in a monetary system? The answer to this second question is not obvious. Nor is it obvious by what method an economist can best go about developing an answer, if there is one. One approach that seems clearly inadequate is worth mentioning and criticizing because it is so popular: the method of sheer presumption. Too often economic analysts begin with what Gerald P. O'Driscoll, Jr., has aptly characterized as “a long ‘laundry list’ of macro-economic goals to be achieved by a monetary standard.”¹ The desirability

of these goals is usually taken for granted by those who propose them. Worse, it is assumed without a second thought that the way to achieve a desirable monetary system is to use the political means to create institutions that can be programmed to generate the behavior in macroeconomic aggregates called for by the goals. That is, monetary institutions are viewed in purely macroinstrumental terms. They are tools that government policymakers may design or redesign, and the relative goodness of various institutional arrangements is to be judged solely by comparing the various statistical time series they generate. A “desirable” monetary system, on this view, is one that produces the outcomes presumed desirable by the analyst.

One alternative to the macroinstrumental approach for judging monetary systems is what we might call the microsovereignty (for “microeconomic” and “individual sovereignty”) approach. It asks: How well does a particular system serve the interests of the individuals who use money, as those individuals themselves see their interests? Does it leave individuals desiring feasible alternative arrangements, yet block them from making the changes they desire? “Feasible” in this context means not just technologically feasible, but potentially achieving consent from all those traders whose participation is desired. The question, in more technical terms, is whether a monetary system leaves Pareto improvements uncaptured.

The microsovereignty approach is, of course, the approach most economists take to the question of the successfulness of arrangements for supplying virtually every good other than money. A “monetary system” is simply a set of institutions for supplying the economic good we call “money.” No proper economist, speaking as an economist, would presume to judge the goodness of the current American playing card (or, for that matter, baseball card) system by contrasting its characteristics to a list of characteristics he thought desirable. None would fault the system for the possible unpredictability of the purchasing power or relative price of cards from year to year, or for the possible nonuniformity of cards from producer to producer. A proper economist would instead ask whether there existed any reason to suppose that card users were not getting the kinds of cards they wanted (that is, any kinds for which they were willing to pay cost-covering prices). He would not try to second guess consumers’ preferences.

Why is money treated differently? It is probably because few economists are accustomed to thinking of money as a private good. Government provision of money has come to be taken for granted, especially so in this century of government fiat monies. *Given* the institution of state-issued fiat money, there clearly must be some definite government policy for regulating the quantity issued. *Given* the inescapability of monetary

policy under a fiat regime, government clearly needs expert opinion regarding the desirable goals to be pursued by monetary policy and the technical means to pursue those goals effectively. Unlike a private firm producing playing cards in a competitive environment, a government producing money is not automatically guided by the profit-and-loss system toward meeting consumer wants. Government monetary authorities have no bottom line for which they are accountable. That of course is a major part of the explanation for their poor performance (poor by almost anyone’s standards) over the past decades.

The possibility of free banking, if it means nothing else, means that government provision of money ought *not* be taken for granted. The fact that monetary policy becomes necessary when government produces money is no more an argument for treating money differently than other goods than is the fact that a playing card policy becomes necessary when government produces cards. The provision of all forms of money, like the provision of cards, can be left to the marketplace. If the microsovereignty approach is respected, then to argue that either good ought to be brought within the province of government requires one to make a case that free market provision leaves some subset of individuals frustrated in attempts to reach mutually preferred arrangements. This case must rely on more than just sheer presumption regarding the content of consumer preferences. It is one thing to attribute concrete preferences to consumers (for example, risk-averse preferences for low variance in aggregate nominal income²) for the sake of particular modeling exercises, although the value of such exercises is questionable, especially when individual preference functions are defined over economywide aggregates that no individual confronts directly. It is quite another thing to claim policy relevance for these models on the implicit assumption that real world consumers have the stipulated preferences. Some evidence of this ought to be provided, namely by reference to the preferences actually demonstrated by money users.

The gold standard in particular is often evaluated on the basis of the behavior of price indexes during the era of the classical gold standard. It is sometimes suggested that the successfulness of gold hinges on whether it produces relative stability or predictability in the purchasing power of money (which operationally means zero mean or low variance in the first differences of a price index). On the microsovereignty approach these would be among the proper criteria only if they were among the criteria money users themselves consulted in choosing among monetary standards.³

Certainly advocates of the gold standard need not view it purely in macroinstrumental terms as a device for producing approximate price-level stability. It is likely that few do view it in such a way. For one, there

are alternative routes to price level stability, namely through various quantity-rule or price-index-rule devices for manipulation of the quantity of fiat money, that do not command much enthusiasm among those who value a gold coin standard. From the perspective that takes departures from the gold coin (*specie*) standard to be compromises of the gold standard ideal, the enthusiasm shown by some supply siders for a fiat money "price rule" looks more like a variant of (early) monetarism than like a wing of the traditional gold standard camp. The same applies to Fisherian "compensated dollar" schemes with or without gold trappings.⁴ Second, the "dishonesty" of fiat money criticized by gold's partisans seems to be not so much its purchasing-power behavior as its potential for inflationary finance—that is, for covert taxation through expansion of the monetary base. Cash balances are taxed even under a fiat money policy that stabilizes the price level, namely by the difference between zero and the rate of appreciation of purchasing power that would be generated by fixing of the monetary base. This corresponds to the rate of base growth necessary to offset secular growth in real demand for base money. In historical experience, of course, inflationary finance has been much greater.

The following statement by Phillip Cagan, though it shows a greater effort to understand the progold position than other monetarists have made, nonetheless misinterprets the position of many in the gold camp:

Stripped of its rhetoric, however, the position of the gold advocates is really a plea for a stable purchasing power of money, with as close to a guarantee of stability as one can obtain in this uncertain world. There is no logical basis for their opposition to any monetary system that provides a reasonable promise of a stable value of the currency. Why then do advocates of gold not support monetarism which shares the same goal?

As far as I can see, the opposition is not over principle but rather over technique.⁵

There is every reason for gold standard advocates who personally value stability in the purchasing power of money indeed to support monetarism (that is, slow and steady growth in the money supply) in the sense of viewing it as preferable, within the context of a fiat money regime, to the sort of discretionary policy seen in the last decade. But again, price level stability is not, or need not be, the point of advocating a gold-based monetary system. The point may instead be minimization of avoidable interferences with provision of the types of money individuals desire to use. It is certainly possible to believe, based on the historical record, that gold and gold-redeemable instruments came to assume a monetary role precisely because they were the kinds of money people wanted to use. On

this view the forced transition to fiat money was a contravention of individual sovereignty that ought to be reversed.

Free Banking and Individual Sovereignty

If the rationale for a gold standard lies in a microeconomic or individual sovereignty approach, then free banking clearly *is* necessary for the success of the system. Individual sovereignty in economic affairs amounts to the freedom of potential buyers and sellers to make their own bargains, unimpeded by third-party impositions or barriers.⁶ It amounts, in other words, to free trade. A system of free banking entails free trade in the market for "inside" money (bank demand liabilities), particularly for bank notes. No legislative barriers are placed in the way of exchanges of bank notes and demand deposits between potential issuers and money users. Individuals are free to accept or reject the liabilities of particular banks as they see fit. Banks are free to pursue whatever policies they find advantageous in the issuing of liabilities and the holding of asset portfolios, subject only to the general legal prohibition against fraud or breach of contract.⁷

Bank demand liabilities under any monetary standard constitute sight claims to the economy's most basic money. Under a gold coin standard the most basic form of money is by definition coined precious metal or *specie*. Mintage services can be performed exclusively by competing private firms, and the ethic of free trade would suggest that they ought to be provided competitively rather than by government monopoly. Only under open competition are there market forces tending to ensure that consumers get coins having the attributes they demand, for example having the denominations (sizes) they find most convenient.⁸ This question is independent, however, of the operation of the bank system.

Claims to *specie* issued by banks serve as money when transactors generally accept payments in the form of transfers of claims which they in turn transfer in payments to others. Titles to *specie* can then change hands without any *specie* physically moving. Historically bankers and their customers early discovered mutual advantage in the service of transferring deposit balances by book entries, sparing the need for making cumbersome withdrawals, transfers, and redeposits of gold. The personal check emerged as a means of signaling banks to perform such transfers. Later the bank note, payable to the bearer on demand, emerged as a means for transferring claims to *specie* without the involvement of the bank.⁹ For particular purposes one or the other form of redeemable

claim on bank specie is more convenient to use than actual specie. The ability of these claims to function as money—their general acceptability as means of payment—of course depends on their being regarded as actually redeemable for basic money at par on demand.¹⁰ This feature fixes the exchange value of notes and demand deposits equal to that of the specie to which they are claims, enabling them to serve as substitutes for coin.

Under free banking individuals may choose among the notes of a plurality of private issuers. They are not limited to using the notes of a privileged central bank. Monopolization of note issue is a defining characteristic of central banking, and a characteristic that has always emerged from legislative intervention. There is no evidence of a tendency toward natural monopoly in the issue of bank notes.¹¹ Open competition in issue ensures that banks will provide notes with the characteristics note holders demand. The quality dimensions along which notes may differ include ease of redemption, reputability of issuer (this is a combination of trustworthiness and renown), and proof against counterfeiting. All of these will affect a note's most important characteristic, its ability to circulate. Competition among bank note issuers is in many respects similar to the competition we see today among issuers of credit cards and traveler's checks, as well as being similar to competition among banks for checking account customers.¹² Respect for microeconomic criteria and individual sovereignty requires that government not limit consumers' choices by interfering with competition among potential bank note issuers.

One argument sometimes made against competitive issue of bank notes (and which presumably also could be made against competitive issue of checking accounts, traveler's checks, and credit cards, though it rarely is) runs the following way: The reason people use money is to lower the information or transactions costs of accomplishing desired trades. Dealing with numerous brands of hand-to-hand currency implies bearing high information or transactions costs. Suppressing the number of issuers therefore improves economic welfare. I have elsewhere offered the rebuttal that this argument amounts to the paternalistic view that too much choice makes life difficult for people and should be eliminated by the government choosing for them; if valid in the case of bank notes, this argument would be valid against brand proliferation in any industry.¹³ Here I wish to elaborate on that rebuttal. Consider an initial situation with only a single brand of bank notes. What is the case against allowing a second brand? Individuals (for example, shopkeepers) who do not wish to be bothered with the new brand can refuse to deal with it. If they do choose to deal with it (accept it), presumably they consider the information and transactions costs worth bearing in light of the benefits

they expect. If the costs are generally considered not worth bearing, the market will not support a second brand. This holds for $n + 1$ brands as well as for two. The rationale of open competition among multiple brands of bank notes (as among brands of anything else) is the freedom to discover which brands and how many brands best suit consumer preferences. Central bank monopoly eliminates the chance for individuals to accept other brands of notes even when the benefit exceeds the cost.

Free Banking and Fractional Reserves

Discussion of free banking usually focuses on the liability side of banks' balance sheets, particularly on the freedom to issue bank notes. But freedom on the asset side is also controversial. The alternative assets banks on a gold standard choose among, when permitted, can be divided most simply into two categories: specie reserves and interest-earning assets such as loans and securities. A bank holds specie reserves to honor its contractual obligation to redeem on demand its notes and deposits. The size of the reserve it chooses reflects its perception of the risk of sudden redemption outflows. The bank holds interest-earning assets having varying degrees of ready marketability, the readiest serving as a "secondary reserve" that can be sold for gold to replenish the specie reserve on short notice.

Each category of assets has been historically subjected to government regulation. Restrictions on earning asset choices were part and parcel of so-called free banking legislation enacted by midnineteenth-century American states. Banks issuing notes were required to own, and to place in the possession of state regulators, certain types of assets, most notably state government bonds. Restrictions on reserve-holding choices, namely "reserve requirements," were imposed by several states before the Civil War. They have been part of federal regulation since the National Bank Act of 1863.¹⁴ Both categories of asset regulation prevent consumers from freely choosing among banks with alternative portfolio policies and hence with alternative risk–return characteristics. They prevent banks from achieving desired risk–return performance most efficiently. The function of banknotes as hand-to-hand currency suggests that consumers will prefer the notes of issuers who present close to zero illiquidity and insolvency risk.¹⁵ It also suggests that bank notes will generally be non-interest-bearing. The forces of competitive selection shaping bank asset portfolios will then focus primarily on the methods of producing consumer confidence in bank notes and deposits (exemplary past redemption performance, which depends on adequate reserves, being the chief method) and on the rates of return paid on deposits (these rates

depend on bank holdings of interest-bearing assets). Under competitive conditions banks are compelled to act in compliance with consumer preferences in balancing the benefits of additional specie reserves (lesser chance of illiquidity) against the alternative benefit of additional interest-bearing assets (higher returns on deposits).

Some gold standard advocates, most notably Murray N. Rothbard, have argued for 100 percent reserve requirements against demand deposits and bank notes. Rothbard urges this position not as a paternalistic intervention into the market for inside money, but on the grounds that the holding of less than 100 percent reserves against demand liabilities is per se fraudulent. This argument is more jurisprudential than economic. He has recently written: "It should be clear that modern fractional reserve banking is a shell game, a Ponzi scheme, a fraud in which false warehouse receipts are issued and circulate as equivalent to the cash supposedly represented by the receipts." And in rebuttal to the argument that a banker hardly needs 100 percent reserves in order to meet all the redemption demands that will in fact confront him at any one time, he writes: "But holders of warehouse receipts to money emphatically *do have* . . . a claim, even in modern banking law, to their own property any time they choose to redeem it. But the legal claims issued by the bank must then be fraudulent, since the bank could not possibly meet them all."¹⁶ Rothbard's view that bank notes are the legal equivalent of warehouse receipts is based on what he thinks legal practice *ought* to be, not on the interpretation courts have actually made of the contractual obligations incurred by the issuers of bank notes.¹⁷

It is difficult to see why an analyst committed to the ethic of individual sovereignty, as Rothbard elsewhere clearly is, would wish to prevent banks and their customers from making whatever sorts of contractual arrangements are mutually agreeable. The British Court decisions cited and criticized by Rothbard, to the effect that bank notes do not contractually bind their issuers to holding 100 percent reserves, seem eminently reasonable given the inscription actually found on the face of a typical British bank note: The Bank of XYZ "promise to pay the bearer on demand one pound sterling."¹⁸ There is no promise made about reserve-holding behavior. There is nothing to indicate that the note constitutes a warehouse receipt or establishes a bailment contract. But ought it do so? On an individual sovereignty approach that depends on the contractual arrangement, a bank and its customer mutually desire. Nothing in a free banking system prevents an individual who desires 100 percent reserve banking from explicitly contracting for it. In historical fact safety deposit boxes have commonly been offered by banks for those who wish their money held as a bailment, who wish, in other words, to retain unconditional title to it. It would be silly to suggest that bank

notes and demand deposits gained acceptance historically only when their holders were fraudulently misled by the misrepresentation of bank demand liabilities as unconditional warehouse receipts. It is in fact evident that most individuals will voluntarily accept nonbailment bank notes and demand deposits.

On a title-transfer view of contracts a bank note payable to the bearer on demand, with no stipulation of the reserves to be held, constitutes a *conditional* title to bank-held specie, conditional on presentation for redemption.¹⁹ In a title-transfer regime prevention of breach of contract by banks issuing such notes requires only that any obligation to redeem on demand be satisfied for all customers who actually present notes and deposits for redemption. Fractional reserves do not constitute breach of contract. A bank furthermore may, consistent with title transfer, insert a clause into note and deposit contracts reserving to itself the option of delaying redemption. Historically the Scottish banks did this for notes before the practice was outlawed, and recent American NOW checking accounts have incorporated such a feature.²⁰ Such option clauses mean that a sudden redemption outflow from a bank can be headed off without breach of contract. In practice an issuer will not likely exercise the option to defer redemption, except in an emergency, because an expectation by the public that the option will be used would impair the circulation of the issuer's notes and hence would reduce the demand to hold those notes.

Free Banking and Macroeconomic Performance

In addition to the argument on microsovereignty grounds there is a case for free banking to be made on macroinstrumental grounds: The aggregate performance of an economy on a gold standard is likely to be better under free banking than under central banking. A large body of theoretical and historical work in economics identifies money supply errors as a significant source of business cycle disturbances.²¹ The advantage of free banking is that a plurality of issuers minimizes the chances for large-scale errors in the money supply. One reason is readily apparent: No single issuer controls a large share of the circulation. Equally important, the plurality of issuers brings with it, in the form of the interbank clearinghouse for bank notes (and checks), an automatic mechanism for preventing major money supply errors by any single bank. The clearinghouse gives each issuer both the information to detect, and the incentive to correct promptly, any deviation of the quantity of inside money it supplies from the quantity of its inside money that the public desires to

hold. This process of negative feedback is absent from a central banking system, where the supply of bank notes is monopolized and the liabilities of the central bank are held as reserves by commercial banks. Only with free banking is the operation of the gold standard fully self-regulating.

The contrast between free banking and central banking with regard to the mechanisms regulating the money stock can be spelled out here in somewhat greater detail.²² The public's demand to hold the demand liabilities (notes or demand deposits) of any particular bank is a definitely limited magnitude (in nominal as well as real terms given that the purchasing power of notes and demand deposits is fixed by their redeemability for specie). Suppose a single bank in a multi-issuer system issues too many notes or deposits, "too many" being more than the public desires to hold. People who find themselves holding excess notes or deposits will get rid of them largely by depositing them in checking or savings accounts at their own banks, or by spending them away to persons who will deposit them. Given that our single bank is relatively small, all but a small fraction of the excess notes or deposits will wind up as deposits in rival banks. The rival banks that accept these deposits will quickly turn around and demand redemption of the first bank's liabilities through the interbank clearing system. The overexpansive bank will discover that its specie reserves are draining away, a situation it cannot let persist. Reserve losses signal to the bank the need to correct its course to prevent complete illiquidity. The negative feedback is rapid enough that any disturbance to the credit market or aggregate spending will likely be quite minor.

A central bank, by contrast, faces no rival for the circulation of its notes. Both its notes and its demand deposits may serve as reserves for commercial banks, displacing specie from that role. Hence an overexpansion of central bank liabilities, supposing one to occur, will not find its way into the clearing mechanism and thereby rapidly reveal its presence. Instead commercial banks that come to hold extra central bank liabilities will be impelled by their swollen reserves to expand their own liabilities. The resulting overexpansion of the entire system will be revealed only through a relatively slow and drawn-out process. An excess stock of money stimulates greater spending as individuals adjust their wealth portfolios. This leads to an "adverse" balance of trade with other nations, that is, an excess of imports over exports, both directly as the excess stock of money prompts greater spending on imports as well as on domestic goods, and indirectly as increased spending on domestic goods bids up their prices and makes imports more attractive. The excess of imports over exports must be paid in international currency, namely gold. Settlement of the balance then drains gold from the central bank's vault. The signal to reverse its course finally appears to the central bank.

But in the meantime the economy may have been driven through an artificial credit boom of major proportions which must be painfully reversed when the central bank contracts credit to stanch its reserve losses.

Even under a gold standard, then, a central bank may have sufficient leeway to issue sharp monetary shocks and thereby to generate severe business cycles. Much modern historical work remains to be done in exploring the applicability of this theory to business cycles actually experienced, particularly in Britain under the gold standard managed by the Bank of England after 1821 and in America under the Second Bank of the United States. There is no question that many sophisticated contemporary observers of the Bank of England under the classical gold standard blamed it for creating or aggravating business cycles through improper issuing policies. It is for this reason that the program of the well-known currency school called for restriction of the Bank of England's discretionary power of issuing notes. Such a restriction was embodied in Peel's Bank Charter Act of 1844. The free banking school of the same era argued more perceptively and radically for an end to the legal privileges that bestowed on the Bank of England its central banking powers.²³ In the United States the Jacksonian case against the Second Bank of the United States, providing the rationale for the veto of its recharter in 1832, rested in part on the argument that its mismanagement of the currency had sent the economy through boom-and-bust cycles.²⁴

The policy of free banking gained Ludwig von Mises' endorsement as an essential barrier against the experience of business fluctuations driven by overexpansory central bank policies. Wrote Mises:

Free banking is the only method available for the prevention of the dangers inherent in credit expansion. It would, it is true, not hinder a slow credit expansion, kept within very narrow limits, on the part of cautious banks which provide the public with all information required about their financial status. But under free banking it would have been impossible for credit expansion with all its inevitable consequences to have developed into a regular—one is tempted to say normal—feature of the economic system. Only free banking would have rendered the market economy secure against crises and depressions.²⁵

The overwhelming source of the cyclical macroeconomic difficulties of recent years has clearly been the money supply shocks emanating from monetary authorities presiding over national fiat money regimes. A major threat to long-term planning is the fact that the purchasing power of money has become impossible to predict with any accuracy more than a few quarters into the future, because the nominal quantity of money is anchored to nothing more than the discretion of a monetary bureaucracy. In this environment the gold standard, which Keynes once derided as a

"barbarous relic," has attracted new attention as a device for limiting the discretion of central banks. There is no question that a commitment to a fixed gold definition of the dollar would anchor the nominal quantity of money, make its purchasing power more predictable, and thereby promote coordination of long-term plans. But as far as damming the source of cyclical monetary disturbances, the gold standard is inadequate without free banking. A central bank tied to gold at a fixed parity can no longer inflate without limit in the long run, but it *can* manipulate in the short run the quantity of high-powered money, and thereby can subject the economy to monetary disruption—to what Mises calls "credit expansion with all its inevitable consequences."

A central bank that has the power to cause monetary disturbances inevitably will cause them. Central bankers, like central economic planners in general, typically lack the incentives and inevitably lack the information that would be necessary for them to perform as skillfully as a market system in matching supplies with demands. The incentive structure surrounding the monetary authorities is important because inflation and recession may often be the by-product of intentional policy actions. The public choice approach to government agencies suggests that government policymakers who are entrusted with control over money should be expected to succumb to the temptations of easy money.²⁶ The information problems of the monetary authorities are at least as important as these incentive problems. Even a "virtuous" central bank on a gold standard must make money supply errors because it lacks any timely and reliable signal of excess supply or demand for its liabilities. It is limited to such macroeconomic indicators as price indexes, interest rates, exchange rate movements within the gold points, and international gold flows. The information they give is either ambiguous or obvious only after an excess has already had its disordinating effects, for example after an external drain has begun.²⁷

Is Gold Necessary to Free Banking?

Quite conceivably free banking could be established in an economy with an outside money other than gold. Silver is an obvious alternative candidate. Supposing that bank liabilities are claims redeemable for silver coin rather than gold coin alters none of the analytical properties of a free banking system. If we take "free banking" to indicate a monetary system free not only from government regulation of the issue of inside money but also from government control over outside money, the field of potential outside monies is circumscribed only by the exclusion of actively issued government fiat money. Several sorts of nonfiat currencies beside

gold and silver have had advocates in the past or present. A third candidate for potential free market outside money is "symmetrical" currency (or the vermeil standard, if you will), where the monetary unit is defined as so many grams of gold plus so many grams of silver. A fourth is currency redeemable for some nonmetallic (and nonmonetary) commodity or basket of commodities. A fifth is redeemable currency whose redemption rate is indexed to provide for stable purchasing power of the monetary unit. A sixth is inconvertible but privately issued currency.²⁸ Two further theoretical possibilities for elimination of government control over the quantity of outside currency also present themselves. The first of these is to freeze the stock of fiat money or the monetary base. The second is to have a payments system that makes no use of outside money.²⁹

From a microsovereignty perspective all these sorts of currencies (with the exception of gold and silver) ought to be regarded as untried entrepreneurial ideas. The way to cut through the confusing welter of proposals in order to discover which one(s) money users would actually prefer to use is to let potential suppliers of the various currencies compete. This would require lifting any prohibitions, taxes, regulations, and legislated accounting rules that could serve as barriers to entry of alternative outside monies. The belief that none of the alternatives would lead to voluntary abandonment of an established precious metallic standard seems warranted by historical experience. But the question, given a microsovereignty ethic, ought not to be foreclosed by anticompetitive policies.

The burden of outcompeting an established standard is significant. Money users in an economy tend to converge on a single monetary standard for the reason, central to the emergence of money in the first place, that each trader finds it most convenient to use as a medium of exchange the item or items most readily accepted by other traders.³⁰ It is therefore difficult to convince any individual in a monetized economy to accept as a medium of exchange an asset that is neither a claim to something nor itself something that other individuals already accept as readily as money. In pondering the transition to open competition among monetary standards there is of course no a priori reason to consider gold or silver, rather than government fiat paper, vermeil, or plywood, as the proper initial monetary standard. The reason must instead be historical: It is gold and silver that emerged historically as money in advanced nations out of an invisible-hand convergence process driven by individual preferences. Gold and silver were chosen as money before governments got into the act of restricting monetary options. They voluntarily displaced other standards, presumably by more or less gradual diffusion and because they represented superior monies in the eyes of money users, in areas that came into trading contact with specie-using areas.³¹

While gold or silver is not logically necessary to free banking, then, respect for historically demonstrated consumer preferences suggests that a specie standard is the natural place to start.

Notes

1. Gerald P. O'Driscoll, Jr., "A Free-Market Money: Comment on Yeager," *Cato Journal* 3 (Spring 1983):327.

2. This example is taken from Allan H. Meltzer, "Monetary Reform in an Uncertain Environment," *Cato Journal* 3 (Spring 1983):97-105. Other examples of preferences attributed (without evidence) to consumers by monetary reformers would be preferences for higher real gross national product, more stable purchasing power of the monetary unit, and uniformity of money across producers.

3. In fact the relative instability and unpredictability of silver's purchasing power may have contributed to its abandonment in favor of gold during the nineteenth century. One would like to have a thorough interpretation of the historical evidence on this question, as governments' interests rather than individuals' preferences may have been responsible for switches from silver to gold.

4. The "compensated dollar" was the brainchild of Irving Fisher, who revived the quantity theory of money early in this century. See Irving Fisher, *Stabilizing the Dollar* (New York: Macmillan, 1920).

5. Phillip Cagan, "A Review of the Report of the Gold Commission and Some Thoughts on Convertible Monetary Systems," unpublished paper, Columbia University, October 1982, p. 4.

6. To use the terminology of Murray N. Rothbard, *Power and Market* (Menlo Park, Calif.: Institute for Humane Studies, 1970), complete individual sovereignty in the market requires the absence of triangular intervention. See also Donald C. Lavoie, "The Development of the Misesian Theory of Interventionism" in Israel M. Kirzner, ed., *Method, Process, and Austrian Economics* (Lexington, Mass.: Lexington Books, 1982), pp. 178-79 where Lavoie points out that certain forms of taxes constitute triangular intervention.

7. It should perhaps be noted explicitly that the so-called free banking systems in several American states between 1837 and 1863 did not meet these conditions. For a recent account of New York State's free banking experience see Robert G. King, "On the Economics of Private Money," *Journal of Monetary Economics* 12 (July 1983):139-56.

8. For American experience with private mints in the Appalachian and Californian gold-producing regions, see Donald H. Kagin, *Private Gold Coins and Patterns of the United States* (New York: Arco, 1981). For an early free trade defense of exclusively private coinage, see Thomas Hodgskin, *Popular Political Economy* (London: Charles Tait, 1827; reprint ed., New York: Augustus M. Kelley, 1966), pp. 190-96. For a recent defense see Rothbard, *Power and Market*, pp. 59-60, where Rothbard points out that only competitive private coinage can be presumed to give consumers the denominations of coins they want.

9. For an evolutionary perspective on monetary institutions, see Lawrence H. White, "Competitive Payments Systems and the Unit of Account," *American Economic Review* 74 (September 1984):699-712. On the early history of European banking see Raymond de Roover, *Business, Banking, and Economic Thought in Late Medieval and Early Modern Europe* (Chicago: University of Chicago Press, 1956), ch. 5. See also Ludwig von Mises, *The Theory of Money and Credit*, new enlarged ed. (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1971), pp. 278-80.

10. See Mises, *Theory of Money and Credit*, pp. 50-53.

11. King, "On the Economics of Private Money," p. 154, affirms this conclusion for New York State's experience, Lawrence H. White, *Free Banking in Britain* (Cambridge, England: Cambridge University Press, 1984), p. 146, affirms it for Scotland's experience with free banking.

12. See White, *Free Banking in Britain*, pp. 7-8.

13. Lawrence H. White, "Competitive Money, Inside and Out," *Cato Journal* 3 (Spring 1983):292. I am grateful to David Price for bringing this question to my attention.

14. See Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, N.J.: Princeton University Press, 1963), p. 56n.

15. Ludwig von Mises, *Human Action*, 3rd ed. (Chicago: Henry Regnery, 1966), pp. 445-47.

16. Murray N. Rothbard, *The Mystery of Banking* (New York: Richardson and Snyder, 1983), pp. 97, 100.

17. Ibid., pp. 93-94, briefly relates the legal precedents on this question.

18. Specimens of Scottish banknotes may be found in S.G. Checkland, *Scottish Banking: A History, 1695-1973* (Glasgow: Collins, 1975), pp. 32, 67, 98, 105, 185, 383, 546-48.

19. On the title-transfer model, see Williamson M. Evers, "Toward Reformulation of the Law of Contracts," *Journal of Libertarian Studies* 1 (Winter 1977): 3-13. I would argue that the title-transfer view is uniquely compatible with an ethic of individual sovereignty.

20. On the option clause in early Scotland, see Checkland, *Scottish Banking*, pp. 67-68, 82, 110. The law banning them in 1765 met with Adam Smith's approval: see *The Wealth of Nations*, edited by R.H. Campbell and A.S. Skinner (Indianapolis: Liberty Classics, 1981), pp. 325-26, 329. It should be noted that the option clauses in Scottish banknotes specified an interest yield (5 percent per annum) in case of deferred redemption, and specified the period of deferral (six months). A representative "optional" note read: "The Royal Bank of Scotland... is hereby obliged to pay to _____ or the Bearer, one pound sterling on demand, or, in the Option of the Directors, one pound six pence sterling at the End of Six Months after the day of the demand...". Checkland, *Scottish Banking*, p. 67, provides a specimen. This interest penalty, imposed by competition, further discouraged banks from exercising the option.

21. Comprehensive referencing of this literature would take a long article by itself. On the early nineteenth-century literature, see White, *Free Banking in Britain*, chs. 3,4. Classic works in the Austrian monetary theory of the business

cycle include Ludwig von Mises, *On the Manipulation of Money and Credit* (Dobbs Ferry, N.Y.: Free Market Books, 1978) and F.A. Hayek, *Prices and Production*, 2nd ed. (New York: Augustus M. Kelley, 1967). Important works in the Monetarist tradition include Friedman and Schwartz, *A Monetary History of the United States, 1867–1960*, and Robert E. Lucas, Jr., *Studies in Business Cycle Theory* (Cambridge, Mass.: MIT Press, 1981).

22. This and the following paragraph draw upon White, *Free Banking in Britain*, pp. 14–19.

23. Again see White, *Free Banking in Britain*, ch. 3 and ch. 4, sec. 3.

24. For an example of fairly sophisticated argument along these lines by a leading Jacksonian theoretician see William Leggett, “Bank of the United States” in *Democratick Editorials*, edited by Lawrence H. White (Indianapolis: Liberty Press, 1984).

25. Ludwig von Mises, *Human Action*, p. 443.

26. Mises, *ibid.*, quite bluntly blamed actual central bank overexpansions either on deliberate attempts to cheapen credit by politicians catering to popular inflationist ideology or on attempts at inflationary finance. For a valuable survey article explaining both the incentive and information problems of central banking, see Pamela Brown, “Constitution or Competition? Alternative Approaches to Monetary Reform,” *Literature of Liberty* 5 (Autumn 1982):7–52.

27. On this point see the remarkably perceptive statements of Samuel Bailey, *A Defence of Joint-Stock Banks and Country Issues* (London: James Ridgway, 1840). Several pertinent passages from this work are quoted in White, *Free Banking in Britain*, pp. 130–33.

28. I have given a similar list, and further discussed the question addressed by this section, in “Gold, Dollars, and Private Currencies,” *Policy Report* 3 (June 1981):6–11. Some combination of the fourth and fifth sorts of nonfiat currency has recently been suggested by Robert E. Hall, “Explorations in the Gold Standard and Related Policies for Stabilizing the Dollar,” in Hall, ed., *Inflation: Causes and Effects* (Chicago: University of Chicago Press, 1982), pp. 111–22. Hall proposes a basket standard composed of ammonium nitrate, copper, aluminum, and plywood.

29. A base freeze is proposed by R.H. Timberlake, Jr., “Monetization Practices and the Political Structure of the Federal Reserve System,” *Cato Institute Policy Analysis* (August 12, 1981):12. The idea of a cashless competitive payments system is explored by Robert L. Greenfield and Leland B. Yeager, “A Laissez-Faire Approach to Monetary Stability,” *Journal of Money, Credit, and Banking* 15 (August 1983):302–15, and proposed as a reform by Leland B. Yeager, “Stable Money and Free-Market Currencies,” *Cato Journal* 3 (Spring 1983):323–25. I criticize on evolutionary grounds the idea that competition would give rise to a cashless payments system, or to a basket standard, in “Competitive Payments System and the Unit of Account.”

30. The *locus classicus* for this theory of the origin of money is Carl Menger, “On the Origin of Money,” *Economic Journal* 2 (1892):239–55.

31. Sweden, for example, had a copper standard in early times. The relative cumbersomeness of this should be obvious.