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## Foreword



by Gary North

You have here a unique academic treatise on money and banking, a book which combines erudition, clarity of expression, economic theory, monetary theory, economic history, and an appropriate dose of conspiracy theory. Anyone who attempts to explain the mystery of banking—a deliberately contrived mystery in many ways—apart from all of these aspects has not done justice to the topic. But, then again, this is an area in which justice has always been regarded as a liability. The moral account of central banking has been overdrawn since 1694: “insufficient funds.” [footnote: P. G. M. Dickson. *The Financial Revolution in England: A Study in the Development of Public Credit, 1688-1756* (New York: St. Martin’s, 1967); John Brewer, *The Sinews of Power: War, Money and the English State, 1688-1783* (New York: Knopf, 1988).]

I am happy to see *The Mystery of Money* available again. I had negotiated with Dr. Rothbard in 1988 to re-publish it through my newsletter publishing company, but both of us got bogged down in other matters. I dithered. I am sure that the Mises Institute will do a much better job than I would have in getting the book into the hands of those who will be able to make good use of it.

I want you to know why I had intended to re-publish this book. It is the only money and banking textbook I have read which forthrightly identifies the process of central banking as both immoral and economically destructive. It identifies fractional reserve banking as a form of embezzlement. [footnote: See Chapter 7.] While Dr. Rothbard made the moral case against fractional reserve banking in his wonderful little book, *What Has Government Done to Our Money?* (1964), as far as I am aware, *The Mystery of Banking* was the first time that this moral insight was applied in a textbook on money and banking.

Perhaps it is unfair to the author to call this book a textbook. Textbooks are traditional expositions that have been carefully crafted to produce a near-paralytic boredom—“chloroform in print,” as Mark Twain once categorized a particular religious treatise. Textbooks are written to sell to tens of thousands of students in college classes taught by professors of widely varying viewpoints.

Textbook manuscripts are screened by committees of conventional representatives of an academic guild. While a textbook may not be analogous to the traditional definition of a camel—a horse designed by a committee—it almost always resembles a taxidermist’s version of a horse: lifeless and stuffed. The academically captive readers of a textbook, like the taxidermist’s horse, can be easily identified through their glassy-eyed stare. Above all, a textbook must appear to be morally neutral. So, *The Mystery of Banking* is not really a textbook. It is a monograph.

Those of us who have ever had to sit through a conventional college class on money and banking have been the victims of what I regard—and Dr. Rothbard regards—as an immoral propaganda effort. Despite the rhetoric of value-free economics that is so common in economics classrooms, the reality is very different. By means of the seemingly innocuous analytical device known in money and banking classes as the T-account, the

student is morally disarmed. The purchase of a debt instrument—generally a national government’s debt instrument—by the central bank must be balanced in the T-account by a liability to the bank: a unit of money. It all looks so innocuous: a government’s liability is offset by a bank’s liability. It seems to be a mere technical transaction—one in which no moral issue is involved. But what seems to be the case is not the case, and no economist has been more forthright about this than Murray Rothbard.

The purchase of government debt by a central bank in a fractional reserve banking system is the basis of an unsuspected transfer of wealth that is inescapable in a world of monetary exchange. Through the purchase of debt by a bank, fiat money is injected into the economy. Wealth then moves to those market participants who gain early access to this newly created fiat money. Who loses? Those who gain access to this fiat money later in the process, after the market effects of the increase of money have rippled through the economy. In a period of price inflation, which is itself the product of prior monetary inflation, this wealth transfer severely penalizes those who trust the integrity—the language of morality again—of the government’s currency and save it in the form of various monetary accounts. Meanwhile, the process benefits those who distrust the currency unit and who immediately buy goods and services before prices rise even further. Ultimately, as Ludwig von Mises showed, this process of central bank credit expansion ends in one of two ways: (1) the crack-up boom—the destruction of both monetary order and economic productivity in a wave of mass inflation—or (2) a deflationary contraction in which men, businesses, and banks go bankrupt when the expected increase of fiat money does not occur.

What the textbooks do not explain or even admit is this: the expansion of fiat money through the fractional reserve banking system launches the boom-bust business cycle—the process explained so well in chapter 20 of Mises’s classic treatise, *Human Action* (1949). Dr. Rothbard applied Mises’ theoretical insight to American economic history in his own classic but neglected monograph, *America’s Great Depression* (1963). [footnote: The English historian Paul Johnson rediscovered *America’s Great Depression* and relied on it in his account of the origins of the Great Depression. See his widely acclaimed book, *Modern Times* (New York: Harper & Row, 1983), pp. 233-37. He was the first prominent historian to accept Rothbard’s thesis.] In *The Mystery of Banking*, he explains this process by employing traditional analytical categories and terminology.

There have been a few good books on the historical background of the Federal Reserve System. Elgin Groseclose’s book, *Fifty Years of Managed Money* (1966), comes to mind. There have been a few good books on the moral foundations of specie-based money and the immorality of inflation. Groseclose’s *Money and Man* (1961), an extension of *Money: The Human Conflict* (1935), comes to mind. But until *The Mystery of Banking*, there was no introduction to money and banking which explained the process by means of traditional textbook categories, and which also showed how theft by embezzlement is inherent in the fractional reserve banking process. I would not recommend that any student enroll in a money and banking course who has not read this book at least twice.

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To

Thomas Jefferson, Charles Holt Campbell, Ludwig von Mises

Champions of Hard Money [\[p. 1\]](#)

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# Chapter I

## Money: Its Importance and Origins

### 1. The Importance of Money

Today, money supply figures pervade the financial press. Every Friday, investors breathlessly watch for the latest money figures, and Wall Street often reacts at the opening on the following Monday. If the money supply has gone up sharply, interest rates may or may not move upward. The press is filled with ominous forecasts of Federal Reserve actions, or of regulations of banks and other financial institutions.

This close attention to the money supply is rather new. Until the 1970s, over the many decades of the Keynesian Era, talk of money and bank credit had dropped out of the financial pages. Rather, they emphasized the GNP and government's fiscal policy, expenditures, revenues, and deficits. Banks and the money supply were generally ignored. Yet after decades of chronic and accelerating inflation—which the Keynesians could not [p. 2] begin to cure—and after many bouts of "inflationary recession," it became obvious to all—even to Keynesians—that something was awry. The money supply therefore became a major object of concern.

But the average person may be confused by so many definitions of the money supply. What are all the Ms about, from M1-A and M1-B up to M-8? Which is the true money supply figure, if any single one can be? And perhaps most important of all, why are bank deposits included in all the various Ms as a crucial and dominant part of the money supply? Everyone knows that paper dollars, issued nowadays exclusively by the Federal Reserve Banks and imprinted with the words "this note is legal tender for all debts, public and private" constitute money. But why are checking accounts money, and where do they come from? Don't they have to be redeemed in cash on demand? So why are checking deposits considered money, and not just the paper dollars backing them?

One confusing implication of including checking deposits as a part of the money supply is that banks *create* money, that they are, in a sense, money-creating factories. But don't banks simply channel the savings we lend to them and relend them to productive investors or to borrowing consumers? Yet, if banks take our savings and lend them out, how can they *create* money? How can their liabilities become part of the money supply?

There is no reason for the layman to feel frustrated if he can't find coherence in all this. The best classical economists fought among themselves throughout the nineteenth century over whether or in what sense private bank notes (now illegal) or deposits should or should not be part of the money supply. Most economists, in fact, landed on what we now see to be the wrong side of the question. Economists in Britain, the great center of economic thought during the nineteenth century, were particularly at sea on this issue. The eminent David Ricardo and his successors in the Currency School, lost a great chance to establish truly hard money in England because they [p. 3] never grasped the fact that bank deposits are part of the supply of

money. Oddly enough, it was in the United States, then considered a backwater of economic theory, that economists first insisted that bank deposits, like bank notes, were part of the money supply. Condy Raguet, of Philadelphia, first made this point in 1820. But English economists of the day paid scant attention to their American colleagues.

## 2. How Money Begins

Before examining what money *is*, we must deal with the importance of money, and, before we can do that, we have to understand how money arose. As Ludwig von Mises conclusively demonstrated in 1912, money does not and cannot originate by order of the State or by some sort of social contract agreed upon by all citizens; it must always originate in the processes of the free market

Before coinage, there was *barter*. Goods were produced by those who were good at it, and their surpluses were exchanged for the products of others. Every product had its barter price in terms of all other products, and every person gained by exchanging something he needed less for a product he needed more. The voluntary market economy became a latticework of mutually beneficial exchanges.

In barter, there were severe limitations on the scope of exchange and therefore on production. In the first place, in order to buy something he wanted, each person had to find a seller who wanted precisely what he had available in exchange. In short, if an egg dealer wanted to buy a pair of shoes, he had to find a shoemaker who wanted, at that very moment, to buy eggs. Yet suppose that the shoemaker was sated with eggs. How was the egg dealer going to buy a pair of shoes? How could he be sure that he could find a shoemaker who liked eggs?

Or, to put the question in its starkest terms, I make a living as a professor of economics. If I wanted to buy a newspaper in a [p. 4] world of barter, I would have to wander around and find a newsdealer who wanted to hear, say, a 10-minute economics lecture from me in exchange. Knowing economists, how likely would I be to find an interested newsdealer?

This crucial element in barter is what is called the *double coincidence of wants*. A second problem is one of *indivisibilities*. We can see clearly how exchangers could adjust their supplies and sales of butter, or eggs, or fish, fairly precisely. But suppose that Jones owns a house, and would like to sell it and instead, purchase a car, a washing machine, or some horses? How could he do so? He could not chop his house into 20 different segments and exchange each one for other products. Clearly, since houses are *indivisible* and lose all of their value if they get chopped up, we face an insoluble problem. The same would be true of tractors, machines, and other large-sized products. If houses could not easily be bartered, not many would be produced in the first place.

Another problem with the barter system is what would happen to business *calculation*. Business firms must be able to calculate whether they are making or losing income or wealth in each of their transactions. Yet, in the barter system, profit or loss calculation would be a hopeless task.

Barter, therefore, could not possibly manage an advanced or modern industrial economy. Barter could not succeed beyond the needs of a primitive village.

But man is ingenious. He managed to find a way to overcome these obstacles and transcend the

limiting system of barter. Trying to overcome the limitations of barter, he arrived, step by step, at one of man's most ingenious, important and productive inventions: *money*.

Take, for example, the egg dealer who is trying desperately to buy a pair of shoes. He thinks to himself: if the shoemaker is allergic to eggs and doesn't want to buy them, what does he want to buy?. Necessity is the mother of invention, and so the egg man is impelled to try to find out what the shoemaker [p. 5] would like to obtain. Suppose he finds out that it's fish. And so the egg dealer goes out and buys fish, not because he wants to eat the fish himself (*he* might be allergic to fish), but because he wants it in order to *resell* it to the shoemaker. In the world of barter, everyone's purchases were purely for himself or for his family's direct use. But now, for the first time, a new element of demand has entered: The egg man is buying fish not for its own sake, but instead to use it as an indispensable way of obtaining shoes. Fish is now being used as a *medium of exchange*, as an instrument of *indirect exchange*, as well as being purchased directly for its own sake.

Once a commodity begins to be used as a medium of exchange, when the word gets out it generates even further use of the commodity as a medium. In short, when the word gets around that commodity X is being used as a medium in a certain village, more people living in or trading with that village will purchase that commodity, since they know that it is being used there as a medium of exchange. In this way, a commodity used as a medium feeds upon itself, and its use spirals upward, until before long the commodity is in general use throughout the society or country as a medium of exchange. But when a commodity is used as a medium for most or all exchanges, that commodity is defined as being a *money*.

In this way money enters the free market, as market participants begin to select suitable commodities for use as the medium of exchange, with that use rapidly escalating until a general medium of exchange, or money, becomes established in the market.

Money was a leap forward in the history of civilization and in man's economic progress. Money—as an element in every exchange—permits man to overcome all the immense difficulties of barter. The egg dealer doesn't have to seek a shoemaker who enjoys eggs; and I don't have to find a newsdealer or a grocer who wants to hear some economics lectures. All we need do is exchange our goods or services for money; for the money [p. 6] commodity. We can do so in the confidence that we can take this universally desired commodity and exchange it for any goods that we need. Similarly, indivisibilities are overcome; a homeowner can sell his house for money, and then exchange that money for the various goods and services that he wishes to buy.

Similarly, business firms can now calculate, can figure out when they are making, or losing, money. Their income and their expenditures for all transactions can be expressed in terms of money. The firm took in, say, \$10,000 last month, and spent \$9,000; clearly, there was a net profit of \$1,000 for the month. No longer does a firm have to try to add or subtract in commensurable objects. A steel manufacturing firm does not have to pay its workers in steel bars useless to them or in myriad other physical commodities; it can pay them in money, and the workers can then use money to buy other desired products.

Furthermore, to know a goods "price," one no longer has to look at a virtually infinite array of relative quantities: the fish price of eggs, the beef price of string, the shoe price of flour, and so forth. Every commodity is priced in only one commodity: money, and so it becomes easy to compare these single money prices of eggs, shoes, beef, or whatever.

### 3. The Proper Qualities of Money

Which commodities are picked as money on the market? Which commodities will be subject to a spiral of use as a medium? Clearly, it will be those commodities most useful as money in any given society. Through the centuries, many commodities have been selected as money on the market. Fish on the Atlantic seacoast of colonial North America, beaver in the Old Northwest tobacco in the Southern colonies, were chosen as money. In other cultures, salt, sugar, cattle, iron hoes, tea, cowrie shells, and many other commodities have been chosen on the market. Many banks display money museums which exhibit various forms of money over the centuries. [p. 7]

Amid this variety of moneys, it is possible to analyze the qualities which led the market to choose that particular commodity as money. In the first place, individuals do not pick the medium of exchange out of thin air. They will overcome the double coincidence of wants of barter by picking a commodity which is *already in* widespread use for its own sake. In short, they will pick a commodity *in heavy demand*, which shoemakers and others will be likely to accept in exchange from the very start of the money-choosing process. Second, they will pick a commodity which is *highly divisible*, so that small chunks of other goods can be bought, and size of purchases can be flexible. For this they need a commodity which technologically does not lose its total value when divided into small pieces. For that reason a house or a tractor, being highly indivisible, is not likely to be chosen as money, whereas butter, for example, is highly divisible and at least scores heavily as a money for this particular quality.

Demand and divisibility are not the only criteria. It is also important for people to be able to carry the money commodity around in order to facilitate purchases. To be easily *portable*, then, a commodity must have *high value per unit weight*. To have high value per unit weight, however, requires a good which is not only in great demand but also relatively scarce, since an intense demand combined with a relatively scarce supply will yield a high price, or high value per unit weight.

Finally, the money commodity should be highly durable, so that it can serve as a store of value for a long time. The holder of money should not only be assured of being able to purchase other products right now, but also indefinitely into the future. Therefore, butter, fish, eggs, and so on fail on the question of durability.

A fascinating example of an unexpected development of a money commodity in modern times occurred in German POW camps during World War II. In these camps, supply of various goods was fixed by external conditions: CARE packages, rations, etc. But after receiving the rations, the prisoners began [p. 8] exchanging what they didn't want for what they particularly needed, until soon there was an elaborate price system for every product, each in terms of what had evolved as the money commodity: cigarettes. Prices in terms of cigarettes fluctuated in accordance with changing supply and demand.

Cigarettes were clearly the most "moneylike" products available in the camps. They were in high demand for their own sake, they were divisible, portable, and in high value per unit weight. They were not very durable, since they crumpled easily, but they could make do in the few years of the camps' existence.<sup>1</sup>

In all countries and all civilizations, two commodities have been dominant whenever they were available to compete as moneys with other commodities: *gold and silver*.

At first, gold and silver were highly prized only for their luster and ornamental value. They were always in great demand. Second, they were always relatively scarce, and hence valuable per unit of weight. And for that reason they were portable as well. They were also divisible, and could be sliced into thin segments without losing their pro rata value. Finally, silver or gold were blended with small amounts of alloy to harden them, and since they did not corrode, they would last almost forever.

Thus, because gold and silver are supremely “moneylike” commodities, they are selected by markets as money if they are available. Proponents of the gold standard do not suffer from a mysterious “gold fetish.” They simply recognize that gold has always been selected by the market as money throughout history.

Generally, gold and silver have both been moneys, side-by-side. Since gold has always been far scarcer and also in greater demand than silver, it has always commanded a higher price, and tends to be money in larger transactions, while silver has been used in smaller exchanges. Because of its higher price, gold has often been selected as the unit of account, although [p. 9] this has not always been true. The difficulties of mining gold, which makes its production limited, make its long-term value relatively more stable than silver.

#### 4. The Money Unit

We referred to *prices* without explaining what a price really is. A price is simply the ratio of the two quantities exchanged in any transaction. It should be no surprise that every monetary unit we are now familiar with—the dollar, pound, mark, franc, et al., began on the market simply as names for different units of weight of gold or silver. Thus the “pound sterling” in Britain, was exactly that—one pound of silver.<sup>2</sup>

The “dollar” originated as the name generally applied to a one-ounce silver coin minted by a Bohemian count named Schlick, in the sixteenth century. Count Schlick lived in Joachimsthal (Joachim’s Valley). His coins, which enjoyed a great reputation for uniformity and fineness, were called *Joachimsthalers* and finally, just *thalers*. The word *dollar* emerged from the pronunciation of *thaler*.

Since gold or silver exchanges by weight, the various national currency units, all defined as particular weights of a precious metal, will be automatically fixed in terms of each other. Thus, suppose that the dollar is defined as 1/20 of a gold ounce (as it was in the nineteenth century in the United States), while the pound sterling is defined as 1/4 of a gold ounce, and the French franc is established at 1/100 of a gold ounce.<sup>3</sup> But in that case, *the exchange rates* between the various currencies are automatically fixed by their respective quantities of gold. If a dollar is 1/20 of a gold ounce, and the pound is 1/4 of a gold ounce, then the pound will automatically exchange for 5 dollars. And, in our example, the pound will exchange for 25 francs and the dollar for 5 francs. The definitions of weight automatically set the exchange rates between them.

Free market gold standard advocates have often been taunted with the charge: “You are against the government [p. 10] fixing the price of goods and services; why then do you make an exception for gold? Why do you call for the government fixing the price of gold and setting the exchange rates between the various currencies?”

The answer to this common complaint is that the question assumes the dollar to be an independent entity, a thing or commodity which should be allowed to fluctuate freely in relation to gold. But the rebuttal of the pro-gold forces points out that the dollar is *not* an independent entity, that it was originally simply a name

for a certain weight of gold; the dollar, as well as the other currencies, is a unit of weight. But in that case, the pound, franc, dollar, and so on, are not exchanging as independent entities; they, too, are simply relative weights of gold. If 1/4 ounce of gold exchanges for 1/20 ounce of gold, how *else* would we expect them to trade than at 1:5?<sup>4</sup>

If the monetary unit is simply a unit of weight, then government's role in the area of money could well be confined to a simple Bureau of Weights and Measures, certifying this as well as other units of weight, length, or mass.<sup>5</sup> The problem is that governments have systematically betrayed their trust as guardians of the precisely defined weight of the money commodity.

If government sets itself up as the guardian of the international meter or the standard yard or pound, there is no economic incentive for it to betray its trust and change the definition. For the Bureau of Standards to announce suddenly that 1 pound is now equal to 14 instead of 16 ounces would make no sense whatever. There is, however, all too much of an economic incentive for governments to change, especially to lighten, the definition of the currency unit; say, to change the definition of the pound sterling from 16 to 14 ounces of silver. This profitable process of the government's repeatedly lightening the number of ounces or grams in the same monetary unit is called *debasement*.

How debasement profits the State can be seen from a hypothetical case: Say the *fur*, the currency of the mythical kingdom [p. 11] of Ruritania, is worth 20 grams of gold. A new king now ascends the throne, and, being chronically short of money, decides to take the debasement route to the acquisition of wealth. He announces a mammoth call—in of all the old gold coins of the realm, each now dirty with wear and with the picture of the previous king stamped on its face. In return he will supply brand new coins with his face stamped on them, and will return the same number of *rurs* paid in. Someone presenting 100 *rurs* in old coins will receive 100 *rurs* in the new.

Seemingly a bargain! Except for a slight hitch: During the course of this recoinage, the king changes the definition of the fur from 20 to 16 grams. He then pockets the extra 20% of gold, minting the gold for his own use and pouring the coins into circulation for his own expenses. In short, the number of grams of gold in the society remains the same, but since people are now accustomed to use the *name* rather than the weight in their money accounts and prices, the number of *rurs* will have increased by 20%. The money supply in *rurs*, therefore, has gone up by 20%, and, as we shall see later on, this will drive up prices in the economy in terms of *rurs*. *Debasement*, then, is the arbitrary redefining and lightening of the currency so as to add to the coffers of the State.<sup>6</sup>

The pound sterling has diminished from 16 ounces of silver to its present fractional state because of repeated debasements, or changes in definition, by the kings of England. Similarly, rapid and extensive debasement was a striking feature of the Middle Ages, in almost every country in Europe. Thus, in 1200, the French *livre tournois* was defined as 98 grams of fine silver; by 1600 it equaled only 11 grams.

A particularly striking case is the *dinar*, the coin of the Saracens in Spain. The *dinar*, when first coined at the end of the seventh century, consisted of 65 gold grains. The Saracens, notably sound in monetary matters, kept the dinars weight relatively constant, and as late as the middle of the twelfth century, it still equalled 60 grains. At that point, the Christian [p. 12] kings conquered Spain, and by the early thirteenth century, the *dinar* (now called *maravedi*) had been reduced to 14 grains of gold. Soon the gold coin was too



lightweight to circulate, and it was converted into a silver coin weighing 26 grains of silver. But this, too, was debased further, and by the mid-fifteenth century, the maravedi consisted of only 11/2 silver grains, and was again too small to circulate.<sup>7</sup>

Where is the total money supply—that crucial concept—in all this? First, before debasement, when the regional or national currency unit simply stands for a certain unit of weight of gold, the total money supply is the aggregate of all the monetary gold in existence in that society, that is, all the gold ready to be used in exchange. In practice, this means the total stock of gold coin and gold bullion available. Since all property and therefore all money is owned by *someone*, *this* means that the total money stock in the society at any given time is the aggregate, the sum total, of all existing *cash balances*, or money stock, owned by each individual or group. Thus, if there is a village of 10 people, A, B, C, etc., the total money stock in the village will equal the sum of all cash balances held by each of the ten citizens. If we wish to put this in mathematical terms, we can say that

$$M = \sum m$$

where M is the total stock or supply of money in any given area or in society as a whole, m is the individual stock or cash balance owned by each individual, and E means the sum or aggregate of each of the Ms.

After debasement, since the money unit is the *name* (dinar) rather than the actual weight (specific number of gold grams), the number of dinars or pounds or maravedis will increase, and thus increase the supply of money. M will be the sum of the individual dinars held by each person, and will increase by the extent of the debasement. As we will see later, this increased money supply will tend to raise prices throughout the economy. [\[p. 13\]](#) [\[p. 14\]](#) [\[p. 15\]](#)