The End of Central Banking, Part II

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As I demonstrated in Part I of this essay (*TOS*, Spring 2013), the "end" or purpose of central banking is not to fix "market failures" in money and banking, as its proponents claim, but to help finance fiscally profligate statist governments that are unwilling and/or unable to raise sufficient tax revenues.[1] By facilitating deficit spending and paper money creation, central banking unavoidably generates harmful economic and financial effects.

Here, in Part II, I will explain why and how we should "end"—as in *terminate*—central banking. Specifically, I will show that: (a) although central banking has accomplished its actual goal of funding statist fiscal regimes, it has failed at its putative aim of ensuring sound money, safe banking, and a robust but stable economy; (b) free banking and gold-based money worked well in the past because they served the needs of producers and traders in free (or relatively free) markets; (c) history is replete with instances in which reformers have helped societies shift from central banking and fiat money to freer banking and gold-based money; (d) the transition from central banking to free banking will require a substantial ideological change from support for statism to support for capitalism (i.e., free markets in general); and (e) given the proper ideological climate, it is possible to swiftly and safely dismantle today's system of central banking and to replace it with a free banking system based on the gold standard.

My proposal for ending central banking—specifically, ending the Federal Reserve System in the United States—has the virtue of being a straightforward, logical reversal of the process by which central banking itself displaced free banking in America; and on a practical level it is also consistent with today's more

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technologically advanced payment and credit systems. A freer monetary system cannot, by itself, restrain a fiscally profligate government; indeed, it is precisely the latter that has politicized our money and banking system. If a free system is to take hold again and survive, the current goals and scope of government will have to be sharply curtailed to pave the way. But, as we work to pave the way, it is worth our while to understand how a sound monetary system ultimately can be restored.

Let us look first at some important history.

The Success and Failure of Central Banking

In judging the effectiveness of an institution such as central banking, one must first grasp its main purpose. To know whether an institution "works," we must know its aims. I have shown that the true purpose of central banking is to help finance the fiscally profligate state. But the question remains: Has central banking nevertheless worked to achieve its alleged goal of fixing "market failures" by fighting inflation, ensuring safe banking, maximizing employment, stabilizing interest rates, and preventing or mitigating financial crises?

A prominent financial historian representatively insists that central banks pursue three goals: "The first and most important is price stability or stability in the value of money," the second is "high and sustainable economic growth" (including a "smooth . . . business cycle"), and the third is "financial stability."[2] It is easy to measure a system's success or failure by such criteria relative to the track record of a previous and freer monetary system. Even the briefest glance at history reveals that, insofar as these are its goals, central banking has failed miserably. History also reveals that insofar as the aim of central banking is to finance fiscally profligate governments, it has succeeded quite well and thereby has undermined sound money and safe banking.

During the classical gold standard era (1880–1914),[3] when central banks were fewer and those that existed had limited powers, sixty nations had gold-based monies, and the value of money—that is, the goods and services money could buy—was preserved over time. Prices in the United States in 1914, for example, were only 6 percent above those in 1880—a rise of only 0.2 percent per year, compounded. Gold-based economies in other nations exhibited similar stability.[4] During the past century, in contrast, prices in the United States have increased twenty-threefold—a compounded annual rate of 3.3 percent, such that the dollar's purchasing power today is a mere 5 percent of what it was when the Fed began in 1913. Since 1971, when the United States abandoned gold entirely and began the era of pure fiat paper money, prices have increased at a compounded annual rate of 4.3 percent. Prices in Britain during the past century have increased ninety-onefold, or nearly 5 percent per year. Other central banks have delivered even worse results in the past century, including hyperinflations. This is hardly the record of "price stability" that central banking acolytes have claimed.

The decades since 1971 in the United States have also been characterized by wild gyrations in interest rates, due mainly to central bank policies and the uncertainties inherent in a pure fiat paper money. Whereas during the era of the classical gold standard U.S. Treasury bond yields averaged 4 percent or so without much variation, since 1913 they have averaged 5 percent; and since 1971 they have averaged 7 percent, as lenders to government trust less and less that they'll be repaid in sound money. Interest rate volatility has also been greater in the past century, as Treasury bond yields have been as low as 1.8 percent (1940–41, 2012–13) and as high as 15.9 percent (1981). Again, not even the most resolute apologist for central banking can call this "stability."

What about the economic growth rate and its volatility (the business cycle)? During the classical gold standard U.S. industrial production increased by an average of 5 percent per year, but has increased only 3 percent per year since the Fed's founding in 1913, and only 2.3 percent per year under the fiat-paper money system in place since 1971. The business cycle has also gyrated more in the past century, under central banking, than it did during the previous, freer century. In the century before 1913, U.S. industrial output grew half again faster and at half the volatility compared to the century after 1913. Certainly the freer banking system in the 1800s never coincided with a 54 percent plunge in industrial production, as occurred in the early 1930s under the Fed.

A recent study in the *Journal of Macroeconomics* asks, "Has the Fed Been a Failure?"—and answers, yes.[5] Historical evidence, it says, "does not support the view that the Federal Reserve System has lived up to its original promise." Indeed, "the Fed's full history (1914 to present) has been characterized by more rather than fewer symptoms of monetary and macroeconomic instability than the decades leading to the Fed's establishment"; and "while the Fed's performance has undoubtedly improved since World War II, even its post-war performance has not surpassed that of its undoubtedly-flawed predecessor, the National Banking system [and the classical gold standard], before World War I." More fundamentally, it concludes, "the Fed's record suggests that its problems go well beyond those of having lacked good administrators," so "the only real hope for a better monetary system lies in regime change."

According to the criteria offered by the most avid defenders of central banking, the system has failed. Yet central banking has succeeded at creating vast new sums of fiat paper monies, at eroding their purchasing power, and at monetizing the public debts incurred by deficit-spending governments. By the criterion I advance—that central banks, in fact, are primarily financiers of welfare states and warfare states[6]—central banks have been a smashing success. Studies show that central banks, especially in the past century, have acted mainly for the purpose of meeting the growing fiscal needs of their government sponsors.[7] Indeed, that fact also explains why central banks have undermined the strength of the banking system[8] and have instigated rather than prevented financial crises.[9]

In the United States, the Fed's priority has been not to deliver sound currency, or to foster safe banking, or to ensure a robust economy, but instead to accommodate Washington's deficit spending and bond issuance.[10] Yet the Fed is not unique in this respect; all central banks have failed to accomplish their alleged goals but have succeeded in accomplishing their main purpose. The more their respective governments have spent beyond their means, the more these governments have borrowed, and, in so doing, the more they've pressured their central banks to help purchase the vast new supply of government bonds, with fiat money created ex nihilo, when no other bond buyers could be found, or found at sufficiently low interest rates. It is no coincidence that the debt monetization and money printing of central banks has expanded in tandem with the growth of welfare states and warfare states over the past century. The relatively few central banks that existed in the 19th century had fewer powers and were significantly limited in their capacities to create money and accommodate fiscally profligate governments, a status that matched the smaller size and scope of governments in that era.

History shows that central banking has failed to ensure sound money, safe banking, or a stable economy—but that it has succeeded in funding statist programs and regimes. Let us turn now to some crucial truths about free banking.

Theory and History of Free Banking and the Gold Standard

Free banking is the system of money and credit that arises when government protects property rights and contract rights. Privately owned and operated financial institutions collect deposits from customers and issue currency, checking accounts or other media of exchange, and make loans—all guided by the profit motive. Banks in such a system are subject to the same laws—including antifraud provisions and bankruptcy codes—as are other businesses.

Free banks make money by charging fees for financial services and charging interest on loans. Although a small share of depositors will be so risk averse as to prefer their bank serve as a mere money warehouse, providing safe-deposit boxes, most depositors will want to forgo the storage charges associated with warehousing and instead receive interest on their deposits—payments that banks can make only if they are not solely warehouses but also specialists earning interest by lending out deposits. As such, a free bank parts with a fraction of its deposits, a fact that most depositors recognize and welcome. This is "fractional-reserve banking," with gold reserves constituting less than 100 percent of the currency and checking accounts held by bank customers. Depositors assume some risk in participating in fractional-reserve banking; it is possible that a bank will be poorly run and thus be unable to pay gold on demand—just as it is possible that any business one deals with could fail to deliver on its contractual promises. But when customers patronize fractional-reserve banks, they do so voluntarily and are compensated for the risk when they are paid interest on their deposits. Although free banking allows for safe deposits, market incentives naturally give rise to a fractional-reserve system, but with banks financially motivated to retain adequate levels of cash reserves and capital.

Because free banks must earn the trust of depositors, they not only aim to retain adequate reserves, they also operate on a gold standard. The gold reserves are not centralized or prone to government manipulation, as they are under central banking; rather, individual private banks control their own gold reserves and issue both banknotes (currency) and checking accounts convertible, uniformly across the system, into a fixed weight of gold. Such banks cannot with legal impunity renege on their commitments and cannot expect bailouts from either central banks or taxpayers.

The only role of government in a free banking system is to protect property rights, enforce financial contracts (for deposits, loans, collateral, etc.), uphold an objective system of weights and measures, and adjudicate the occasional dispute or bankruptcy. In such a system the government still conducts its valid fiscal affairs—raising its necessary revenues, spending on legitimate programs, and borrowing when necessary—but it does so using the voluntarily accepted money of the realm. Government does not grant special privileges to banks, not even to those that falter or fail, whether by subsidies, deposit insurance, bailouts, or exemptions from bankruptcy codes; nor does government regulate, prescribe, or proscribe any non-fraudulent practices in a free banking system.

For the sake of legal clarity and objectivity, government may properly designate gold or silver as monetary "legal tender" for its fiscal dealings or for court-mandated payments of debt; but it does not, thereby, establish a money monopoly.[11] Moreover, government may not declare any particular medium of exchange to be the sole means of payment in the marketplace, nor may it issue inconvertible paper money itself, nor mandate its use. A proper government leaves markets free to choose the money they use, and itself issues no money. In a system of free banking, government passively acknowledges but also legally enforces generally accepted standards, such as objective weights and measures, just as it passively acknowledges yet legally enforces generally accepted meanings of concepts in contracts (e.g., "oak lumber" is oak lumber). Under free banking, government does not interfere with or regulate any aspect of money or credit. It simply protects everyone's rights by prohibiting fraud, breach of contract, and the like. Even a constitutionally limited, rights-respecting government must touch money and credit to conduct its fiscal duties, but this never justifies even a partial political co-opting of the system.

Various kinds of non-fraudulent, trustworthy money might emerge in a freer system, but in modern times gold-based money has been the preferred kind, as it possesses unique existential qualities that render it a superior medium and an objective monetary standard. Gold is scarce, high in value per weight, imperishable, portable, divisible, uniform in quality, recognizable globally, and, relative to every other commodity and currency, the least variable in purchasing power over many centuries.[12] As such, gold serves as a reliable monetary yardstick by which to measure the value of other goods and services, and it is a dependable store of liquid wealth. This is also why, historically, the gold standard and free banking have coincided; when left free to choose in money and credit, men have chosen gold money.

Gold was the freely chosen medium of exchange and the basis of an objective monetary system, largely devoid of politics, in the 1700s and 1800s, not only in the United States and Britain, but in most developed nations. Prominent private banks issued their own currency, as well as checks, but these derived their value from being reliably redeemable in a fixed weight of gold. No inherent confusion arose from the fact that free banks issued "private label" currency or checks. Despite a robust "competition in currency," commodity money (gold and silver) was the uniform, base money that held its value. The profit motive ensured that bank liabilities (currency and checks, comprising the bulk of the money supply) were not unduly expanded. Gold served as the solid foundation of rational pricing, sound lending, and robust but sustainable prosperity.[13]

Critics of the freer monetary systems of the 1700s and 1800s insist that periodic "shortages" of gold or gold-convertible money restricted production or prevented governments from borrowing temporarily or justifiably (e.g., during legitimate wars, when spending was briefly higher, or recessions, when revenues were briefly lower). But the facts say otherwise. The global stock of gold increased nearly sixfold in the century prior to the Fed's establishment in 1913, a compounded growth rate of 1.8 percent per year. As the economy grew, so did the demand for gold; and as its value increased, so did the incentive to discover and mine more of it. The gold standard did not impede robust production, and gold itself was, in fact, a crucial part of production. Complaints about a "shortage" of gold related, in fact, to the occasional bad banking practice of issuing too much currency, that is, too many *claims* upon gold. Such practices are far more typical of central banks than free banks. Under gold money and free banking, economic output generally grew faster than did money supplies, prices, or debts—whereas in the past century (1914–2013), under practically unlimited government and widespread central banking, money supplies, debts, and prices have risen faster than the production of real goods and services. Gold money and free banking coincided with a lower cost of living and rising living standards.

The two greatest success stories in economic history occurred in Britain, beginning in the late-17th century, followed by the United States, beginning in the late-18th century. Each nation was built on a foundation of relatively free banking, gold-based currencies, and balanced budgets. Although the monetary systems of Britain and the United States in the 1700s and 1800s were not completely free of government interventions, they were quite free, and economic performance in each nation benefited enormously from that fact. Government spending typically was less than 5 percent of gross domestic product (GDP), a mere tenth of today's level, and deficit spending was the exception rather than the norm, which it has been for the past century. Britain was on the classical gold standard from 1717 to 1914, except for the few decades when it was at war with France (1797–1821); the United States was on that same standard from 1792 to 1914, with the exception of the Civil War (1861–1865) and its aftermath (1866–1879).

The transition from a (largely) free-market monetary system to a (largely) government-dominated system was part and parcel of the transition from relatively free markets more generally to the substantially mixed system we have today; it resulted not from natural economic evolution but from executive-legislative fiat. Just as free banking and gold-based money are natural concomitants (both historically and logically), so too central banking and fiat paper are natural concomitants. The intermediate or hybrid system, involving adulterations to the classical gold standard and regulations of banking, lasted from 1914 to 1971. It was an unstable mix, resolvable in only two ways: either by removing central banks from the system and preserving the gold standard, or by removing gold money and preserving central banking. The United States chose the latter, and its citizens and businesses have paid dearly for that.

If we want to fix our money and our banking system—if we want to cut off the funding spigot to illegitimate government spending and regain fiscal responsibility—we must call for a return to free banking and its concomitant, a gold standard. Free banking and gold money worked well in the past because they served the commercial needs of a free economy. And, as we will see in our next section, history shows that free banking *can* rise again and replace central banking, even though the latter is heavily ensconced.

Principles and Practices of Rational Monetary Reform

History is replete with reforms of money and banking, from which we can draw lessons to guide future reforms. Some reforms have occurred amid financial crises, when capitalism was unfairly blamed for what statism wrought and even more statist elements were introduced.[14] Yet other reforms have occurred in more pro-capitalist contexts, when statist elements were rescinded.[15] These latter cases of constructive reform should interest pro-capitalists today who seek rational reforms and should allay the fears of those who distrust preplanned, fully designed reforms that require material state action. Spontaneous improvement by the mere repeal of a few laws is unlikely, if not impossible, at this late stage of monetary-fiscal statism; a more radical reconstruction is required. Government activism that enhances economic liberty and protects rights is morally justified and politically necessary.

Let's consider six cases, in chronological order.

Case #1: The United States in 1792

In the early 1780s, near the end of America's war of independence, the national government was insolvent; its debts were in default, and its currency had been inflated to near worthlessness. A confusing array of foreign coins, paper currencies, and debts of indecipherable value circulated throughout the colonies. By 1792, the U.S. Constitution had replaced the Articles of Confederation, due substantially to the efforts of the Federalists led by Alexander Hamilton, America's first Treasury secretary (from 1789 to 1795). Hamilton was among those framers who in 1787 rejected extant proposals to permit the federal government to issue irredeemable paper money; in the end, the framers agreed that neither the federal government nor the states could declare anything but gold or silver to be legal tender.[16] As Treasury secretary, Hamilton crafted plans, which were then adopted by Congress, to restructure federal and state debts without defaults; to raise revenues; to establish a mint; and to define the U.S. dollar in terms of gold and silver.

To facilitate tax collections, government payments, and public debt service, and to ensure that private banks redeemed their currencies on demand, Hamilton also advised a national bank: the Bank of the United States (BUS). The BUS was privately owned, operated on a gold standard, could not lend to government, had a limited-duration charter (1791–1811), and was conservatively managed (with capital equal to 50 percent of assets, or ten times the typical central bank ratio today). The BUS was not a central bank in the sense known today. Hamilton insisted the BUS would "promote commerce by furnishing a more extensive, valuable medium" of exchange in place of depreciating, volatile, and untrustworthy currencies. He knew that some reformers wanted a politicized bank, based on "considerations of public advantage" and "on principles that would cause the profits of it to redound to the immediate benefit of the State." But, for Hamilton, such a scheme faced "insuperable objections." The BUS, he insisted, must not be political:

> To attach full confidence to an institution of this nature, it appears to be an essential ingredient in its structure, that it shall be under a private not a public direction, under the guidance of individual interest, not of public policy; which would be supposed to be, and in certain emergencies, under a feeble or too sanguine administration would, really, be, liable to being too much influenced by public necessity. The suspicion of this would most likely be a canker, that would continually corrode the vitals of the credit of the Bank, and would be most likely to prove fatal in those situations, in which the public good would require, that they should be the most sound and vigorous. It would indeed be little less than a miracle should the credit of the Bank be at the disposal of the government, if in a long series of time, there was not experienced a calamitous abuse of it. . . . The interdiction of loans [to] the United States, or any particular State, beyond the moderate sum specified, or [to] a foreign power, will serve as a barrier to executive encroachments; and to combinations inauspicious to the safety or contrary to the policy of the Union.[17]

The BUS was not a prototype of a central bank: It did not issue irredeemable fiat paper money, did not impose a money monopoly, did not monetize government debt, did not manipulate interest rates, and did not regulate banks. Subsequent history validated Hamilton's financial reforms; they worked impeccably, as planned. The BUS was operated competently and honestly, and was terminated when its charter expired in 1811. The credit of the United States was restored immediately, and the nation was able to enjoy an industrial revolution in the subsequent (19th) century, made possible not only by the political revolution of 1776 and the adoption of the Constitution in 1787–1788, but also by Hamilton's reforms in the 1790s. America's "financial founding fathers"[18] recognized that a constitutionally limited, rights-respecting government does not require a central bank and, in fact, must explicitly eschew it.

Case #2: Britain in 1821

Britain accomplished a remarkable restoration of the gold standard and sound banking in 1821 after having suspended convertibility of the pound during war with France (1797–1815) in order to finance war expenses not covered by tax revenues. Amid high and volatile rates of inflation and stagnant growth during these years, Parliament convened a Bullion Committee, which studied and debated the causes, consequences, and remedies of the fiat paper money. Although some economists and politicians defended the Bank of England, insisting it could effectively manage paper money, "hard money" economists disagreed and blamed inflation on the lack of any link of the pound to gold or silver. The advocates of hard money who called for a return to a gold standard eventually succeeded in obtaining the needed reforms. In 1816, Britain pledged a return to the gold standard and, in 1821, returned to it. Britain then stayed on the gold standard for eight decades and prospered while doing so, until it suspended the standard again in 1914, at the beginning of World War I.

Case #3: The United States in 1837

The U.S. "free banking" era of 1837 to 1862 was the only quarter-century period in American history when private banks were relatively free to incorporate and operate without onerous regulation, as long as they met their contractual obligations, including the redemption of currencies and checks in gold or silver. Unfortunately, banks were chartered at the state level and faced limits on branching. Some were even required to back their currencies with state bonds (yet another case of government trying to co-opt banks for its fiscal needs). But there was no central bank, no deposit insurance, not even a national bank, as Congress chose not to renew the charter of the Second Bank of the United States (1816–1836). Also, 1836 was the only year in U.S. history that the national debt was zero, having declined since the War of 1812 from a peak of 14 percent of GDP (in 1815). By 1836, government faced no political pressure to exploit the banking system out of fiscal need, or to have a central bank to monetize its debts. The U.S. free banking era was a practical success,[19] and President Andrew Jackson promulgated its unique ideological context, in 1837, as follows:

> Now is the time to separate the Government from all banks. Receive and disburse the revenue in nothing but gold and silver coin, and the circulation of our coin through all public disbursements will regulate the currency forever hereafter. Keep the Government free from all embarrassments, whilst it leaves the commercial community to trade upon its own capital, and the banks to accommodate it with such exchange and credit as best suits their own interests—both being money making concerns, devoid of patriotism, looking alone to their interests—regardless of all others. It has been, and ever will be a curse to the Government to have any entanglement or interest with either, more than a general superintending care of all.[20]

Case #4: The United States in 1879

Perhaps the most relevant of the gold money restorations occurred in the United States in 1879, when a freer system was substituted for the mess of public debt, inflation, and stagnation that characterized the Civil War years (1861–1865). During the gold-based free banking era (1837–1862), U.S. federal debt had averaged less than 2 percent of GDP, and the cost of living had declined by 0.2 percent per year; so prices in 1862 were 5 percent below their level in 1837. In contrast, the United States jettisoned the gold standard in 1862, printed piles of irredeemable "greenbacks," and increased federal debt thirtyfold, from 2 percent of GDP in 1861 to 30 percent in 1866. Prices increased an average of 18 percent per year from 1861 to 1865, which doubled the price level by halving the dollar's purchasing power. Then, for a decade after the war, U.S. officials manipulated fiat money such that prices *plummeted*, and the economy stagnated. To its credit, Congress debated a return to the gold standard, and, in 1875, legally committed to a return in 1879 at the dollar's prewar gold value. The resumption succeeded, and the dollar remained defined at that fixed weight of gold until World War I. From 1879 to 1913, without an income tax or a central bank, Washington restrained its spending, generated budget surpluses most years, and reduced its debt from 25 percent to 3 percent of GDP. By 1913, Americans were much wealthier and enjoyed a cost of living (measured by the price level) no higher than that of 1879. Real (inflation-adjusted) income per capita in the United States more than *doubled* during these decades. The astounding advance in prosperity was built on a gold-based private banking system—and made possible by a government severely restrained in size, scope, and cost.

Case #5: The United States in 1944

The reform that created the Bretton Woods monetary system (1944–1971) was the last attempt by the United States (or any leading nation) to link its currency to gold. Unfortunately, the Bretton Woods system was a diluted gold standard operated by central banks wedded to the growing demands of deficit-spending governments. Private gold ownership was actually *illegal* in the United States from 1933 to 1974. Keynes called Bretton Woods "the direct opposite of the gold standard" (i.e., compared to the classical gold standard).[21] Nevertheless, this was a better system than and produced superior results to both the subsequent system and the prior one (1914–1943), the latter of which was marred by devaluations, bank failures, and economic breakdowns amid world wars and depression.

During World War I, combatant governments seized gold coins from citizens and banks, melted them into bars, and hoarded the bullion in their treasury's vaults while central banks manipulated gold flows and interest rates, triggering the 1929 stock-price crash and causing the Great Depression. In 1931, Britain abandoned its gold-convertible pound; and, in 1933, the United States abandoned its gold-convertible dollar. Yet, in 1944, the United States, Britain, and other major nations arranged for a return to a gold-dollar-exchange standard, whereby the dollar was made convertible (albeit, only to other central banks, not to the public at large) into a fixed weight of gold (1/35 of an ounce), and other currencies were convertible into the dollar at fixed rates.[22]

The United States unilaterally terminated the Bretton Woods system in 1971—not because of any inherent failing of gold, but because in the 1960s government had expanded its welfare spending, warfare spending, and deficit spending; and, in helping to finance the deficits, the Fed issued too many dollars relative to U.S. gold reserves. Instead of reversing course, the government "shut the gold window" and disallowed gold withdrawals by central bank dollar-holders. The subsequent four decades (1972 to present) have seen widespread disorder and suffering under a monetary system of pure fiat paper money, which has delivered inferior results on all significant counts—inflation, interest rates, employment, economic growth—but also has permitted an unrestrained Fed to finance vast new increases in U.S. government deficit spending.

Case # 6: The United States in 1981–1982

Whereas in prior cases better monetary systems were studied, debated, and enacted into law, in 1981–1982 the U.S. Gold Commission of the U.S. Congress seriously studied and debated a return to the gold standard,[23] but it was rejected, ultimately, due to insufficient ideological-political support. Newly elected President Ronald Reagan and his supply-side advisors favored various types of gold standard,[24] but prominent economists such as Alan Greenspan joined with monetarists to advise Congress and the Reagan administration against any return to gold-based money.[25] In 1972–1981, the decade after the end of the Bretton Woods system, U.S. prices had increased an average of 9 percent per year, as the dollar lost 60 percent of its purchasing power. In 1981, the banks, expecting further inflation, charged 18 percent for a thirty-year mortgage. The Fed, more aware of its critics and fearful of a return to gold money, subsequently reduced its rate of inflation and interest rates, too, yet *its very existence* continued to enable Washington's deficit spending. Banks were slightly less regulated in the subsequent decades, but they also got more subsidies (cheap Fed loans, expanded deposit insurance, "too-big-to-fail" warranties), which increased "moral hazard" and systemic risk.

History shows that societies can return to free or freer banking systems from central banking systems—just as they can shift the other way. But history also shows that all such shifts presuppose and are ultimately caused by more fundamental shifts: shifts in ideology. If a genuine, pro-capitalist ideological context is absent, or not widespread, a freer monetary system, even if clearly needed (as in 1981–1982) will not be possible.

Pro-Capitalist Ideology: Prerequisite of Free Banking

The most advanced, rights-respecting nations in the 18th and 19th centuries were Britain and the United States, and it is no coincidence that they also enjoyed prosperity on the basis of the gold standard and freer banking systems. Writing in 1776, Adam Smith, the father of economics and the leading proponent of a free market (what we now call capitalism), described it as "the obvious and simple system of natural liberty" and declared that "the establishment of perfect justice, of perfect liberty, and of perfect equality [before the law] is the very simple secret which most effectually secures the highest degree of prosperity."[26] A free market, he observed, requires gold-based money and a free banking system. "A paper money consisting in bank notes," Smith wrote, "issued by people of undoubted credit, payable upon demand [in gold and silver] without any condition," is "equal in value to gold and silver money" and provides a solid grounding for free trade and prosperity. A nation's "commerce and industry," he wrote, "cannot be altogether so secure, when they are thus, as it were, suspended upon the Dædalian wings of paper money, as when they travel about upon the solid ground of gold and silver." Smith was insistent that government may not forbid fractional reserves and must punish any broken promise to pay gold or silver. As long as bankers were held legally to their contractual obligations and "subjected to the obligation of an immediate and unconditional payment of [their] bank notes as soon as presented, their trade may, with safety to the public, be rendered in all other respects perfectly free."[27] Although Smith did not consistently defend individualism, to the extent that he extolled freedom in economic affairs, he also extolled free banking and the gold standard.

In contrast, the father of communism, Karl Marx, called for a system of collectivism, the basic principle of which he would later codify as "from each according to his ability, to each according to his needs." As Marx's ideas spread and became widely embraced after the mid-19th century, so too did their corollary: the demand, as Marx and Engels put it in their *Communist Manifesto* (1848), for "centralization of credit in the hands of the state, by means of a national bank with state capital and an exclusive monopoly." These ideas ultimately gave rise to the monetary systems of the past century, systems dominated by central banking and fiat money—systems designed to facilitate and fund collectivist and statist governments. (For details, see Part I of this essay.)

The principle we must draw from these and similar examples in history is that the dominant ideology of a society, whether individualist-capitalist or collectivist-statist, influences that society's political and financial institutions. Just as the individualist-capitalist ideas of the late-18th century eventually spread and enabled the rise of freer monetary systems, so too the collectivist-statist ideas of the mid-19th century eventually spread and enabled the rise of statist, centrally planned monetary systems. Advocates of free banking would do well to bear this in mind: Free banking and gold-based money presuppose and depend on an ideology of individualism and capitalism.

In the paper-money decades since 1971, sundry advocates of liberty, most of them aware that central banks facilitate rights-violating, deficit-spending governments, have called for the phasing out or abolition of central banks, including the Federal Reserve.[28] Yet some of these reformers do not appreciate the primacy of ideology; by restraining or abolishing central banks, they hope to restrain or abolish statist governments. But central banking is the *effect* of statism, not its cause, and statism itself reflects a deeper, collectivist ideology. Absent a deep and abiding change in ideology—from collectivism and socialism to individualism and capitalism—a radical, pro-liberty reform of the monetary system will remain dormant and chimerical. Even if reform somehow were to occur in the absence of an ideological shift toward individualism and capitalism, it would not long endure.

We know from history that a freer system in the United States was dissipated over the past century by an onslaught of collectivism and statism.

Some theorists who fundamentally oppose central banking, being consistent advocates of free banking, have recognized the primacy of ideology in any rational reform effort. Ludwig von Mises once observed that "just as the sound money policy of the gold standard advocates went hand in hand with liberalism, free trade, capitalism, and peace, so inflationism [was] part and parcel of imperialism, militarism, protectionism, statism and socialism"; so it is a "serious error" to believe "a sound monetary system can once again be attained" without a "renunciation" of the ideology and politics of statism.[29]

If the state is to be all-powerful, as statism requires, the state will need a powerful and privileged central bank to do its bidding and pave the way. Without rejecting central planning, one cannot reject central banking, which is but central planning applied to money and credit. To argue for free banking, one must embrace the ideology of individualism and capitalism. As Henry Hazlitt noted, "the gold standard is not an isolated gadget, but an integral part of a system of free enterprise and limited government, of good faith and law, of promise-keeping and the sanctity of contract. It is this system—and the confidence to which it gave rise—that has been destroyed. It is this system that must be slowly and painfully rebuilt."[30] And just as free banking presupposes an ideology of individualism and capitalism, so too does a (true) gold standard. As I argued in *Gold and Liberty*:

> Gold money is inextricably linked with human freedom. Whenever men were free to choose over the centuries, they eventually settled on gold as money. As a form of money not subordinated to the arbitrary manipulations of rulers, gold permits a free economy to operate with a common denominator and standard of value. Whenever human freedom has been threatened, gold money has been attacked. That has been the pattern for most of this century, an age of nationalism, dictatorship, and the welfare state. Gold money is incompatible with statism and its extensions, such as central banking. Gold is the money that accompanies the rule of law and the sanctity of contract.[31]

Obviously, today's ideological context is not sufficiently pro-capitalist to support a movement to end central banking and fiat money. Indeed, in the past dozen years we've witnessed a renewed expansion of welfare states, and with it, an expansion of deficit spending, public debts, and money creation by central banks. The welfare state creates more debt and more fiat money, not more jobs or more wealth; yet many people still favor it, morally, ideologically, politically, and electorally. And whatever economic problems arise statists reflexively attribute to dwindling vestiges of individualism and liberty. Notably, the recent financial crisis (2008–2010) was blamed not on central banks or on official, collectivist policies toward housing and mortgages,[32] but on Wall Street "greed," the banks, and the rich ("1 percent")—that is, on *capitalism*.

Given today's anticapitalist context, it is no wonder mainstream economists oppose any restoration of the gold standard or free banking, especially in pure form. Both Keynesians—such as Paul Krugman—and monetarists—such as Milton Friedman—have opposed free banking and the gold standard, and defended central banking and fiat paper monies that fluctuate at the whim of central banks.[33] They differ only slightly over how much governments should deficit-spend and whether central banks should have complete autonomy or instead follow various arbitrary rules, and how (not whether) government debts should be monetized. They condone central planning in money, and quibble merely over which specific plans to enact.

On the other hand, those who have been more supportive of individualism and capitalism have also been more supportive of free banking and the gold standard—notably, supply-side economists[34] and Austrian school economists.[35] Yet supply-siders typically insist central banks can reliably operate the system without corrupting it (which defies history), and some Austrian economists believe that no system can be stable or free of fraud unless government forbids fractional-reserve banking (which would be the end of banking per se). Congressman Ron Paul's populist pitch to "end the Fed" is short on details but entails unnecessary chaos ("upheaval" in "the entire banking industry") and odd decrees (a money supply to be "frozen in place").[36] Austrian economists such as Friedrich Hayek propose a contrived competition between privately issued, irredeemable paper money and the government's existing paper-money monopoly,[37] a hybrid scheme that would multiply confusion without achieving a practical, pro-capitalist remedy.

Capitalist reformers must always recall how (and why) central banking invariably proves inimical to the gold standard, and also why a system in which gold money anchors a fractional-reserve system of free banking is ethically justified, mutually profitable, and economically optimal. Thus, economists who have counseled a system of fractional-reserve free banking based on the classical gold standard,[38] although a minority even among free-market economists, nevertheless have history and logic on their side.

A Proposal to Replace the Federal Reserve with Free Banking

Assuming the necessary ideological context for transitioning to free banking—that is, a widespread and substantial embrace of individualism and capitalism—the United States could easily, safely, and justly replace its existing central banking system with free banking.[39] This ideological context is crucial because, in addition to the reasons stated above, the transition would require the passage of laws mandating and specifying the transition; such laws could not be enacted and maintained without substantial cultural support.

My proposal seeks to enhance liberty, rights, and the rule of law in money and banking by an equitable, simple, and practical transition from central banking to free banking. The proposal essentially reverses the long-term process by which the United States shifted from (relatively) free banking to central banking over the past century. At its core, that process transferred gold and freedom of action from banks and citizens to the Fed, forbade banks to issue currency, and declared the Fed to be the sole issuer of fiat paper money. My plan makes the government return gold to banks and thus to citizens, frees banks to issue convertible currency, and ends the Fed, along with its destructive power to issue fiat money, to subsidize bad banking, and to monetize government debt.

In simplest terms, my plan would have the U.S. government transfer all of the Fed's assets and liabilities, including its gold, to private commercial banks in proportion to their capital (net worth). Within a legislatively established window, all Fed currency would be turned in for private bank currency, which would be convertible into gold. As part of the reform, the government would legislatively define the dollar as a fixed weight of gold, a fixity that would be legally permanent. Such an act would not be "price fixing," as some monetarists claim; it would mean that government once again would enforce weights and measures in all areas—including money. The U.S. government would again recognize the objective identity of the term "dollar"—as a fixed weight of gold. Just as a yard of lumber is objectively (and permanently) defined as three feet of it, and just as a pound of coffee always and everywhere equals sixteen ounces of it, and just as government properly upholds such standards in contracts and in courts of law—so a dollar would again be defined as a fixed weight of gold. This would not be new. The dollar was so defined in the United States from its founding until 1971, and it has been so defined in other countries at various times throughout history. In practical terms, the main effect would be that the dollar once again would reflect the relatively stable purchasing power of gold.

In the freer system, private banks would not be required to issue currency, but those that did so and denominated them in dollars would have to deliver a dollar—that is, a fixed weight of gold—upon demands for redemption, as they did under the classical gold standard. Banks would be free to provide forms of money *other* than gold, in other denominations, so long as they refrained from calling them dollars, which otherwise would constitute fraud. Because the Fed would be phased out of existence and there would be no further "top-down" monetary central planning or manipulation, all decisions regarding the money supply, lending volumes and terms, and interest rates henceforth would be set by private, profit-seeking financial institutions and capital markets. This manner of determining such aggregates is not unprecedented; it succeeded before 1913.

The government would continue to conduct its legitimate fiscal affairs—raising revenues, spending, and borrowing—but mainly through the private financial system. The United States would still have a Treasury department to conduct the government's fiscal affairs, and just as it now issues interest-bearing short-term bills and long-term bonds, it would not be barred from holding some gold and issuing dollar-denominated notes (currency) to facilitate collections and payments (as it did under the classical gold standard). The Treasury would hold checking deposit accounts at private banks (just as the Defense department legitimately purchases weapons from private weapons manufacturers), but in so doing, it would be forbidden to prop up, bail out, or manipulate any bank. Nor would the Treasury be permitted to hoard gold; if it were to run budget surpluses, it would be required to use accumulated gold to retire public debt. Because Treasury bills and bonds would be denominated in dollars, they too would be repayable in gold at maturity.

The transition to free banking should be conducted so as to exert as little impact as possible on the money supply, aggregate prices, interest rates, and wage levels. The goal should be to alter not the *quantity* but rather the *nature* of money, credit, and income, for the better and for the future, while limiting those disruptions in contractual relationships that could undermine the financial sector, throttle the economy, or cause unemployment.

To better visualize the reform I envision, consider the balance sheets (or assets, liabilities, and net worth) of the U.S. Treasury,[40] Federal Reserve,[41] U.S. banks,[42] and the general public (U.S. households),[43] as shown in Table One.[44] First, observe that the U.S. Treasury holds $393 billion worth of gold (at today's price of around

$1,500 per ounce), plus deposit accounts, but its main "asset" is its power to tax (i.e., its capacity to obtain future revenues, which are used to fund its expenditures and service its debts). The Treasury's debts now total more than $17 trillion (the "national debt"), which take the form of interest-paying securities. Not shown are its "unfunded obligations" (of $100 trillion or so), including primarily the current value of estimated payments to future recipients of Social Security and Medicare.

Table One: The Current U.S. Monetary System
$ in Billions

	U.S. Treasury		
Assets		**Liabilities**	
Gold (262 million ounces)	$393	Gold Certificates	$393
Deposits at the Fed	$121	U.S. Treasury Bills & Bonds owed:	
Deposits at U.S. Banks	$83	- Fed Banks	$1,795
Property & Real Estate	-	- U.S. Banks	$1,384
Power to Tax	-	- All Others & Trust Funds	$13,592
Total Assets	**$597**	**Total Liabs. & Capital**	**$17,164**
	Federal Reserve		
Assets		**Liabilities**	
Gold Certificates	$393	Federal Reserve Notes	$1,135
U.S. Treasury Bills & Bonds	$1,795	Deposits due U.S. Treasury	$121
Mortgage-Backed Securities	$1,071	Deposits due U.S. Banks	$1,833
Mortgage GSE Bonds	$72	Other Liabilities	$123
Other Assets	$255	Capital	$374
Total Assets	**$3,586**	**Total Liabs. & Capital**	**$3,586**
	U.S. Banks		
Assets		**Liabilities**	
Federal Reserve Notes	$92	Demand Deposits, Treasury	$83
Deposits at Federal Reserve	$1,833	Demand Deposits, Public	$1,288
U.S. Treasury Bills & Bonds	$1,384	Time Deposits, Public	$8,057
Mortgage-Backed Securities	$1,334	Long-Term Debt & Liabs.	$2,375
Loans	$8,664	Capital	$1,504
Total Assets	**$13,307**	**Total Liabs. & Capital**	**$13,307**
	U.S. Households (Public)		
Assets		**Liabilities**	
Federal Reserve Notes	$568	Mortgages	$9,430
Deposits at Banks	$7,935	Consumer Loans	$2,779
U.S. Treasury Bills & Bonds	$1,036	Other Obligations	$1,244
Stocks, Bonds, Mutual Funds	$30,792		
Pensions	$14,060		
Real Estate & Misc.	$25,134	Net Worth	$66,071
Total Assets	**$79,524**	**Total Liabs. & Capital**	**$79,524**

Next, observe the pre-reform balance sheets of the Federal Reserve, the banks, and households. The Fed holds gold certificates (a claim on $393 billion of physical gold held in the U.S. Treasury's vaults), plus $1.8 trillion of Treasury securities, $1 trillion of mortgage-backed securities, and other items—or $3.6

trillion in total assets. The Fed's liabilities include its notes ($1.1 trillion of fiat paper currency) plus deposits. The Fed's capital (net worth) is $374 billion, or roughly 10 percent of its $3.6 trillion in assets. Observe that U.S. banks now have assets totaling $13.3 trillion, comprised mostly of loans, securities, and deposits at the Fed; their liabilities are comprised mainly of deposits and long-term debt. The banks have capital (net worth) of $1.5 trillion, or 11 percent of total assets. Finally, observe that U.S. households have assets of nearly $80 trillion, some of which include deposits at banks (nearly $8 trillion) and Treasury securities ($1 trillion); households also own stocks, bonds, mutual funds, and pensions ($45 trillion) and real estate ($25 trillion); after subtracting liabilities, U.S. households show a net worth of $66 trillion.

On this plan for establishing free banking, legislation would provide for the transfer of the Fed's assets and liabilities to the banks proportionately, based on their capital (net worth). Some items would cancel out—such as Federal Reserve Notes (cash) and bank deposits at the Fed ($1,833 billion)—and other transfers would be relatively straightforward. Of the existing $1,135 billion in Federal Reserve Notes, banks already hold $92 billion (as vault cash), so they would assume the difference ($1,043 billion) as an obligation (i.e., new, privately issued banknotes, convertible into gold). Other than gold, the banks already own the types of assets they would receive from the Fed, easing the banks' assimilation of those assets.

The initial assets and liabilities of the new monetary system—free of the Fed—appear in Table Two. The U.S. Treasury still exists, as all governments require a fiscal agent, but its gold has been transferred through the Fed to the banks, which issue gold-convertible currency. The banks now hold the $393 billion in gold; and over a brief, legally defined period (perhaps six months or a year) will issue $1 trillion in banknotes (currency) to replace the $1.1 trillion in Federal Reserve Notes (less the $92 billion that banks now hold in vaults).[45] Unlike today's Fed currency, the new banknotes are a currency of substantially stable purchasing power, freely convertible to holders, on demand, into a fixed weight of gold. The dollar once again is "good as gold."

Perhaps the most crucial element in the transition to free banking is the determination of an accurate and sustainable *identity* for the dollar in terms of gold. The current U.S. dollar has no identity: The Federal Reserve "note," shorthand for "promissory note," once meant a promise to pay holders in gold on demand; but since 1971, this "note" has promised to pay nothing. The most essential feature of a gold standard is not the supply of gold, nor even the fraction at which gold is available to redeem currency, but the *definition* of the unit of account (in this case,

Table Two: The New System Without the Federal Reserve *$ in Billions*			
U.S. Treasury			
Assets		**Liabilities**	
Deposits at U.S. Banks	$83	U.S. Treasury Bills & Bonds owed	
Property & Real Estate	-	- U.S. Banks	$3,179
Power to Tax	-	- All Others & Trust Funds	$13,592
Loans to Public		Other Obligations	
Total Assets	**$83**	**Total Liabs. & Capital**	**$16,771**
U.S. Banks			
Assets		**Liabilities**	
Gold (262 million ounces)	$393	Banknotes (Currency)	$1,043
U.S. Treasury Bills & Bonds	$3,179	Demand Deposits, Public & Treas	$1,409
Mortgage-Backed Securities	$2,405	Time Deposits	$8,057
Mortgage GSE Bonds, Other	$327	Long-Term Debt & Liabs	$2,375
Loans	$8,664	Capital	$2,084
Total Assets	**$14,968**	**Total Liabs. & Capital**	**$14,968**
U.S. Households (Public)			
Assets		**Liabilities**	
Banknotes (Currency)	$1,043	Mortgages	$9,430
Deposits at Banks	$7,935	Consumer Loans	$2,779
U.S. Treasury Bills & Bonds	$1,036	Other Obligations	$1,244
Stocks, Bonds, Mutual Funds	$30,792		
Pensions	$14,060		
Real Estate & Misc	$25,134	Net Worth	$66,547
Total Assets	**$80,000**	**Total Liabs. & Capital**	**$80,000**

"dollar") as a fixed weight of gold. Today's gold price (around $1,500 per ounce) is a good starting point for establishing the new definition, because the price embodies widespread market estimates of the dollar-gold relation. If a single ounce of gold is worth $1,500, then a single dollar is worth 1/1500 of an ounce of gold; the latter is the "gold content" of the dollar, or the reciprocal of the dollar-gold price.

In the reform, the government must designate a future date, perhaps a year ahead, as "gold dollar restoration day." In the interim it must explain what the new monetary infrastructure will entail. The gold price no doubt will change in the interim, in anticipation of the new system, but by restoration day the dollar's gold content will have been established naturally by the calculations and decisions of many millions of individuals and businesses in anticipation of the restoration. A gold content established this way, by the aggregate decisions of informed and interested parties in the marketplace, will prevent both a burst of dollar deflation (which could occur if the content were too high) and a burst of dollar inflation (which could occur if the content were too low). If the gold price is near $1,000 per ounce prior to restoration day, the government will define the dollar henceforth as 1/1000 of an ounce of gold; if instead the gold price is near $2,000 per ounce, the dollar henceforth will be defined as 1/2000 of an ounce of gold. The dollar's new and permanent definition, having been set in an objective, market-based manner that respects people's existing plans and future expectations, would not likely cause material disruptions in prices, interest rates, incomes, employment, or debt burdens.

In the new private banking system, the money supply (currency plus demand deposits) initially totals $2.4 trillion, matching the old supply under the Fed; but henceforth it fluctuates according to the commercial needs of the economy, not the fiscal needs of government. This is still a fractional-reserve banking system, but the banks are now much safer than under central banking; in the new system they are more liquid and better capitalized. The most liquid asset of all—gold—is now held by banks, and it safely amounts to 38 percent of banknotes (currency), while the banks' total liquid assets (gold plus U.S. Treasury securities) comprise 34 percent of their total notes and deposits. At this ratio, banks are unlikely to see bank runs, but if they feel the need for even more liquidity, they can increase gold holdings and reduce other assets. There are no legal "reserve requirements" on gold to preclude its full deployment for redemptions. In the fully private system, the banks are also more solvent, with capital of $2 trillion, or 14 percent of total assets, nearly a third better than today's ratio of 11 percent. The banks are more liquid and solvent, thus better able to operate safely, profitably, and sustainably.

Several objections might be made against my proposal: 1) "it unfairly subsidizes banks"; 2) "there is not enough gold to sustain the new system"; 3) "the new dollar definition might be wrong"; 4) "the new system will not by itself stop government deficit spending"; and 5) "it offers no intermediate or hybrid system consistent with a capitalist endpoint."

As explained, the plan entails transferring Fed assets and liabilities (roughly $374 billion in net worth) to the banks, thus increasing their capital from $1.5 trillion (11 percent of previous total assets) to $2 trillion (14 percent of new total assets). This transfer is justified for several reasons. Notably, the transfer simply reverses what was done previously. The Fed accumulated its net worth at the expense of the banks, and removed gold from banks and citizens. Importantly, in the new system, banks are legally required to make their dollar-denominated currency convertible into gold on demand by public holders of currency. Accordingly, bank owners, borrowers, and depositors alike benefit from the transfer of the Fed's net worth. Indeed, the full transition will benefit all taxpayers by relieving them of future subsidizations of banking—and will benefit all citizens by establishing an economy based on sound money, safe banking, lower tax burdens, and fiscal responsibility.

Moreover, although the banks receive substantial assets from the Fed at the outset of this return to free banking, it is a onetime event, and they lose *all* Fed and government subsidies henceforth, in perpetuity (and taxpayers are relieved of the perpetual burdens such subsidies entail). Accompanying the transfer of Fed assets and liabilities and the end of regulations dictating the terms of contracts (made with borrowers, bondholders, depositors, etc.) would be the permanent termination of an array of subsidies, including government deposit insurance, cheap loans from the Fed, pledges to make taxpayers bail out banks deemed "too big to fail," and special exemptions from the U.S. bankruptcy code. Under a gold standard, which would radically reduce the wide swings in currency values and interest rates that accompany the system of fiat paper money, the biggest banks would also forgo the large profits they now earn from designing and trading the "derivatives" (options and futures contracts) that help businesses mitigate such swings.

The complaint by some economists that the world does not have enough gold to support a gold standard has no basis in either logic or history. The gold standard does not require vast gold stocks, or fast growth in new gold output, or 100 percent gold reserves; its essence is the gold-dollar identity (an objective unit of monetary account) and strict convertibility of currency on demand. In a *gold standard*, the *standard* element is more fundamental than the *gold* element. Moreover, the gold standard worked for hundreds of years and undergirded an Industrial Revolution. Gold-based money did not fail for any alleged deficiency in gold's supply relative to economic growth; gold-based money was first co-opted and later jettisoned by profligate, deficit-spending governments.

Even if critics ignore the crucial issue of the gold *standard* and focus instead on the gold *supply*, they have nothing to worry about if they consult the relevant facts. For more than two centuries the gold supply has increased steadily and should continue to do so for at least the next two centuries. In 1811, worldwide gold output was 360,000 ounces, and the total gold stock was 119 million ounces. By 1911, annual output was 22.5 million ounces, and the gold stock was up to 695 million ounces. By 2011, output was 95.2 million ounces, and the accumulated stock had reached 5.1 billion ounces. Gold reserves (underground) are now estimated at 1.83 billion ounces, or 35 percent of the above-ground stock,[46] and reserve estimates have increased with every passing decade. Nearly 2.7 billion ounces of gold were taken from mines over the past four decades (1971–2011), almost twice the 1.4 billion ounces taken in the prior four decades (1931–1971). This is no "gold shortage."

Does gold-based money impede prosperity? During the past century (1911–2011) the gold stock increased eightfold, while U.S. industrial output increased thirty-twofold; but U.S. industrial output increased one-hundred-twenty-eightfold during the prior century (1811–1911), even though the gold stock increased just sixfold. The gold stock has not only increased *amply*, but also *steadily*—more so than any other commodity or currency. Indeed, its increase during the past century has averaged 2 percent per annum—never more than 3 percent (1940) and never less than 1.5 percent (1980).

When gold critics aren't complaining that gold increases too slowly to serve as money, they're complaining that it grows too quickly, as it (allegedly) did during new gold discoveries, as during the California "gold rush" (1849–1854); but even then the total gold stock never increased more than 4 percent per year, and prices in the United States increased by less than 2 percent per year. Again, we see that what truly aids prosperity is not the supply of gold *per se*, but the fact that money is *gold-based* and objectively *standardized*. Whether or not governments have respected (or issued) gold-redeemable money, the principle holds: As long as men are self-interested and free, they will mine, store, and exchange gold, because it is objectively precious and economically practical.

As for the understandable worry that the new dollar definition may be wrong, or might prove unsustainable, no more objective, safe, or accurate way of establishing the dollar's new gold content can be had than the open-market process I defend. If the government accurately explains the mechanics of the transition in advance of gold-dollar restoration day, and fairly and competently executes the necessary asset transfers, markets will home in on the best, most information-inclusive gold-dollar ratio.

Some reformers presume that an intrinsic gold-dollar ratio must be reestablished, regardless of the market's current estimates and expectations—perhaps some critical ratio from a better past, as before 1971. But tying the dollar to gold in this way has in the past caused—and would again cause—deflation, depression, and debt defaults. Other reformers, including advocates of 100 percent gold reserves, would have the gold-dollar ratio be established by arbitrarily dividing the current money supply ($2.4 trillion, consisting of Fed currency plus checking accounts) by the U.S. Treasury's current gold supply (262 million ounces). But that would render a gold price of $9,500 per ounce, compared to today's market price of $1,500 per ounce; the new dollar would be defined as having a mere 1/9500 of an ounce of gold, not 1/1500 of an ounce of gold. Gold would flood into the United States from abroad, and hyperinflation would ensue along with wrenching dislocations in prices, interest rates, wage contracts, and creditor-debtor relations. This approach is arbitrary not only because insistence on 100 percent gold reserves is arbitrary, but also because there is nothing special about the fact that for decades Washington has decided to hoard the same stock of gold since it abandoned the gold-exchange standard in 1971.

The contention that a return to free banking and gold money will not necessarily stop public deficit spending, and thus not preclude governments from again co-opting and corrupting the monetary system with central banking elements, is understandable. But part of any debate or reform toward a freer monetary system would also likely entail debate and reform in favor of fiscal responsibility; if monetary and fiscal reforms alike were to be enacted in the light of a pro-capitalist ideology, they would be mutually reinforcing.

Finally, even if it is not possible anytime soon to obtain a pure form of free banking and gold standard, because the pro-capitalist ideological path has yet to be paved, a hybrid system consisting of key steps in the right direction remains possible and advisable. If, for ideological-political reasons, the Fed cannot be eliminated anytime in the near future, steps toward its elimination and restoration of gold money still can be taken. One such step is a legislated "gold-price rule" compelling the Fed to buy and sell gold for dollars at the legally defined rate, and forbidding it from manipulating interest rates, multiplying the money supply, monetizing government debt, or bailing out banks.[47] This is possible now. In fact, this year a U.S. congressman introduced a bill that, if enacted, would accomplish precisely that much.[48] More directly, a U.S. president, by executive order, might simply direct the Treasury to again define the dollar in terms of gold, just as similar orders were issued in 1933 and 1971 to sever the dollar-gold link. The Fed could do little to adulterate the new dollar so defined.[49]

My assessment of our money and banking system in 1990 seems no less applicable in 2013:

> Today there is instability and weakness in our banking system because there is instability and weakness in our money. We will continue to have unsound banking as long as we have unsound money and we will continue to have unsound money as long as we have both government money and unlimited government. . . . [T]he only way to achieve sound money and banking is not to reform central banking but gradually to phase it out of existence. In practice, phasing out central banking will involve phasing out its four basic features: its monopoly on note issue, its role as the lender of last resort (open market operations and the discount window), deposit insurance, and bank regulation. As central banking is dismantled, it will be necessary to develop an infrastructure that will permit free banking to flourish.[50]

Ending central banking is not properly an end in itself. A rational, rights-respecting government must seek to end central banking in a way that transitions justly and smoothly into a system of free banking that can survive and flourish. It requires the reestablishment of the kind of infrastructure (i.e., mechanisms, laws, and standards) that has been missing from money and banking since at least 1971. A transition to free banking requires specific, constructive reforms, not a contextless termination of the Fed.

No material *technical* barriers exist to achieving a free banking a system. Nor do significant *economic* barriers exist. Banking can and should be a safe, honest, profit-maximizing business based on gold, which operates free of favors or burdens from the government. The barrier to a better system, the reason we now have central banking instead of free banking, is *political*. We have central banking not because free banking is impractical, but because fiscally profligate governments seek perpetual financial assistance, mainly through the unlimited money-printing and debt monetization schemes that central banks uniquely provide.

Advocates of free banking must reject futile efforts to make central monetary planners behave better, must consider more radical reform, and must reject claims that a transition to free banking is too technically complex, too economically risky, or too historically unprecedented. More fundamentally, they must advocate the *ideology of capitalism*—that is, fully free markets, rule of law, and protection of individual rights, including the rights of bankers and their customers. To the extent that the culture more widely endorses genuine capitalism, a transition to free banking will be possible.

Endnotes

1. Richard M. Salsman, "The End of Central Banking, Part I," *The Objective Standard*, vol. 8, no. 1, Spring 2013, pp. 13–29.
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3. The best account of the system is found in Giulio M. Gallarotti, *The Anatomy of an International Monetary Regime: The Classical Gold Standard*, 1880–1914 (New York: Oxford University Press, 1995).
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5. George A. Selgin, William D. Lastrapes, and Lawrence H. White, "Has the Fed Been a Failure?," *Journal of Macroeconomics*, vol. 34, no. 3, September 2012, pp. 569–96.
6. Although warfare, unlike welfare, is a legitimate function of governments, many have become financially profligate by fighting unjust wars or wars not in the national interest.

7. See Luis I. Jacome et al., "Central Bank Credit to the Government: What Can We Learn from International Practices?," IMF Working Paper 12/16, January 2012; and Maxwell J. Fry, *Emancipating the Banking System and Developing Markets for Government Debt* (New York: Routledge, 1997).
8. Richard M. Salsman, *Breaking the Banks: Central Banking Problems and Free Banking Solutions* (Great Barrington, MA: American Institute for Economic Research, 1990).
9. George A. Selgin, "Central Banks as Sources of Financial Instability," *Independent Review*, vol. 14, no. 4, Spring 2010, pp. 485–96.
10. Peter J. Boettke and Daniel J. Smith. "A Century of Accommodation: The Failed Record of Federal Reserve Independence," GMU Working Paper in Economics No. 12–40, George Mason University, August 23, 2012. In fact, all central banks are politicized: Christopher Adolph, *Bankers, Bureaucrats, and Central Bank Politics: The Myth of Neutrality* (London: Cambridge University Press, 2013).
11. "Legal tender" is money that government designates as legally valid in commercial exchanges, debt settlements, civil judgments, and revenue payments to the Treasury. Gold and silver can be legal tender, and indeed the U.S. Constitution says no other monies can be so. In contrast, any government that issues inconvertible fiat paper and declares it to be the nation's *sole* legal tender establishes a fiat money monopoly.
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44. This exercise draws upon chapter 9 in my book, *Breaking the Banks* (1990), "Money and Banking Reform: The Transition from Central Banking to Free Banking," but with slight revisions and the use of current data.
45. As in historical cases of currency substitution, the government would simply designate some future date (perhaps a half year hence) by which time holders of existing (Fed) currency must exchange it (at any nearby bank) for the new (free banking) currency. Thereafter the old currency would be unusable. The Fed has estimated that more than half of its currency is held *outside* the United States, but this could be redeemed at foreign banks, which redeem them, in turn, at U.S. banks.
46. For historical gold data, see the World Gold Council and the U.S. Geological Survey. In recent years the fastest-growing supply of new gold has come from China, and this is predicted to persist; such a result was not anticipated by gold mining analysts a decade ago.
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48. In April 2013 Congressman Ted Poe (R-TX) introduced a bill (H.R. 1576, the "Dollar Bill Act of 2013") to have the Fed operate on such a gold-price rule and to refrain from manipulating interest rates.
49. For a pro-capitalist account of the legal-constitutional aspects of gold-based money versus fiat paper money, of the relative monetary powers of the three branches of U.S. government, and of those Supreme Court rulings that might have to be revised to achieve a freer monetary system, see Richard H. Timberlake, *Constitutional Money: A Review of the Supreme Court's Monetary Decisions* (New York: Cambridge University Press, 2013).
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