What Has Government Done to Our Money?

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Part 1

II. Money in a Free Society

1. The Value of Exchange

Men exchange because both parties expect to benefit from it, which implies that they value the goods differently (reversed valuation)

Exchange is such a universal phenomenon because of the great variety in nature (in man, and in location) If one could not exchange one would have to be self-sufficient. Uncool.

2. Barter

Barter (direct exchange) is not much better than self-sufficiency because of the problems of 1) indivisibility, 2) lack of coincidence of wants

3. Indirect Exchange

Indirect exchange (you sell your product for a good that you can in turn sell for the good that you want to have) solves these two problems and permits civilization to develop. If one good is more *marketable* (if everyone is confident that it will be readily sold) then demand will become greater because it will be used as a *medium* of exchange.

Several criteria determine the marketability of a good: 1. non-exchange demand, 2. divisibility, 3. durability 4. transportability

More marketability causes wider use as a medium of exchange which causes more marketability → reinforcing spiral. Eventually, one or two commodities are used as general media and we call these *money.*

Money can only arise through cumulative development of a medium of exchange on the market (Mises's regression theorem) because embedded in the demand for money is knowledge of the money-prices of the immediate past (this is a distinction with directly used consumer or producer goods) but if we continue to trace this back this means that originally money had to be a commodity valued for its direct use. Money is simply a commodity that now mainly gets used as a medium of exchange.

4. Benefits of Money

1. Money solves 'divisibility' and 'lack of coincidence of wants' problems
2. money allows all goods to be expressed in it. Such exchange ratios are called prices and money then serves as a common denominator which in turn enables economic calculation which in turn is the only way to rationally allocate resources to their most productive use – to those uses that will most satisfy consumer demand

5. The Monetary Unit

Weight is the distinctive unit of a tangible commodity and so trade takes place in terms of weight units. On the free market various names that units may have (dollar, pound, euro) are simply definitions of units of weight (e.g. 1/20, 1/5, 17/426 of ounce of gold)

6. The Shape of Money

The entire stock of the commodity available to man constitutes world's stock of money. It does not matter in what shape it comes (in bars, used in machinery, chunks, jewelry, whatever) though coins are often preferred.

7. Private Coinage

Private coinage would work like any other business. The objection that minters might defraud their customers can be at least equally well applied to governments with *total control* over the money

supply, and it flies in the face of evidence of transactions in the free market that depend on similar guarantees of standards.

Another counter-objection concerns Gresham's Law which says that bad money drives out good money, which in this case would mean that the free market cannot be trusted to provide good money. But Gresham's Law is basically about *price controls*: if government insists that money that is worth only 9/10 of the other money be treated equally then people will get the good money out of the country and bring 9/10 money in. On a free market the bad money would be worth 9/10 and be dealt with as such and so cease to be bad money. The money now is bad because of the price control.

8. The "Proper" Supply of Money

Changes in money stock will be governed by the same causes as changes in other goods. Changes in money supply tend to be small (little new production, little wear and tear).

Should the money supply move with population growth, with volume of trade, with production, should it be left to the market?

The price of money can be expressed in terms of all the other goods in the market (1 dollar is 1/100 of an mp3-player, 1 bread, etc.) The price of money is determined by supply and demand. The demand for money consists of various goods offered in exchange for money plus the money retained in cash and not spent over a period of time. Now what if the supply increases? There is no social benefit, it only dilutes the effectiveness of each ounce of gold, but nobody is better or worse off if the amount of money would double (equally spread out). *So the supply of money simply does not matter*. *It only confers a social benefit because it is also a commodity* (gold in jewelry)

9. The Problem of "Hoarding"

What's wrong with people who hoard up gold in their cellar and don't let it circulate in the economy? Nothing. All it means is that the demand for money (to hold) increases, so prices of goods will fall, purchasing power rises. No benefit or loss to society occurs.

Moreover, it is not irrational to hoard money. Money is not only useful in a present exchange but also in an expected and preferred future exchange and so hoarding confers that benefit to the owner. People keep cash balances because of uncertainty of the future: 1. if we knew exactly how much money we were gonna use, then there is no need for cash balances, 2. if we expect money to become worth more, we'd want to stock up on it now.

Total cash balance is always equal to total supply since all money must be owned. If there was no uncertainty nobody would be willing to hold cash, price of money would fall and thus of other goods will rise infinitely causing monetary breakdown. This also means that the idea of money 'circulating' is a misleading metaphor. The only thing that takes place is transfers from one cash balance to another's.

Unlike changes in the supply *of money, changes in the demand for money* do *confer social benefits*, for they satisfy a public desire for either a higher or lower proportion of cash balances to the work done by cash How can an increase in demand for money be satisfied if changes in supply stays the same? If people value cash balances more highly, then demand for money increases and prices of goods fall, so the same total sum of cash balances confers a higher "real" balance, i.e. higher in proportion to the prices of goods.

10. Stabilize the Price Level?

Should we try to keep the price of the money unit stable? Arguments for it are:

1. Money is supposed to be a fixed yardstick
2. Stability would provide justice to debtors or creditors.

But 1) artificial stabilization would distort and hamper workings of the market (e.g. people would be unavoidably frustrated in their desire to alter real proportion of cash balances, one wouldn't be able to change cash balances in proportion to prices) and 2) lenders and borrowers can already protect themselves from changes by agreeing on an index number of changes in value of money.

Yet they hardly ever do so, so why then force them?

11. Coexisting Moneys

Would the coexistence of e.g. two different moneys (gold and silver) be very chaotic? No way Jose. The relative supplies of and demands for the two metals will determine the exchange rates between the two and this, like any other price, may continuously fluctuate in response to these changing forces, like any other exchange relation between goods.

12. Money Warehouses

Commodity-money may be cumbersome to carry with you all the time and it has to be stored somewhere. So warehouses for money will be created on the market. If you store money there you get a warehouse receipt. Because money, unlike other goods, is mainly not used in a "physical" sense convenience inevitably leads to transfer of warehouse receipt instead of the physical good itself. So warehouse receipts tend to become money substitutes. There will be three limits on the advance of the substitution process:

1. the extent to which people use these warehouses (banks)
2. extent of the clientèle of each bank (if transaction between clients of different banks, then gold has to be moved after all)
3. confidence that clientèle have in the trustworthiness of the banks

As banks and the confidence in them grow clients may find it easier to waive their right to paper receipts (bank notes) and instead keep their titles as open book accounts (in the monetary realm these are called bank deposits). Exchanges are made by writing orders to your bank to transfer a portion of his account to the seller. Nothing in this process changes the money supply, just the *form* of the supply. Banks earn a profit from service charges to their customers.

What is fractional reserve banking? Since money can remain in warehouses for very long banks may be tempted to use some of the money for its own account to make a profit. This is fraud and *inflation* (increase in the money supply not consisting of an increase in the stock of the money metal). The bank becomes insolvent (bankrupt) if it lends out gold or warehouse receipts for gold and it thereby increases the effective money supply until the fraud is discovered.

Defenders of fractional reserve banking hold that banks take risks like other businesses but the difference is that they are doing it with other people's money without permission. When businesses borrow or lend money he does not add to the money supply. He uses *saved* money.

But suppose fractional reserve banking *is* permitted and banks are only required to redeem gold *on demand* and can thus take their chances in the meantime(free banking), then what would happen? It would not, contrary to public opinion, lead to massive inflation because the banks would be checked by the same three limits mentioned above.

So each bank's expansion will be limited by a loss of gold to another bank cuz it can only expand money within limits of its own clientele. But in a market that new money will at some point reach an owner who is a client of another bank after which bank B will call upon bank A to redeem. Thus, the smaller the bank the less room there is for inflation.

What if banks form a cartel and agree to pay out each other's receipts and not call for redemption, and if bank money is in universal use? Then there still is the limit of client confidence and clients will tend to want to get their money out if they lose confidence.

Credit (money is lent in exchange for agreement to pay back at some future date, with interest to reflect higher valuation of present goods over future goods) is useful, but bank notes or deposits are not credit but warehouse receipts, *instantaneous* claims to cash.

13. Summary

There is nothing special about money that requires extrensive governmental dictation. Free market works for money as well.