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Central Banking Beats Free Banking? It Just Ain't So!

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In "More Bits on Whether We Need a Fed," a November 21 Marginal Revolution blog post (www.tinyurl.com/3y2gsbx), George Mason University economics professor Tyler Cowen questions "why free banking would offer an advantage over post-WWII central banking (combined with FDIC and paper money)." He adds, "That's long been the weak spot of the anti-Fed case."

Free banking is better than central banking because only in a free market can the optimal prices and quantities of goods be determined. Those goods include the money supply, and prices include the rate of interest.

> The optimal quantity of money in the economy, like any other good, can only be discovered by markets, not predicted by the Fed.

There is no scientific way to know in advance the right price of goods. With ever-changing populations, technology, and preferences, markets are turbulent, and fluctuating human desires and costs cannot be accurately predicted.

The quantity of money in the economy is like that of other goods. The optimal amount can only be discovered by the dynamics of supply and demand. The impact of money on prices depends not just on the amount of money but also on its velocity—that is, how fast the money turns over. The Fed cannot control this since it cannot control the amount people want to hold, or the demand. Also, even if the Fed could determine the best amount of money for today, the impact of its moves take months to play out, so the central bankers would need to be able to accurately predict the state of the economy months into the future.

The Fed also fails because of political pressure. Although the Fed is supposed to be independent, in practice, when the economy is depressed, there is strong political pressure to "do something," specifically to "stimulate" by expanding the money supply. Since Congress created the Fed and can alter it, it is impossible for the Fed to be purely independent of politics.

The Federal Reserve was set up to provide price stability, yet the United States suffered high inflation during the 1970s and continuous inflation since World War II. The Fed was also supposed to provide economic stability, but since World War II there have been severe recessions in 1973, 1980, 1990, and 2007–2009. The Fed was supposed to ensure stability in the financial system, but it failed to prevent the Crash of 2008 and the Great Recession that followed. But the challenge is to explain why free banking would be better.

Suppose gold once again became a global currency. It would be the real money, and the U.S. dollar would be defined as a particular weight of gold. A $20 gold coin had about an ounce of gold before 1933.

Under free banking most transactions would not occur with gold, but rather with more convenient money substitutes. Banks would issue paper bank notes inscribed with their bank names. Anyone holding bank notes could exchange them for gold. For example, if $1,000 was equivalent to an ounce of gold, then anyone could go to a bank and convert $1,000 in paper bills to one ounce of gold coins. Likewise one could withdraw $1,000 of deposits in gold coins.

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Competition among banks, as well as convertibility into gold, would result in price stability, since the banks would only be able to issue as many bank notes as the public was willing to hold. If there were more bank notes than that, they would come back to the bank to be exchanged for gold. But the money supply would also be flexible, since if there were a greater demand to hold money, the amount of bank notes or bank deposits would increase.

The Structure of Capital Goods

Free banking mitigates the boom-bust cycle. There is a structure to capital goods similar to a stack of pancakes. At the bottom of the stack are rapidly circulating capital goods such as inventory close to the consumer-goods level. As we go up the stack, the capital goods turn over more slowly. At the top are long-duration investments such as real-estate development. Goods become more sensitive to interest rates as you move up the stack. Lower interest rates make the stack steeper, as there is more investment in long-term investments.

In a free market the "natural rate" of interest depends on the preference for goods sooner rather than later, or "time preference." Interest is the premium paid to shift purchases from the future, for which one would have to save enough to pay cash, to the present day by borrowing.

The Fed lowers the rate of interest by creating fiat money out of nothing. As a result, businesspeople borrow more for capital goods high on the stack, such as real estate. Prices rise fastest and soonest where the money is being injected into the economy with loans. Thus real-estate prices escalate, creating a bubble like those that occurred before 1973, 1980, 1990, and 2007; indeed a similar bubble occurred during the 1920s before the Great Depression.

Every boom preceding a bust has been fueled by artificially cheap credit. With free banking the interest rate would not be manipulated down. The natural rate of interest would raise the carrying cost of borrowed funds, reducing if not preventing the financial fever.

> Free banking is not a panacea. Government still distorts the economy in many ways. But even without further reforms, the case for replacing central banking is strong.

Further Reforms

Free banking is not a panacea: There need to be other reforms to achieve sustainable economic growth. Punitive taxes, subsidies, and arbitrary restrictions all distort the economy, stifle enterprise, and create turbulence. But even without such other reforms, the case for replacing central banking with free banking is strong, resting on three facts:

1. The optimal money supply and interest rates are unknowable in advance, and can only be discovered by market dynamics.
2. Political pressure makes the Fed expand the money supply and reduce interest rates when the economy is depressed, and this fuels an unsustainable boom that results in the next bust.
3. Government insurance, guarantees, the expectation of bailouts, and other subsidies induce excessive risk-taking, making financial crashes worse.

Cowen states that if the Fed were to shut down, the new base money would be Treasury bills. (Base money currently consists of money in circulation, bank vault cash, and commercial bank reserves on account at the Fed.) But folks don't buy groceries with Treasury bills. The best transition base money would be the current amount of Federal Reserve notes, whose supply would be frozen, as suggested by Professor George Selgin. Then new-money expansion would be the money substitutes issued by the banks, convertible into base money. Eventually, with the abolition of legal-tender laws, world financial markets would converge on a common global currency, gold.

The case for free banking is similar to the case for healthy living. It is better to prevent economic illness than to have to treat it. FEE