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Improving Money Through Competition

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Money is the means of payment for virtually all goods and services, but policymakers rarely think about improving the quality of money with the same competitive market forces that improve other goods and services. These forces push entrepreneurs to innovate and improve products to satisfy customers, and they expose weaknesses and inefficiencies in existing products, thus improving people's lives.

Economists generally acknowledge that private competitive markets produce such benefits, but many view money as an exception that should be provided by the government. Some scholars acknowledge that the "biggest threat to the value of the currency is often the government itself," but still argue for *increased* centralization and government control of money.[1] For instance, some economists want to ban the use of paper currency so that the government can easily penalize people who fail to spend money during an economic downturn.[2]

Such conflicting views are surprising because the government's actual record of monetary stewardship is so poor. That historical record, including recent monetary policy failures, highlights the importance of preserving citizens' ability to use whichever forms of money they choose. Nothing can provide as powerful a check on the government's ability to diminish the quality of money as allowing competitive private markets to provide it. Suppressing such competition, if history is any guide, only deprives citizens of beneficial innovations in the means of payments.

Competitive Money in the United States (Post-World War II)

The U.S. monetary system consists of two types of money:

1. Base money, often referred to as outside money, is the ultimate means of payment in the economy, and it comes from outside the private sector (i.e., the government).

2. Inside money, often called credit money, consists of claims to the underlying base money, and it comes from inside the private sector.

Private financial firms compete to provide various types of credit money, such as checkable deposits with bankcards, money market accounts, and travelers' checks. These financial firms are heavily regulated, often to the detriment of their ability to operate,[3] but few policymakers question whether they should actually provide money.

Even fewer policymakers question whether anyone *other than* the federal government should provide base money, despite its fundamental economic importance. Because the Federal Reserve is the monopoly provider of base money, the U.S. government ultimately determines the total amount—and type—of money that private firms can create.[4] This monopoly necessarily limits the extent to which

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competitive processes can strengthen money, and exposes the means of payment for all goods and services to the mistakes of a single government entity.

Precisely because people are so vulnerable to the abuse of money (including modern monetary policy errors), Congress should not interfere with citizens' ability to opt out of official currency.

The competitive process is, ultimately, the only way to discover what people view as the best means of payment.[5] Although unregulated markets receive most of the blame for U.S. monetary instability prior to the creation of the Federal Reserve, the historical record shows otherwise. Major regulatory problems impeded the nation's currency supply prior to the 1900s, and the actual competitive issue of money, in the form of private banknotes, worked reasonably well.[6]

Harmful Regulation Led to Instability

The U.S. has never had a truly unregulated banking system. However, because the period from 1837 to 1863 is known as the free-banking era, free markets in money have been mistakenly associated with the nation's monetary ills. In fact, the only thing from which these so-called free banks were freed was the patronage system whereby state legislators voted on specific bank charters.[7] The primary cause of financial turmoil during this period was overly strict and harmful regulation, particularly restrictive bond collateral requirements and branching restrictions.[8]

Monetary instability was *not* the result of these banks issuing their own banknotes, many of which traded at a discount. Indeed, by the beginning of the Civil War, paper currency in the U.S. consisted almost entirely of notes competitively issued by state-chartered banks.[9]

1. Kenneth Rogoff, *The Curse of Cash* (Princeton, NJ: Princeton University Press, 2016), p. 19.
2. Ibid.
3. Ideally, Congress would relieve the banking and non-banking financial sectors from the many restrictive regulatory burdens it has imposed on them. See Norbert J. Michel, ed., *Prosperity Unleashed: Smarter Financial Regulation* (Washington, DC: The Heritage Foundation, 2017), http://www.heritage.org/prosperity-unleashed.
4. The Federal Reserve has control over the total amount of base money (currency plus reserves) because only it can change the total amount of reserves in the banking system. All Fed open-market purchases, for example, either increase the amount of reserves or U.S. currency in circulation.
5. The question of whether there should be a single monetary standard is separate from whether the production of money is a natural monopoly. Similarly, the question of whether the monetary standard is a public good is separate from the question of whether actual hand-to-hand currency is a public good. Markets have clearly *not* failed to produce money. Regardless, neither criticism justifies the government suppression of alternative forms of money. For more on these issues, see Lawrence H. White, "Competitive Money, Inside and Out," *Cato Journal*, Vol. 3, No. 1 (1983), pp. 289–298, https://object.cato.org/sites/cato.org/files/serials/files/cato-journal/1983/5/cj3n1-16.pdf (accessed July 1, 2017); and, George Selgin, *The Theory of Free Banking: Money Supply under Competitive Note Issue* (Lanham, MD: Rowman & Littlefield, 1988), pp. 120–135, http://lfoll.s3.amazonaws.com/titles/2307/Selgin_1544_EBk_v6.0.pdf (accessed July 1, 2017).
6. More than 60 episodes of successful competitive private note issue have been identified, with well-studied episodes in Canada, Chile, Scotland, Sweden, and Switzerland. The Canadian and Scottish systems, in particular, were two of the most successful (and lightly regulated) systems. Internationally, money was often common tender before it was legal tender, and legal tender laws then generally protected government monopolies. See Gerald Dwyer and Norbert J. Michel, "Bits and Pieces: The Digital World of Bitcoin Currency," Heritage Foundation *Backgrounder* No. 3047, September 16, 2015, http://www.heritage.org/government-regulation/report/bits-and-pieces-the-digital-world-bitcoin-currency.
7. See Richard Hildreth, *The History of Banks* (Boston: Hilliard, Gray & Company), 1837, pp. 97–98, https://mises.org/system/tdf/The%20History%20of%20Banks_3.pdf?file=1&type=document (accessed July 3, 2017). In fact, these so-called free-banking laws do not appear to have allowed many new entrants into the banking industry. See Kenneth Ng, "Free Banking Laws and Barriers to Entry in Banking, 1838–1860," *The Journal of Economic History*, Vol. 48, Issue 4 (1988), pp. 877–889.
8. The collateral restrictions forced banks to invest in risky (often worthless) state bonds, and the branching restrictions further inhibited their ability to diversify risks. See Gerald P. Dwyer, "Wildcat Banks, Banking Panics and Free Banking in the United States," *Federal Reserve Bank of Atlanta Economic Review*, Vol. 81, No. 6 (1996), pp. 1–20, https://www.frbatlanta.org/research/publications/economic-review/1996/no3-6/vol81nos3-6_wildcat-banking.aspx (accessed July 1, 2017); Daniel Sanches, "The Free-Banking Era: A Lesson for Today?" *Federal Reserve Bank of Philadelphia Economic Insights*, 3rd Quarter, 2016, https://www.philadelphiafed.org/-/media/research-and-data/publications/economic-insights/2016/q3/eiq316_free_banking_era.pdf?la=en (accessed July 1, 2017); Arthur Rolnick and Warren Weber, "The Causes of Free Bank Failures: A Detailed Examination," *Journal of Monetary Economics*, Vol. 14, No. 3 (1984), pp. 265–403; and Howard Bodenhorn, *State Banking in Early America: A New Economic History* (New York: Oxford University Press, 2003).
9. Research indicates that the discount on all non-confederate state notes as of October 1863 was less than one percent. See George Selgin, "The Suppression of State Banknotes," *Economic Inquiry*, Vol. 38, No. 4 (October 2000), pp. 600–615. See also Hugh Rockoff, "The Free Banking Era: A Reexamination," *Journal of Money, Credit, and Banking* (1974), Vol. 6, No. 2, pp. 141–167.

In just five years, however, very few state banks remained and they did not issue notes. Instead, after a series of new federal banking laws,[10] most of those state banks had converted to national banks that issued *national* bank notes. Citizens did not scorn competitively issued state banknotes for a national system of uniform government-backed banknotes.[11]

Most state banks resisted joining the national banking system because demand for state bank currency remained relatively strong. In fact, the federal government had to impose a 10 percent tax on state bank notes specifically because customers preferred those notes to the national banknotes.[12] As with any privately produced good or service, no inferior form of money would be expected to replace an economy's preferred medium of exchange, and targeted government policies were clearly necessary to monopolize currency in the face of strong consumer preferences for competitively issued notes.[13]

Failed Stabilization Policies

The federal government's monopoly of base money and of modern monetary policies is widely believed to have stabilized the economy, although more than enough evidence suggests that this belief is erroneous.

For instance, a comparison of the entire Federal Reserve period, as opposed to only a portion of the post–World War II period, with the full pre-Fed era, shows that the frequency and severity of recessions has not decreased.[14] Some measures even show that there is more economic volatility compared to the pre-Fed period.[15] Furthermore, updated data suggests that economic contractions were shorter, and recoveries were faster, in the pre-Fed era than previously believed, and that the apparent decline in postwar volatility (in both output and employment) is "a figment of the data."[16]

Despite good reason to question the federal government's stewardship of money, an increasing number of policymakers are actively seeking to further expand government control over money by ending deposit banking, shutting down both the Eurodollar market and the money market mutual fund industry,[17] and even banning the use of paper currency.[18] These policymakers want to ban paper currency to prevent people from mitigating economic

10. During this time, the federal government gradually monopolized currency so that it could finance the Civil War.
11. For a detailed description of the forced transition to a national system that includes many additional citations, see George Selgin, *Money: Free and Unfree* (Washington, DC: Cato Institute, 2017), pp. 67–122.
12. Various scholars of the period observed this fact. For example, in the late nineteenth century, William Graham Sumner noted: "We would expect that a free, self-governing, and, at times, obstreperous, people would have refused and rejected these notes with scorn, and would have made their circulation impossible, but the American people did not. They treated the system with toleration and respect." William Graham Sumner, *A History of Banking in All the Leading Nations, Vol. 1: The United States*, ed. the Editor of the *Journal of Commerce and Commercial Bulletin* (New York: *Journal of Commerce and Commercial Bulletin*, 1896), p. 409, http://lf-oll.s3.amazonaws.com/titles/2237/Sumner_1453-01_EBk_v6.0.pdf (accessed July 1, 2017).
13. The concept known as Gresham's law—that bad money drives good money out of circulation—is sometimes erroneously invoked as an argument against currency competition. Gresham's law applies when government regulation requires different monies to be traded at the same price irrespective of the value to consumers and firms. For a broader overview of the theoretical issues and the economics literature, see George A. Selgin and Lawrence H. White, "How Would the Invisible Hand Handle Money?" *Journal of Economic Literature*, Vol. 32, No. 4 (1994), pp. 1718–1749.
14. Christina D. Romer, "Remeasuring Business Cycles," *The Journal of Economic History*, Vol. 54, No. 3 (September 1994), pp. 573–609.
15. George Selgin, William Lastrapes, and Lawrence White, "Has the Fed Been a Failure?" *Journal of Macroeconomics*, Vol. 34, No. 3 (2012), pp. 569–596. See also Norbert J. Michel, "Federal Reserve Performance: Have Business Cycles Really Been Tamed?" Heritage Foundation *Backgrounder* No. 2965, October 24, 2014, http://www.heritage.org/debt/report/federal-reserve-performance-have-business-cycles-really-been-tamed, and Norbert J. Michel, "Federal Reserve Performance: What Is the Fed's Track Record on Inflation?" Heritage Foundation *Backgrounder* No. 2968, October 27, 2014, http://www.heritage.org/debt/report/federal-reserve-performance-what-the-feds-track-record-inflation.
16. This finding holds for several measures even when the volatile interwar period is excluded. See Christina Romer, "Is the Stabilization of the Postwar Economy a Figment of the Data?" *The American Economic Review*, Vol. 76, No. 3 (June 1986), pp. 314–334.
17. Morgan Ricks, "A Simpler Approach to Financial Reform," *Regulation* (Winter 2013/2014), http://object.cato.org/sites/cato.org/files/serials/files/regulation/2014/1/regulation-v36n4-8.pdf (accessed July 1, 2017).
18. See Rogoff, *The Curse of Cash*.

stabilization policies,[19] especially when nominal interest rates are near zero. If, for example, the government forces citizens to use only electronic money, then the Federal Reserve can always, in an effort to boost consumption, assess a direct penalty (negative interest rates) on people for saving money instead of spending it.

Ensuring a Level Playing Field

Congress should remove barriers to entry in the market for alternative monies, and ensure that no single type of money enjoys a regulatory advantage. At minimum, Congress should address the following anti-competitive issues:[20]

- **Legal Tender Laws.** Congress should amend legal tender laws because they allow courts to force acceptance of a certain amount of official currency to satisfy debts even if a contract calls for delivery in another means of payment.[21]

- **Capital Gains Taxes.** Since the Internal Revenue Service treats (effectively all) alternative currencies as assets, every such transaction is a taxable event and is reportable on Schedule D of the taxpayers' Form 1040 (or, if a business, the analogous business tax form).[22] Congress should amend the Internal Revenue Code to provide that gains or losses attributable to the purchase or sale of alternative currencies are not taxable.

- **Private Coinage.** Congress should modify statutes concerning coinage to clarify that they do not prohibit the honest production of alternative monies for use in private transactions.[23]

- **Bank Secrecy and Anti-Money-Laundering Rules.** Congress should address bank secrecy and anti-money-laundering laws so that producers of alternative monies are not held to higher or lower standards than traditional financial companies.[24]

Conclusion

Money is the means of payment for virtually all goods and services. Most innovations in the means for payment have originated in private markets, but they were later monopolized by the government, thus mitigating their benefits. Policymakers rarely think about improving money with the same competitive market forces that improve other goods and services. That competitive process is the best way to expose weaknesses and inefficiencies in existing products, thus improving people's lives.

Congress should avoid policies that single out alternative forms of money and impede people from using their preferred medium of exchange. Although it cannot provide absolute protection, allowing competitive private markets to provide currency would present as powerful a check on the government's ability to diminish the quality of money as possible.

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19. The ban is also promoted as a way to stop criminal activity. While there is a strong public interest in preventing terrorist attacks and prosecuting criminal behavior, there is an equally strong public interest in protecting law-abiding citizens' right to engage in commerce. Criminals have also used laundry detergent as money, but it would make little sense to ban the use of soap to stop criminal activity. Jordan Weissmann, "Why Are Criminals Stealing Tide Detergent and Using It for Money?" *The Atlantic*, March 18, 2012, https://www.theatlantic.com/business/archive/2012/03/why-are-criminals-stealing-tide-detergent-and-using-it-for-money/254631/ (accessed July 1, 2017).
20. For more on ensuring a level playing field, See Dwyer and Michel, "Bits and Pieces."
21. See 31 U.S. Code § 5103.
22. U.S. Department of the Treasury, Internal Revenue Service, "Schedule D (Form 1040) Capital Gains and Losses," http://www.irs.gov/pub/irs-pdf/f1040sd.pdf (accessed July 6, 2014).
23. See, for example, 18 U.S. Code, §§ 485, 486, 489, and 490.
24. See Norbert J. Michel and David Burton, "Financial Privacy in a Free Society," Heritage Foundation *Backgrounder* No. 3157, September 23, 2016, http://www.heritage.org/markets-and-finance/report/financial-privacy-free-society.