

banking was not allowed, so notes issued by unknown faraway banks, as well as those that were suspect for other reasons, sometimes traded at a discount. This was not, however, an impossible inconvenience: Bill brokers sprang up to act as middlemen. It would be even less of a problem in these days of instant communications—and, above all, if nationwide branch banking were allowed.

Still, the wildcat banks left their clawmarks on the U.S. economics profession. Many economists concluded that private banks had a theoretical incentive to behave badly: They would produce money until its value had been driven down to its cost of production, which is essentially zero.



This would cause a price explosion—severe inflation.

David Glasner, however, rebuts this argument by pointing out that a bank can make profits only to the extent that the public will hold its money. Otherwise it will be driven into insolvency by adverse clearings with its competitors as the public converts out of its money and into their money. If people trust Wristons more than Rockefellers, Chase would have to either mend its ways or be driven out of business, and vice versa. Thus, for a bank like Chase Manhattan, the key question would be not the cost of physically creating Rockefellers but of keeping them in circulation. Chase's "cost of production" would be the resources it expended in maintaining sufficient balances of whatever was necessary in order to convince its customers that their Rockefellers could be redeemed whenever they wanted.

But doesn't bad money drive out good?

Everyone has heard of Gresham's law, but practically no one understands it. Queen Elizabeth I's financial adviser was talking about a situation where two monies exchange at a rate fixed by law—for example, if both are legal tender and must be accepted in discharge of debt. Under these circumstances, people will try to pass on the "bad" money—the money whose value is suspect, either because of debasement or overissue—and hoard the money that's "good." But if the rate of exchange between the monies is free to fluctuate, it is the debauched currency that will depreciate and be driven out.

Well, who would be the lender of last resort—as the Fed can be after disasters such as Oct. 19 last year or the 1970 Penn Central bankruptcy?

Nobody. A free banking system, its advocates insist, pointing to Scotland, is not inherently unstable. The celebrated 19th-century banking "panics" were relatively brief and self-correcting compared with the Great Depression, with the sound banks lending reserves to rescue unsound ones out of their own interest in preventing general collapse, as J.P. Morgan did in the panic of 1907. In Scotland, banks competed for the customers of failed banks by accepting their notes at par.

In fact, private money proponents think the Fed's activities as a lender of last resort, and the New Deal's deposit insurance programs, have actually made the U.S. banking

system's problems worse. They have encouraged bankers to take risks, knowing that the feds would bail them out, and thus in effect subsidized imprudent banking. Ask anyone in Texas.

The advocates of private monies are still arguing among themselves about other aspects of the scheme, including Hayek's idea number two (different denominations) and idea number three (private fiat money). Lawrence H. White, for example, thinks that, as in Scotland, all monies should be denominated in the same unit, albeit visually distinguishable so that they could trade at a discount if necessary. And he predicts that the emerging successful money would probably turn out to be one offering convertibility into gold or silver.

But these disputes are not conducted with the usual academic acerbity. This is because all private-money advocates agree that such questions can really be settled only by allowing competition to begin. Then the free market, to employ a key Hayekian conceit, will search out the best solution.

The privatization of money has important macroeconomic implications. It offers, according to its advocates, a way out of the current grand impasse of monetary policy.

For most of its existence, the Fed has focused on interest rates, the price of credit, assuming that the amount of money it was supplying to the economy was less important. But interest rates are affected by many factors, and the Fed often ended up supplying so much money that the resulting inflation could not be ignored.

But by the time the Fed finally admitted to the importance of the money supply, in the early 1980s, it turned out that the demand for money—its "velocity of circulation"—was jumping about unpredictably, too. Thus, judged by the usual measures, the Fed supplied massive quantities of money to the economy after 1982. But, contrary to what Friedman and like-minded monetarists predicted, it did not boil off into inflation. The velocity simply slowed.



So now the Fed appears to be flying blind, following neither a price rule nor a quantity rule, responding to ad hoc considerations such as the beliefs of the Fed chairman or whatever exchange rate influential politicians happen to feel would be convenient for the dollar.

Monetary policy would not be a problem if banks issued their own monies; it would cease to exist. Banks would automatically extend credit to the extent that they and their customers agree it is economically productive. If business conditions deteriorated, loans would be liquidated, liabilities written down to match, and the banks' balance sheets would shrink. Thus the quantity of money demanded by the economy would be automatically supplied by the market, just as it now supplies the appropriate number of automobiles. (Imagine the mess if an outfit like the Fed were to control auto production, based on its best guesses of what demand ought to be.)