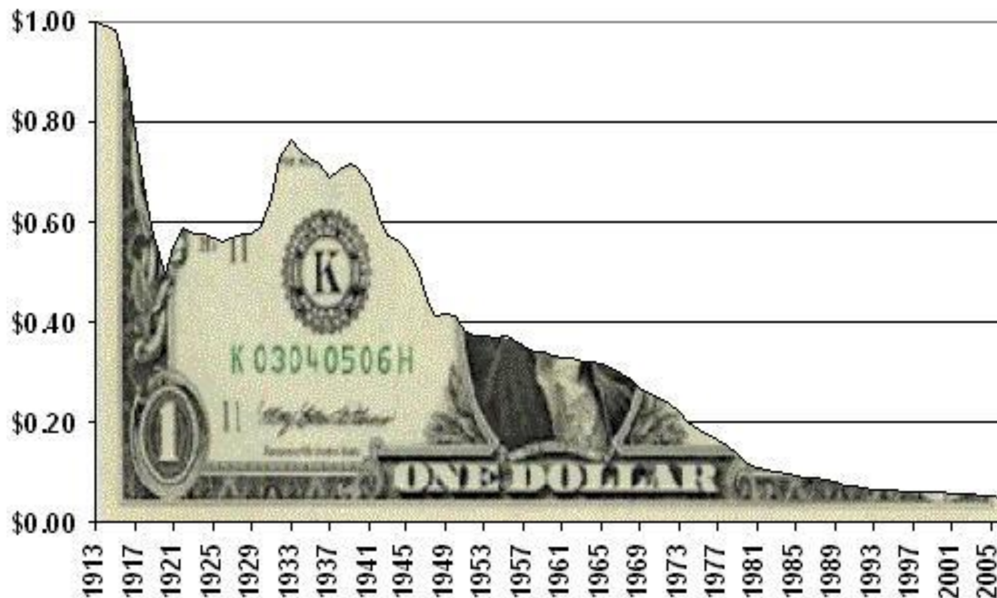
- **8 February - 14 February**



Reading: Chapters III and IV, pp. 50-78

Chapters III and IV, pp. 50-78. (The specific details of the historical illustrations in Chapter III aren't that important. The student should just try to understand the conceptual point Mises is making with them.)

CHAPTER 3: The Various Kinds of Money

1 Money and Money Substitutes

When an indirect exchange is transacted with the aid of money, it is not necessary for the money to change hands physically; a perfectly secure claim to an equivalent sum, payable on demand, may be transferred instead of the actual coins. In this by itself there is nothing remarkable or peculiar to money. What is peculiar, and only to be explained by reference to the special characteristics of money; is the extraordinary frequency of this way of completing monetary transactions.

In the first place, money is especially well adapted to constitute the substance of a generic obligation. Whereas the fungibility of nearly all other economic goods is more or less circumscribed and is often only a fiction based on an artificial commercial terminology, that of money is almost unlimited. Only that of shares and bonds can be compared with it. The sole factor that could possibly prevent any of these from being completely fungible is the difficulty of sub-

dividing their separate units; and various expedients have been adopted, which, at least as far as money is concerned, have entirely robbed this difficulty of all practical significance.

A still more important circumstance is involved in the nature of the function that money performs. A claim to money may be transferred over and over again in an indefinite number of indirect exchanges without the person by whom it is payable ever being called upon to settle it. This is obviously not true as far as other economic goods are concerned, for these are always destined for ultimate consumption.

The special suitability for facilitating indirect exchanges possessed by **absolutely secure** and **immediately payable** claims to money, which we may briefly refer to as ***money substitutes***, is further increased by their standing in law and commerce.

Technically, and in some countries legally as well, the transfer of a banknote scarcely differs from that of a coin. The similarity of outward appearance is such that those who are engaged in commercial dealings are usually unable to distinguish between those objects that actually perform the function of money and those that are merely employed as substitutes for them. The businessman does not worry about the economic problems involved in this; he is only concerned with the commercial and legal characteristics of coins, notes, checks, and the like. To him, the facts that banknotes are transferable without documentary evidence, that they circulate like coins in round denominations, that no fight of recovery lies against their previous holders, that the law recognizes no difference between them and money as an instrument of debt settlement, seem good enough reason for including them within the definition of the term money, and for drawing a fundamental distinction between them and cash deposits, which can be transferred only by a procedure that is much more complex technically and is also regarded in law as of a different kind. This is the origin of the popular conception of money by which everyday life is governed. No doubt it serves the purposes of the bank official, and it may even be quite useful in the business world at large, but its introduction into the scientific terminology of economics is most undesirable.

The controversy about the concept of money is not exactly one of the most satisfactory chapters in the history of our science. It is chiefly remarkable for the smother of juristic and commercial technicalities in which it is enveloped and for the quite undeserved significance that has been attached to what is after all merely a question of terminology. The solution of the question has been regarded as an end in itself and it seems to have been completely forgotten that the real

aim should have been simply to facilitate further investigation. Such a discussion could not fail to be fruitless.

In attempting to draw a line of division between money and those objects that outwardly resemble it, we only need to bear in mind the goal of our investigation. The present discussion aims at tracing the laws that determine the exchange ratio between money and other economic goods. This and nothing else is the task of the economic theory of money. Now our terminology must be suited to our problem. If a particular group of objects is to be singled out from among all those that fulfill a monetary function in commerce and, under the special name of money (which is to be reserved to this group alone), sharply contrasted with the rest (to which this name is denied), then this *distinction must be made* in a way that will facilitate the further progress of the investigation.

It is considerations such as these that have led the present writer to give the name of money substitutes and not that of money to those objects that are employed like money in commerce but consist in perfectly secure and immediately convertible claims to money.

Claims are not goods;[1] they are means of obtaining disposal over goods. This determines their whole nature and economic significance. They themselves are not valued directly, but **indirectly;** their value is derived from that of the economic goods to which they refer. Two elements are involved in the valuation of a claim: first, the value of the goods to whose possession it gives a right; and, second, the greater or less probability that possession of the goods in question will actually be obtained. Furthermore, if the claim is to come into force only **after a period of time**, then consideration of this circumstance will constitute a third factor in its valuation. The value on January 1 of a right to receive ten sacks of coal on December 31 of the same year will be based not directly on the value of ten sacks of coal, but on the value of ten sacks of coal to be delivered in a year's time. This sort of calculation is a matter of common experience, as also is the fact that in reckoning the value of claims their soundness or security is taken into account.

Claims to money are, of course, no exception. Those which are payable on demand, if there is no doubt about their soundness and no expense connected with their settlement, are valued just as highly as cash and tendered and accepted in the same way as money. [2]Only claims of this sort—that is, claims that are payable on demand, absolutely safe as far as human foresight goes, and perfectly liquid in the legal sense—are for business purposes exact substitutes for the money to which they refer. Other claims, of course, such as notes issued by banks of doubtful credit or bills that are not yet mature, also enter into financial transactions and may just as well be employed

as general media of exchange. This, according to our terminology, means that **they are money**. But then they are **valued independently**; they are reckoned equivalent neither to the sums of money to which they refer nor even to the worth of the rights that they embody. What the further special factors are that help to determine their exchange value, we shall discover in the course of our argument.

Of course it would be in no way incorrect if we attempted to include in our concept of money those absolutely secure and immediately convertible claims to money that we have preferred to call money substitutes. But what must be entirely **condemned** is the widespread practice of giving the name of money to certain classes of money substitutes, usually banknotes, token money, and the like, and contrasting them sharply with the remaining kinds, such as cash deposits. [3] This is to make a distinction without any adequate difference; for banknotes, say, and cash deposits differ only in mere externals, important perhaps from the business and legal points of view, but quite insignificant from the point of view of economics.

On the other hand, arguments of considerable weight may be urged in favor of including all money substitutes without exception in the single concept of money. It may be pointed out, for instance, that the significance of perfectly secure and liquid claims to money is quite different from that of claims to other economic goods; that whereas a claim on a commodity must sooner or later be **liquidated**, this is not necessarily true of claims to money. Such claims may pass from hand to hand for indefinite periods and so take the place of money without any attempt being made to liquidate them. It may be pointed out that those who require money will be quite satisfied with such claims as these, and that those who wish to spend money will find that these claims answer their purpose just as well; and that consequently the supply of money substitutes must be reckoned in with that of money, and the demand for them with the demand for money. It may further be pointed out that whereas it is impossible to satisfy an increase in the demand, say, for bread by issuing more bread tickets without adding to the actual supply of bread itself, it is perfectly possible to satisfy an increased demand for money by just such a process as this. It may be argued, in brief, that money substitutes have certain peculiarities of which account is best taken by including them in the concept of money.

Without wishing to question the weight of such arguments as these, we shall on grounds of convenience prefer to adopt the **narrower formulation of the concept of money, supplementing it with a separate concept of money substitutes.** Whether this is the most advisable course to pursue, whether perhaps some other procedure might not lead to a better understanding of our

subject matter, must be left to the judgment of the reader To the author it appears that the way chosen is the only way in which the difficult problems of the theory of money can be solved.

2 The Peculiarities of Money Substitutes

Economic discussion about money must be based **solely on economic considerations** and may take legal distinctions into account only insofar as they are significant from the economic point of view also. Such discussion consequently must proceed from a concept of money based, not on legal definitions and discriminations, but on the economic nature of things. It follows that our decision not to regard drafts and other claims to money as constituting money itself must not be interpreted merely in accordance with the narrow juristic concept of a claim to money. Besides strictly legal claims to money, we must also take into account such relationships as are not claims in the juristic sense, but are nevertheless treated as such in commercial practice because some concern or other deals with them as if they actually did constitute claims against itself. [4]

There can be no doubt that the German token coins minted in accordance with the Coinage Act of July 9, 1873, did not in law constitute claims to money. Perhaps there are some superficial critics who would be inclined to classify these coins actually as money because they consisted of stamped silver or nickel or copper discs that had every appearance of being money. But despite this, from the point of view of economics these token coins merely constituted drafts on the national Treasury. The second paragraph of section nine of the Coinage Act (in its form of June 1, 1909) obliged the Bundesrat to specify those centers that would pay out gold coins on demand in return for not less than 200 marks' worth of silver coins or fifty marks' worth of nickel and copper coins. Certain branches of the Reichsbank were entrusted with this function. Another section of the Coinage Act (sec. 8) provided that the Reich would always be in a position actually to maintain this convertibility. According to this section, the total value of the silver coins minted was never to exceed twenty marks per head of the population, nor that of the nickel and copper coins two and one-half marks per head. In the opinion of the legislature, these sums represented the demand for small coins, and there was consequently no danger that the total issue of token coinage would exceed the public demand for it. Admittedly, there was no statutory recognition of any right to conversion on the part of holders of token coins, and the limitation of legal tender (sec. 9, par 1) was only an inadequate substitute for this. Nevertheless, it is a matter of general knowledge that the token coins were in fact cashed without any demur at the branches of the Reichsbank specified by the Chancellor.

Exactly the same sort of significance was enjoyed by the Reich Treasury notes, of which not more than 120 million marks' worth were allowed to be in circulation. These also (sec. 5 of the act of April 30, 1874) were always cashed for gold by the Reichsbank on behalf of the Treasury. It is beside the point that the Treasury notes were not legal tender in private transactions while everybody was obliged to accept silver coins in amounts up to twenty marks and nickel and copper coins in amounts up to one mark; for, although they were not legally bound to accept them in settlement of debts, people in fact accepted them readily.

Another example is afforded by the German thaler of the period from the introduction of the gold standard until the withdrawal of the thaler from circulation on October 1, 1907. During the whole of this period the thaler was undoubtedly legal tender. But if we seek to go behind this expression, whose juristic derivation makes it useless for our present purpose, and ask if the thaler was *money* during this period, the answer must be that it was not. It is true that it was employed in commerce as a medium of exchange; but it could be used in this way solely because it was a claim to something that really was money, that is, to the common medium of exchange. For although neither the Reichsbank nor the Reich nor its separate constituent kingdoms and duchies nor anybody else was obliged to cash them, the Reichsbank, acting on behalf of the government, always took pains to ensure that no more thalers were in circulation than were demanded by the public. It achieved this result by refusing to press thalers on its customers when paying out. This, together with the circumstance that thalers were legal tender both to the bank and to the Reich, was sufficient to turn them in effect into drafts that could always be converted into money, with the result that they circulated at home as perfectly satisfactory substitutes for money. It was repeatedly suggested to the directors of the Reichsbank that they should cash their own notes not in gold but in thalers (which would have been well within the letter of the law) and pay out gold only at a premium, with the object of hindering the export of it. But the bank steadily refused to adopt this or any proposal of a similar nature.

The exact nature of the token coinage in other countries has not always been so easy to understand as that of Germany, whose banking and currency system was fashioned under the influence of such men as Bamberger, Michaelis, and Soetbeer. In some legislation, the theoretical basis of modern token-coinage policy may not be so easy to discover or to demonstrate as in the examples already dealt with. Nevertheless, all such policy has ultimately the same intent. The universal legal peculiarity of token coinage is the limitation of its power of payment to a specified maximum sum; and as a rule this provision is supplemented by legislative restriction of the amount that may be minted.

There is no such thing as an economic concept of token coinage. All that economics can distinguish is a particular subgroup within the group of claims to money that are employed as substitutes for money, the members of this subgroup being intended for use in transactions where the amounts involved are small. The fact that the issue and circulation of token coins are subjected to special *legal* rules and regulations is to be explained by the special nature of the purpose that they serve. The general recognition of the right of the holder of a banknote to receive money in exchange for it while the conversion of token coins is in many countries left to administrative discretion is a result of the different lines of development that notes and token coinage have followed respectively. Token coins have arisen from the need for facilitating the exchange of small quantities of goods of little value. The historical details of their development have not yet been brought to light and, almost without exception, all that has been written on the subject is of purely numismatical or metrological importance. [5] Nevertheless, one thing can safely be asserted: token coinage is always the result of attempts to remedy deficiencies in the existing monetary system. It is those technical difficulties, that hinder the subdivision of the monetary unit into small coins, that have led, after all sorts of unsuccessful attempts, to the solution of the problem that we adopt nowadays. In many countries, while this development has been going on, a kind of fiat money[6] has sometimes been used in small transactions, with the very inconvenient consequence of having two independent kinds of money performing side by side the function of a common medium of exchange. To avoid the inconveniences of such a situation the small coins were brought into a fixed legal ratio with those used in larger transactions and the necessary precautions were taken to prevent the quantity of small coins from exceeding the requirements of commerce. The most important means to this end has always been the restriction of the quantity minted to that which seems likely to be needed for making small payments, whether this is fixed by law or strictly adhered to without such compulsion. Along with this has gone the limitation of legal tender in private dealings to a certain relatively small amount. The danger that these regulations would prove inadequate has never seemed very great, and consequently legislative provision for conversion of the token coins has been either entirely neglected or left incomplete by omission of a clear statement of the holder's right to change them for money. But everywhere nowadays those token coins that are rejected from circulation are accepted without demur by the state, or some other body such as the central bank, and thus their nature as claims to money is established. Where this policy has been discontinued for a time and the attempt made by suspending effectual conversion of the token coins to force more of them into circulation than was required, they have become credit money, or even commodity money. Then they have no longer been regarded as claims to money, payable on demand, and therefore equivalent to money, but have been valued independently.

The banknote has followed quite a different line of development. It has always been regarded as a claim, even from the juristic point of view. The fact has never been lost sight of that if its value was to be kept equal to that of money, steps would have to be taken to ensure its permanent convertibility into money. That a cessation of cash payments would alter the economic character of banknotes could hardly escape notice; in the case of the quantitatively less important coins used in small transactions it could more easily be forgotten. Furthermore, the smaller quantitative importance of token coins means that it is possible to maintain their permanent convertibility without establishing special funds for the purpose. The absence of such special funds may also have helped to disguise the real nature of token coinage. [7]

Consideration of the monetary system of Austria-Hungary is particularly instructive. The currency reform that was inaugurated in 1892 was never formally completed, and until the disruption of the Hapsburg monarchy the standard remained legally what is usually called a paper standard, since the Austro-Hungarian Bank was not obliged to redeem its own notes, which were legal tender to any amount. Nevertheless, from 1900 to 1914 Austria-Hungary really possessed a gold standard or gold-exchange standard, for the bank did in fact readily provide gold for commercial requirements. Although according to the letter of the law it was not obliged to cash its notes, it offered bills of exchange and other claims payable abroad in gold (checks, notes, and the like), at a price below the upper theoretical gold point. Under such conditions, those who wanted gold for export naturally preferred to buy claims of this sort, which enabled them to achieve their purpose more cheaply than by the actual export of gold.

For internal commerce as well, in which the use of gold was exceptional since the population had many years before gone over to banknotes and token coins,[8] the bank cashed its notes for gold without being legally bound to do so. And this policy was pursued, not accidentally or occasionally or without full recognition of its significance, but deliberately and systematically, with the object of permitting Austria and Hungary to enjoy the economic advantages of the gold standard. Both the Austrian and the Hungarian governments, to whose initiative this policy of the bank was due, cooperated as far as they were able. But in the first place it was the bank itself which had to ensure, by following an appropriate discount policy, that it would always be in a position to carry out with promptitude its voluntary undertaking to redeem its notes. The measures that it took with this purpose in view did not differ fundamentally in any way from those adopted by the banks-of-issue in other gold-standard countries. [9] Thus the notes of the Austro-Hungarian Bank were in fact nothing but money substitutes. The money of the country, as of other European countries, was gold.

3 Commodity Money, Credit Money, and Fiat Money

The economic theory of money is generally expressed in a terminology that is not economic but **juristic.** This terminology has been built up by writers, statesmen, merchants, judges, and others whose chief interests have been in the legal characteristics of the different kinds of money and their substitutes. It is useful for dealing with those aspects of the monetary system that are of importance from the legal point of view; but for purposes of economic investigation it is practically valueless. Sufficient attention has scarcely been devoted to this shortcoming, despite the fact that confusion of the respective provinces of the sciences of law and economics has nowhere been so frequent and so fraught with mischievous consequences as in this very sphere of monetary theory. It is a mistake to deal with economic problems according to legal criteria. The juristic phraseology, like the results of juristic research into monetary problems, must be regarded by economics as one of the objects of its investigations. It is not the task of economics to criticize it, although it is entitled to exploit it for its own purposes. There is nothing to be said against using juristic technical terms in economic argument where this leads to no undesirable consequences. But for its own special purposes, economics must construct its own special terminology.

There are two sorts of thing that may be used as money: on the one hand, **physical commodities** as such, like the metal gold or the metal silver; and, on the other hand, objects that do not differ technologically from other objects that are not money, the factor that decides whether they are money being not a physical but a **legal characteristic**. A piece of paper that is specially characterized as money by the imprint of some authority is in no way different, technologically considered, from another piece of paper that has received a similar imprint from an unauthorized person, just as a genuine five-franc piece does not differ technologically from a "genuine replica." **The only difference lies in the law that regulates the manufacture of such coins and makes it impossible without authority.** (In order to avoid every possible misunderstanding, let it be expressly stated that all that the law can do is to regulate the issue of the coins and that it is beyond the power of the state to ensure in addition that they actually shall become money; that is, that they actually shall be employed as a common medium of exchange. All that the state can do by means of its official stamp is to single out certain pieces of metal or paper from all the other things of the same kind so that they can be subjected to a process of valuation independent of that of the rest. Thus it *permits* those objects possessing the special legal qualification to be used as a common medium of exchange while the other commodities of the same sort remain mere commodities. It can also take various steps with the object of encouraging the actual employment of the qualified commodities as common media of exchange. **But these commodities**

can never become money just because the state commands it; money can be created only by the usage of those who take part in commercial transactions.)

We may give the name *commodity money* to that sort of money that is at the same time a commercial commodity; and the name *fiat money* to money that comprises things with a special legal qualification. A third category may be called *credit money*, this being that sort of money which constitutes a claim against any physical or legal person. But these claims must not be both payable on demand and absolutely secure; if they were, there could be no difference between their value and that of the sum of money to which they referred, and they could not be subjected to an independent process of valuation on the part of those who dealt with them. In some way or other the maturity of these claims must be postponed to some future time. It can hardly be contested that fiat money in the strict sense of the word is theoretically conceivable. The theory of value proves the possibility of its existence. Whether fiat money has ever actually existed is, of course, another question, and one that cannot offhand be answered affirmatively. It can hardly be doubted that most of those kinds of money that are not commodity money must be classified as credit money. But only detailed historical investigation could clear this matter up.

Our terminology should prove more useful than that which is generally employed. It should express more clearly the peculiarities of the processes by which the different types of money are valued. It is certainly more correct than the usual distinction between metallic money and paper money. Metallic money comprises not only standard money but also token coins and such coins as the German thaler of the period 1873-1907; and paper money, as a rule, comprises not merely such fiat money and credit money as happen to be made of paper, but also convertible notes issued by banks or the state. This terminology is derived from popular usage. Previously, when more often than nowadays "metallic" money really was money and not a money substitute, perhaps the nomenclature was a little less inappropriate than it is now. Furthermore, it corresponded—perhaps still corresponds—to the naive and confused popular conception of value that sees in the precious metals something "intrinsically" valuable and in paper credit money something necessarily anomalous. Scientifically, this terminology is perfectly useless and a source of endless misunderstanding and misrepresentation. The greatest mistake that can be made in economic investigation is to fix attention on mere appearances, and so to fail to perceive the fundamental difference between things whose externals alone are similar, or to discriminate between fundamentally similar things whose externals alone are different.

Admittedly, for the numismatist and the technologist and the historian of art there is very little difference between the five-franc piece before and after the cessation of free coinage of silver, while the Austrian silver gulden even of the period 1879 to 1892 appears to be fundamentally different from the paper gulden. But it is regrettable that such superficial distinctions as this should still play a part in economic discussion.

Our threefold classification is not a matter of mere terminological gymnastics; the theoretical discussion of the rest of this book should demonstrate the utility of the concepts that it involves.

The decisive characteristic of commodity money is the employment for monetary purposes of a commodity in the technological sense. For the present investigation, it is a matter of complete indifference what particular commodity this is; **the important thing is that it is the commodity in question that constitutes the money, and that the money is merely this commodity**. The case of fiat money is quite different. Here the deciding **factor is the stamp,** and it is not the material bearing the stamp that constitutes the money, but the stamp itself. The nature of the material that bears the stamp is a matter of quite minor importance. Credit money, finally, is a claim falling due in the future that is used as a general medium of exchange.

4 The Commodity Money of the Past and of the Present

Even when the differentiation of commodity money, credit money, and fiat money is accepted as correct in principle and only its utility disputed, the statement that the freely mintable currency of the present day and the metallic money of previous centuries are examples of commodity money is totally rejected by many authorities and by still more of the public at large. It is true that as a rule nobody denies that the older forms of money were commodity money. It is further generally admitted that in earlier times **coins circulated by weight and not by tale**. Nevertheless, it is asserted, money changed its nature long ago. The money of Germany and England in 1914, it is said, was not gold, but the mark and the pound. Money nowadays consists of "specified units with a definite significance in terms of value, that is assigned to them by law" (Knapp). "By 'the standard' we mean the units of value (florins, francs, marks, etc.) that have been **adopted as measures of value**, and by 'money' we mean the tokens (coins and notes) that represent the units that function as a measure of value. The controversy as to whether silver or gold or both **together** should function as a standard and as currency is an idle one, because neither silver nor gold ever has performed these functions or ever could have done so" (Hammer). [10]

Before we proceed to test the truth of these remarkable assertions, let us make one brief observation on their genesis—although it would really be more correct to say renascence than to say genesis, since the doctrines involved exhibit a very close relationship with the oldest and most primitive theories of money. Just as these were, so the nominalistic monetary theories of the present day are, characterized by their inability to contribute a single word toward the solution of the chief problem of monetary theory—one might in fact simply call it ***the* problem of monetary theory—namely that of explaining the exchange ratios between money and other economic goods.** For their authors, the economic problem of value and prices simply does not exist. They have never thought it necessary to consider how market ratios are established or what they signify. Their attention is accidentally drawn to the fact that a German thaler (since 1873), or an Austrian silver florin (since 1879), is essentially different from a quantity of silver of the same weight and fineness that has not been stamped at the government mint. They notice a similar state of affairs with regard to "paper money." They do not understand this, and endeavor to find an answer to the riddle. But at this point, just because of their lack of acquaintance with the theory of value and prices, their inquiry takes a peculiarly unlucky turn. They do not inquire how the exchange ratios between money and other economic goods are established. This obviously seems to them quite a self-evident matter. They formulate their problem in another way: *How does it come about that three twenty-mark pieces are equivalent to twenty thalers despite the fact that the silver contained in the thalers has a lower market value than the gold contained in the marks?* And their answer runs: *Because the value of money is determined by the state, by statute, by the legal system*. Thus, ignoring the most important facts of monetary history, they weave an artificial network of fallacies; a theoretical construction that collapses immediately the question is put: *What exactly are we to understand by a unit of value?* But such impertinent questions can only occur to those who are acquainted with at least the elements of the theory of prices. Others are able to content themselves with references to the "nominality" of the unit of value. No wonder, then, that these theories should have achieved such popularity with the man in the street, especially since their kinship with inflationism was bound to commend them strongly to all "cheap-money" enthusiasts.

It may be stated as an assured result of investigation into monetary history that at all times and among all peoples the principal coins have been tendered and accepted, not by tale without consideration of their quantity and quality, but only as pieces of metal of specific degrees of weight and fineness. Where coins have been accepted by tale, this has always been in the definite belief that the stamp showed them to be of the usual fineness of their kind and of the correct weight. Where there were no grounds for this assumption, weighing and testing were resorted to again.

Fiscal considerations have led to the promulgation of a theory that attributes to the minting authority the right to regulate the purchasing power of the coinage as it thinks fit. For just as long as the minting of coins has been a government function, governments have tried to fix the weight and content of the coins as they wished. Philip VI of France expressly claimed the right "to mint such money and give it such currency and at such rate as we desire and seems good to us"[11]and all medieval rulers thought and did as he in this matter. Obliging jurists supported them by attempts to discover a philosophical basis for the divine right of kings to debase the coinage and to prove that the true value of the coins was that assigned to them by the ruler of the country.

Nevertheless, in defiance of all official regulations and prohibitions and fixing of prices and threats of punishment, commercial practice has always insisted that what has to be considered in valuing coins is not their face value but their value as metal. The value of a coin has always been determined, not by the image and superscription it bears nor by the proclamation of the mint and market authorities, but by its metal content. Not every kind of money has been accepted at sight, but only those kinds with a good reputation for weight and fineness. In loan contracts, repayment in specific kinds of money has been stipulated for, and in the case of a change in the coinage, fulfillment in terms of metal required. [12] In spite of all fiscal influences, the opinion gradually gained general acceptance, even among the jurists, that it was the metal value—the*bonitas intrinseca* as they called it—that was to be considered when repaying money debts. [13]

Debasement of the coinage was unable to force commercial practice to attribute to the new and lighter coins the same purchasing power as the old and heavier coins. [14] The value of the coinage fell in proportion to the diminution of its weight and quality. Even price regulations took into account the diminished purchasing power of money due to its debasement. Thus the Schöffen or assessors of Schweidnitz in Silesia used to have the newly minted pfennigs submitted to them, assess their value, and then in consultation with the city council and elders fix the prices of commodities accordingly. There has been handed down to us from thirteenth-century Vienna a *forma institutionis que fit per civium arbitrium annuatim tempore quo denarii renovantur pro rerum venalium qualibet emptione* in which the prices of commodities and services are regulated in connection with the introduction of a new coinage in the years 1460 to 1474. Similar measures were taken on similar occasions in other cities. [15]

Wherever disorganization of the coinage had advanced so far that the presence of a stamp on a piece of metal was no longer any help in determining its actual content, commerce ceased entirely to rely on the official monetary system and created its own system of measuring the precious metals. In large transactions, ingots and trade tokens were used. Thus, the German

merchants visiting the fair at Geneva took ingots of refined gold with them and made their purchases with these, employing the weights used at the Paris market, instead of using money. This was the origin of the Markenskudo or scutus marcharum, which was nothing but the merchants' usual term for 3.765 grams of refined gold. At the beginning of the fifteenth century, when the Geneva trade was gradually being transferred to Lyons, the gold mark had become such a customary unit of account among the merchants that bills of exchange expressed in terms of it were carried to and from the market. The old Venetian *lire di grossi* had a similar origin. [16] In the giro banks that sprang up in all big commercial centers at the beginning of the modern era we see a further attempt to free the monetary system from the authorities' abuse of the privilege of minting. The clearinghouse business of these banks was based either on coins of a specific fineness or on ingots. This bank money was commodity money in its most perfect form.

The nominalists assert that the monetary unit, in modern countries at any rate, is not a concrete commodity unit that can be defined in suitable technical terms, but a nominal quantity of value about which nothing can be said except that it is created by law. Without touching upon the vague and nebulous nature of this phraseology, which will not sustain a moment's criticism from the point of view of the theory of value, let us simply ask: *What, then, were the mark, the franc, and the pound before 1914?* Obviously, they were nothing but certain weights of gold. Is it not mere quibbling to assert that Germany had not a gold standard but a mark standard? According to the letter of the law, Germany was on a gold standard, and the mark was simply the unit of account, the designation of 1/2790 kg. of refined gold. This is in no way affected by the fact that nobody was bound in private dealings to accept gold ingots or foreign gold coins, for the whole aim and intent of state intervention in the monetary sphere is simply to release individuals from the necessity of testing the weight and fineness of the gold they receive, a task which can only be undertaken by experts and which involves very elaborate precautionary measures. The narrowness of the limits within which the weight and fineness of the coins are legally allowed to vary at the time of minting, and the establishment of a further limit to the permissible loss by wear of those in circulation, are much better means of securing the integrity of the coinage than the use of scales and nitric acid on the part of all who have commercial dealings. Again, the right of free coinage, one of the basic principles of modern monetary law, is a protection in the opposite direction against the emergence of a difference in value between the coined and uncoined metal. In large-scale international trade, where differences that are negligible as far as single coins are concerned have a cumulative importance, coins are valued, not according to their number, but according to their weight; that is, they are treated not as coins but as pieces of metal. It is easy to see why this does not occur in domestic trade. Large payments within a country never involve

the actual transfer of the amounts of money concerned, but merely the assignment of claims, which ultimately refer to the stock of precious metal of the central bank.

The role played by ingots in the gold reserves of the banks is a proof that the monetary standard consists in the precious metal, and not in the proclamation of the authorities.

Even for present-day coins, so far as they are not money substitutes, credit money, or fiat money, the statement is true that they are nothing but ingots whose weight and fineness are officially guaranteed. [17] The money of those modern countries where metal coins with no mint restrictions are used is commodity money just as much as that of ancient and medieval nations.

---

[1] See Böhm-Bawerk, *Rechte und Verhältnisse* (Innsbruck, 1881), pp. 120 ff.

[2] Wagner, *Beiträge zur Lehre von den Banken* (Leipzig, 1857), pp. 34 ff.

[3] For instance, Helfferich, *Das Geld*, 6th ed. (Leipzig, 1923), pp. 267 ff.; English trans., *Money*(London, 1927), pp. 284 ff.

[4] See Laughlin, *The Principles of Money* (London, 1903), pp. 516 ff.

[5] See Kalkmann, *Englands Übergang zur Goldwährung im 18. Jahrhundert* (Strassburg, 1895), pp. 64 ff.; Schmoller, "Über die Ausbildung einer richtigen Scheidemünzpolitik vom 14. bis zum 19. Jahrhundert," *Jahrbuch fur Gesetzgebung, Verwaltung und Volkswirtschaft im Deutschen Reich* 24 (1900): 1247-74; Helfferich, *Studien über Geld und Bankwessen*(Berlin, 1900), pp. 1-37.

[6] On the concepts of commodity money, credit money, and fiat money, see sec. 3 of this chap.

[7] On the nature of token coinage, see Say, *Cours complet d'économie politique pratique*, 3d ed. (Paris, 1852), vol, 1, p. 408; and Wagner, *Theoretische Sozialökonomik* (Leipzig, 1909), Part II pp. 504 ff. Very instructive discussions are to be found in the memoranda and debates that preceded the Belgian Token Coinage Act of 1860. In the memorandum of Pirmez, the nature of modern convertible token coins is characterized as follows: "With this property (of convertibility) the coins are no longer merely coins; they become claims, promises to pay. The holder no longer has a mere property right to the coin itself [*jus in re*]; he has a claim against the state to the amount of the

nominal value of the coin [*jus ad rem*], a right which he can exercise at any moment by demanding its conversion. Token coins cease to be money and become a credit instrument [*une institution de crédit*], banknotes inscribed on pieces of metal ..." (see *Loi décretant la fabrication d'une monnaie d'appoint ... précédee des notes sur la monnaie de billon en Belgique ainsi que la discussion de la loi à la Chambre des Représentants*[Brussels, 1860], p. 50).

[8] The silver gulden in Austria-Hungary held the same position as the silver thaler in Germany from 1873 to 1907. It was legal tender, but economically a claim to money, since the bank-of-issue in fact always cashed it on demand.

[9] See my articles "Das Problem gesetzlicher Aufnahme der Barzahlungen in Österreich-Ungarn," *Jahrbuch für Gesetzgebung, Verwaltung und Volkswirtschaft im Deutschen Reich* 33 (1909): 985-1037; "Zum Problem gesetzlicher Aufnahme der Barzahlungen in Österreich-Ungarn," *ibid.* 34 (1910): 1877-84; "The Foreign Exchange Policy of the Austro-Hungarian Bank," *Economic Journal* 19 (1909): 202-11; "Das vierte Privilegium der Österreichisch-Ungarischen Bank," *Zeitschrift für Volkswirtschaft, Sozialpolitik und Verwaltung* 21 (1922): 611-24.

[10] See esp. Hammer, *Die Hauptprinzipien des Geld-und Währungswesens und die Lösung der Valutafrage* (Vienna, 1891), pp. 7 ff.; Gesell, *Die Anpassung des Geldes und seiner Verwaltung an die Bedürfnisse des modernen Verkehres*(Buenos Aires, 1897), pp. 21 ff.; Knapp, *Staatliche Theorie des Geldes*, 3d ed. (Munich, 1921), pp. 20 ff.

[11] See Luschin, *Allgemeine Münzkunde und Geldgeschichte des Mittelalters und der neureren Zeit*(Munich, 1904), P. 215; Babelon, *La théorie féodale de la monnaie (Extrait des mémoires de l'Académie des Inscriptions et Belles-Lettres*, vol. 38, Part I [Paris, 1908], p. 35).

[12] For important references, see Babelon, *op. cit.*, p. 35.

[13] See Seidler, "Die Schwankungen des Geldwertes und die juristische Lehre von dem Inhalt der Geldschulden,"*Jahrbücher für Nationalökonomie und Statistik* (1894), 3d. Series, vol. 7, p. 688.

[14] For earlier conditions in Russia, see Gelesnoff, *Grundzüge der Volkswirtschaftslehre*, trans. into German by Altschul (Leipzig, 1918), p. 357.

[15] See Luschin, *op. cit.*, pp. 221 f.

[16] *Ibid.*, p. 155; Endemann, *Studien in der romanisch-kanonistischen Wirtschafts-und Rechtslehre bis gegen Ende des 17. Jahrhunderts* (Berlin, 1874), vol. 1, pp. 180 ff.

[17] Chevalier, *Cours d'économie politique, III., La monnaie* (Paris, 1850), pp. 21 ff; Goldschmidt,*Handbuch des Handelsrechts* (Erlangen, 1868), vol. 1, Part II, pp. 1073 ff.

--

THE VARIOUS KINDS OF MONEY (Study Guide)

A **money substitute** is a perfectly secure and immediate claim on money. Because the claims themselves can facilitate indirect exchange, they become a "substitute" for the original commodity money.

The definition of *money* should serve the purposes of economic theory, the most important being the explanation of the **purchasing power** of money. For economics, what matters is the actual practices and expectations of individuals in the market, rather than legal formalities.

Commodity money is a common medium of exchange that is also an economic good in its own right. For example, gold, silver, and even tobacco have historically been used as money, and yet people also valued and traded these commodities for other reasons.

Fiat money is accepted as a common medium of exchange *not* because of its technological properties, but because of a special legal designation provided by the appropriate authority. For example, in the current United States "green rectangular pieces of paper" become money when certain ink patterns are placed on them.

Credit money occurs when a claim on a physical or legal person, falling due in the future, is itself used as a medium of exchange.

Some theorists explain the value of money as due to State commands. But the government cannot force people to adopt a particular item as the commonly accepted medium of exchange, let alone to accept it with a particular purchasing power. The government can use its tremendous power to make it more likely that people will adopt a particular item (such as green pieces of paper with certain ink patterns) as money, but economically something is money because of its usage by people in the market. A government edict per se cannot transform it into money.

1. Money and Money Substitutes

A **money substitute** is a perfectly secure and immediate claim on money. For example, suppose the commonly accepted medium of exchange is gold, and a reputable bank issues a paper ticket entitling the bearer to one ounce of gold. So long as people in the community

are certain that they will be paid in physical gold whenever they present the ticket to a branch of the bank, then such tickets are money substitutes and may change hands during purchases the same way physical gold would.

In the market economy, people can issue perfectly secure and immediate claims (i.e., redemption tickets) to all sorts of goods, not just money. But the crucial feature of such claims on money is that the claims themselves can facilitate indirect exchange, and so become a "substitute" for the original commodity money. In other words, pieces of paper entitling the owner to an ounce of gold can circulate in the market the same way actual 1 oz. gold coins would (so long as everyone is assured of immediate redemption).

In principle merchants might never actually turn the tickets in, to receive the physical gold. In contrast, people might trade paper claims guaranteeing the owner to a loaf of bread, but they would eventually redeem them. Such tickets could never become "bread substitutes" because the paper couldn't serve the same function as actual bread.

For economists—as opposed to legal theorists or the businessperson—the definition of *money* should serve the purposes of economic theory. The central task of the economic analysis of money is to explain the exchange ratios between money and all other goods, i.e., to explain the **purchasing power** of money.

Distinguishes between the underlying "**money in the narrower sense**" versus perfectly secure and immediate *claims* to such money, i.e., money substitutes. He concedes that it would be logically consistent to include money substitutes in the definition of *money* itself, but believes his preferred distinction (i.e., between money and money substitutes) will make it easier to explain other phenomena (such as the purchasing power of money, as well as the boombust cycle) more clearly in later chapters. (See the Appendix B on page 231 for a diagram outlining Mises's classification scheme for various items that are often included in the concept of money.)

2. The Peculiarities of Money Substitutes

In the economic analysis of money, what matters is the actual practices and expectations of individuals in the market. For example, whether or not legislation declares that **token coins** are *legally binding* claims on money, if *in practice* the holder of a token can easily exchange it for the "equivalent" amount of actual money, then *economically speaking* the token is a money substitute.

The same principle applies to **banknotes**. For example, conventional accounts say that Austria-Hungary from 1900 to 1914 possessed a **paper standard**, because *legally* the Austro-Hungarian Bank had no obligation to redeem its paper notes for commodity money, and in fact the notes were declared **legal tender**. Yet in practice during this period, the Austro-Hungarian Bank would voluntarily **cash** its paper notes for gold upon request, and so economically speaking Austria-Hungary was on a **gold standard**.

3. Commodity Money, Credit Money, and Fiat Money

Commodity money is a common medium of exchange that is also an economic good in its own right. For example, gold, silver, and even tobacco have historically been used as money, and yet people also valued and traded these commodities for other reasons.

Fiat money is accepted as a common medium of exchange *not* because of its technological properties, but because of a special legal designation provided by the appropriate authority. For example, in the current United States "green rectangular pieces of paper" are not money per se. They only become money when they are cut to exact size and printed with the correct designs by the U.S. Treasury. Thus the green pieces of paper appear to become money by "fiat" (i.e., command) of the U.S. government. However, in economics the definition of money is a commonly accepted medium of exchange. The government can only use its powers to encourage people to use a particular class of items—for example, green pieces of paper with the appropriate ink patterns—as a common medium of exchange; the mere legal declaration isn't what makes them money, economically speaking.

Credit money occurs when a claim on a physical or legal person (e.g., a corporation or government agency), falling due in the future, is itself used as a medium of exchange. To distinguish credit *money* from mere credit, it is necessary that people are generally willing to accept the claim in trade *not* because they want to wait and receive the underlying payment (to which the claim entitles them), but because they expect to be able to easily trade away the claim itself for other goods. For example, suppose a government originally promised to redeem its paper notes immediately upon demand for commodity money (such as gold). But during a war, the government suspends convertibility, so that the paper notes are now not legally binding claims on anything. However, if the public expects that at some point in the future, redeemability will be restored, then the notes would circulate as credit money (not fiat money) because they would be claims to gold falling due in the future (at an uncertain date). So long as the paper notes are considered so **liquid** that virtually everyone is willing to accept them in trade, they are a common medium of exchange and hence money.

4. The Commodity Money of the Past and of the Present

Some theorists explain the value of money as due to State commands. For example, "The monetary unit of the United States is the dollar, because the U.S. government has passed a law." But this is a very inadequate reading of history, because governments cannot simply force a particular good to command a particular *purchasing power* in the market. For example, a king can collect taxes in the form of silver coins, and then **debase** them by melting them down and minting a greater number of coins with less silver content per coin. But the market will react by raising prices (quoted in terms of the coins), and even if the king resorts to **price controls** with draconian penalties, he will cause shortages in accordance with economic law.

On pages 56 –57 , Mises argues that token coinage is not an independent economic concept, but rather **a special type of money substitute**. Token coinage was developed to facilitate small transactions. For example, in a country using gold as its commodity money, it would be awkward to purchase an item with a price of $^1/_{100}$th of an ounce of gold, if customers had to use the physical gold itself. The government might therefore produce a limited number of small discs (perhaps made of copper or nickel) that were stamped with, “Legal Tender, $^1/_{100}$th oz. of gold.” Even though the actual metal content of the tokens would be less, they would nonetheless trade at their face value so long as everyone believed that the government would faithfully exchange one ounce of physical gold for 100 tokens.

The important point is not whether such redemption were a legal requirement, but merely whether *in practice* people expected the option to be available upon demand. (Also note that the “coins” Mises discusses on pages 50 –51 are *not* token coins, but coins consisting of the commodity money. In other words, such coins are valued because they actually *consist of* a recognized weight in gold or silver, not because the holders expect to be able to *redeem* them for gold or silver.)

- In the Misesian scheme, credit money is not the same as a money substitute because the claims constituting credit money are not due immediately, whereas they must be for a true money substitute. Money substitutes are valued the same as the underlying money to which they are claims; a banknote entitling the bearer to one ounce of gold, upon request, will have the same purchasing power as one ounce of gold. However, a corporate bond promising the bearer one ounce of gold in 30 years, if it is to become a credit money and circulate as a common medium of exchange, will be subject to an independent valuation, depending not merely on the reliability of the claim and the wait involved, but also on the liquidity of the bond. (See p. 61.)

. . . .

Banknotes: Paper notes issued by banks, typically entitling the bearer to a specified amount of the money good.

Cash (verb): To redeem a claim (such as a banknote) by paying the specified amount of the money good.

Commodity money: A common medium of exchange that is an economic good in its own right, valued for nonmonetary reasons.

Credit money: A common medium of exchange that is a claim on a person or legal person (such as a corporation or government agency), not falling due until a (possibly uncertain) future date.

Debase: To dilute the value of the money, for example when a ruler introduces “base” metals into the coinage, reducing their precious-metal content.

Fiat money: A common medium of exchange accepted not because of its technological properties, but because of a special legal designation provided by the appropriate authority. Fiat money is not "backed up" by anything else.

Gold standard: The arrangement by which a nation's money (such as the U.S. dollar or the British pound) can be redeemed for a definite weight of gold.

Legal tender: An item that the government declares to be valid for the payment of debts denominated in money, at par value.

Liquid (adjective): The ability of being sold for the full market price with a very short search time. (For example, a share of corporate stock is much more liquid than a house.)

Money in the narrower sense: The actual money good (whether commodity, fiat, or credit money), not including money substitutes.

Money in the broader sense: The actual money good (whether commodity, fiat, or credit money), plus money substitutes.

Money substitute: A perfectly secure and instantly redeemable claim on money, which itself circulates as money (in the broader sense) because it fulfills the functions of money.

Paper standard: The arrangement by which the government does not redeem paper notes for a precious metal. (A paper standard stands in contrast to a gold standard.)

Price controls: Government decrees threatening fines or other punishment for people trading at prices that are either too high (in the case of a price ceiling) or too low (in the case of a price floor).

Purchasing power: The amount of goods and services that a unit of money can command because of the various prices in the market.

Token coins: Coins that serve as representatives of money (usually in very small denominations), even though they do not contain the full weight of metal in the case of a commodity money.

.

Chapter 3: The Various Kinds of Money

. . . .

What is "peculiar" about the fact that people may use claims on money, rather than money itself? How is this peculiarity "explained by reference to the special characteristics of money"? (p. 50)

What does Mises think of the treatment economists had given to money, before his own contribution? (p. 51)

What is the task of economic theory, regarding money? (p. 51)

Explain: “[W]hereas it is impossible to satisfy an increase in the demand, say, for bread by issuing more bread-tickets . . . it is perfectly possible to satisfy an increased demand for money by just such a process as this.” (p. 53)

Would Mises be surprised at the world’s current monetary system? (p. 61)

CHAPTER 4: Money and the State

1 The Position of the State in the Market

The position of the state in the market differs in no way from that of any other parties to commercial transactions. Like these others, the state exchanges commodities and money on terms which are governed by the laws of price. It exercises its sovereign rights over its subjects to levy compulsory contributions from them; but in all other respects it adapts itself like everybody else to the commercial organization of society. As a buyer or seller the state has to conform to the conditions of the market. If it wishes to alter any of the exchange ratios established in the market, it can only do this through the market's own mechanism. As a rule it will be able to act more effectively than anyone else, thanks to the resources at its command outside the market. It is responsible for the most pronounced disturbances of the market because it is able to exercise the strongest influence on demand and supply. But it is nonetheless subject to the rules of the market and cannot set aside the laws of the pricing process. In an economic system based on private ownership of the means of production, no government regulation can alter the terms of exchange except by altering the factors that determine them.

Kings and republics have repeatedly refused to recognize this. Diocletian's edict *de pretiis rerum venalium*, the price regulations of the Middle Ages, and the maximum prices of the French Revolution are the most well-known examples of the failure of authoritative interference with the market. These attempts at intervention were not frustrated by the fact that they were valid only within the state boundaries and ignored elsewhere. It is a mistake to imagine that similar regulations would have led to the desired result even in an isolated state. It was the functional, not the geographical, limitations of the government that rendered them abortive. They could have achieved their aim only in a socialistic state with a centralized organization of production and distribution. In a state that leaves production and distribution to individual enterprise, such measures must necessarily fail of their effect.

The concept of money as a creature of law and the state is clearly untenable. It is not justified by a single phenomenon of the market. To ascribe to the state the power of dictating the laws of exchange, is to ignore the fundamental principles of money-using society.

2 The Legal Concept of Money

When both parties to an exchange fulfill their obligations immediately and surrender a commodity for ready cash, there is usually no motive for the judicial intervention of the state. But when the exchange is one of present goods against future goods it may happen that one party fails to fulfill his obligations although the other has carried out his share of the contract. Then the judiciary may be invoked. If the case is one of lending or purchase on credit, to name only the most important examples, **the court has to decide how a debt contracted in terms of money can be liquidated.** Its task thus becomes that of determining, in accordance with the intent of the contracting parties, what is to be understood by *money* in commercial transactions. From the legal point of view, money is not the common medium of exchange, but the common medium of payment or debt settlement. But money only becomes a medium of payment by virtue of being a medium of exchange. And it is only because it is a medium of exchange that the law also makes it the medium for fulfilling obligations not contracted in terms of money, but whose literal fulfillment is for some reason or other impossible.

The fact that the law regards money only as a means of canceling outstanding obligations has important consequences for the legal definition of money. What the law understands by money is in fact not the common medium of exchange but the legal medium of payment. It does not come within the scope of the legislator or jurist to define the economic concept of money.

In determining how monetary debts may be effectively paid off there is no reason for being too exclusive. It is customary in business to tender and accept in payment certain money substitutes instead of money itself. If the law refused to recognize the validity of money substitutes that are sanctioned by commercial usage, it would only open the door to all sorts of fraud and deceit. This would offend against the principle *malitiis non est indulgendum*. Besides this, the payment of small sums would, for technical reasons, hardly be possible without the use of token money. Even ascribing the power of debt settlement to banknotes does not injure creditors or other recipients in any way, so long as the notes are regarded by the businessman as equivalent to money.

But the state may ascribe the power of debt settlement to other objects as well. The law may declare anything it likes to be a medium of payment, and this ruling will be binding on all courts

and on all those who enforce the decisions of the courts. But bestowing the property of legal tender on a thing does not suffice to make it money in the economic sense. **Goods can become common media of exchange only through the practice of those who take part in commercial transactions;** and it is the valuations of these persons alone that determine the exchange ratios of the market. Quite possibly, commerce may take into use those things to which the state has ascribed the power of payment; but it *need* not do so. It may, if it likes, reject them.

Three situations are possible when the state has declared an object to be a legal means of fulfilling an outstanding obligation. First, the legal means of payment may be identical with the medium of exchange that the contracting parties had in mind when entering into their agreement; or, if not identical, it may yet be of equal value with this medium at the time of payment. For example, the state may proclaim gold as a legal medium for settling obligations contracted in terms of gold, or, at a time when the relative values of gold and silver are as 1 to 15½, it may declare that liabilities in terms of gold may be settled by payment of 15½ times the quantity of silver. Such an arrangement is merely the legal formulation of the presumable intent of the agreement. It damages the interests of neither party. It is economically neutral.

The case is otherwise when the state proclaims as medium of payment something that has a higher or lower value than the contractual medium. The first possibility may be disregarded; but the second, of which numerous historical examples could be cited, is important. From the legal point of view, in which the fundamental principle is the protection of vested rights, such a procedure on the part of the state can never be justified, although it might sometimes be vindicated on social or fiscal grounds. But it always means, not the fulfillment of obligations, but their complete or partial cancellation. When notes that are appraised commercially at only half their face value are proclaimed legal tender, this amounts fundamentally to the same thing as granting debtors legal relief from half of their liabilities.

State declarations of legal tender affect only those monetary obligations that have already been contracted. But commerce is free to choose between retaining its old medium of exchange or creating a new one for itself, and when it adopts a new medium, so far as the legal power of the contracting parties reaches, it will attempt to make it into a standard of deferred payments also, in order to deprive of its validity, at least for the future, the standard to which the state has ascribed complete powers of debt settlement. When, during the last decade of the nineteenth century, the bimetallist party in Germany gained so much power that the possibility of experiment with its inflationist proposals had to be reckoned with, gold clauses began to make their appearance in long-term contracts. The recent period of currency depreciation has had a similar

effect. If the state does not wish to render all credit transactions impossible, it must recognize such devices as these and instruct the courts to acknowledge them. And, similarly, when the state itself enters into ordinary business dealings, when it buys or sells, guarantees loans or borrows, makes payments or receives them, it must recognize the common business medium of exchange as money. The legal standard, the particular group of things that are endued with the property of unlimited legal tender, is in fact valid only for the settlement of existing debts, unless business usage itself adopts it as a general medium of exchange.

3 The Influence of the State on the Monetary System

State activity in the monetary sphere was originally restricted to the manufacture of coins. To supply ingots of the greatest possible degree of similarity in appearance, weight, and fineness, and provide them with a stamp that was not too easy to imitate and that could be recognized by everybody as the sign of the state coinage, was and still is the premier task of state monetary activity. Beginning with this, the influence of the state in the monetary sphere has gradually extended.

Progress in monetary technique has been slow. At first, the impression on a coin was merely a proof of the genuineness of its material, including its degree of fineness, while the weight had to be separately checked at each payment. (In the present state of knowledge this cannot be stated dogmatically; and in any case the development is not likely to have followed the same lines everywhere.) Later, different kinds of coins were distinguished, all the separate coins of any particular kind being regarded as interchangeable. The next step after the innovation of classified money. was the development of the parallel standard. This consisted in the juxtaposition of two monetary systems, one based on gold commodity money, and one on silver. The coins belonging to each separate system constituted a self-contained group. Their weights bore a definite relation to each other, and the state gave them a legal relation also, in the same proportion, by sanctioning the commercial practice which had gradually been established of regarding different coins of the same metal as interchangeable. This stage was reached without further state influence. All that the state had done till then in the monetary sphere was to provide the coins for commercial use. As controller of the mint, it supplied in handy form pieces of metal of specific weight and fineness, stamped in such a way that everybody could recognize without difficulty what their metallic content was and whence they originated. As legislator, the state attributed legal tender to these coins—the significance of this has just been expounded—and as judge it applied this legal provision. But the matter did not end at this stage. For about the last two hundred years the influence of the state on the monetary system has been greater than this. One thing, however,

must be made clear; even now the state has not the power of directly making anything into money, that is to say into a common medium of exchange. Even nowadays, it is only the practice of the individuals who take part in business that can make a commodity into a medium of exchange. But the state's influence on commercial usage, both potential and actual, has increased. It has increased, first, because the state's own importance as an economic agent has increased; because it occupies a greater place as buyer and seller as payer of wages and levier of taxes, than in past centuries. In this there is nothing that is remarkable or that needs special emphasis. It is obvious that the influence of an economic agent on the choice of a monetary commodity will be the greater in proportion to its share in the dealings of the market; and there is no reason to suppose that there should be any difference in the case of the one particular economic agent, the state.

But, besides this, the state exercises a special influence on the choice of the monetary commodity, which is due not to its commercial position nor to its authority as legislator and judge, but to its official standing as controller of the mint and to its power to change the character of the money substitutes in circulation.

The influence of the state on the monetary system is usually that ascribed to its legislative and judicial authority. It is assumed that the law, which can authoritatively alter the tenor of existing debt relations and force new contracts of indebtedness in a particular direction, enables the state to exercise a deciding influence in the choice of the commercial medium of exchange.

Nowadays the most extreme form of this argument is to be found in Knapp's *State Theory of Money*;[1] but very few German writers are completely free from it. Helfferich may be mentioned as an example. It is true that this writer declares, with regard to the origin of money, that it is perhaps doubtful whether it was not the function of common medium of exchange alone that sufficed to make a thing money and to make money the standard of deferred payments of every kind. Nevertheless, he constantly regards it as quite beyond any sort of doubt that for our present economic organization certain kinds of money in some countries, and the whole monetary system in other countries, are money, and function as a medium of exchange, only because compulsory payments and obligations contracted in terms of money must or may be fulfilled in terms of these particular objects. [2]

It would be difficult to agree with views of this nature. They fail to recognize the meaning of state intervention in the monetary sphere. By declaring an object to be fitted in the juristic sense for the liquidation of liabilities expressed in terms of money, the state cannot influence the choice of

a medium of exchange, which belongs to those engaged in business. History shows that those states that have wanted their subjects to accept a new monetary system have regularly chosen other means than this of achieving their ends.

The establishment of a legal ratio for the discharge of obligations incurred under the regime of the superseded kind of money constitutes a merely secondary measure which is significant only in connection with the change of standard which is achieved by other means. The provision that taxes are in future to be paid in the new kind of money, and that other liabilities imposed in terms of money will be fulfilled only in the new money, is a *consequence* of the transition to the new standard. It proves effective only when the new kind of money has become a common medium of exchange in commerce generally. A monetary policy can never be carried out merely by legislative means, by an alteration in the legal definitions of the content of contracts of indebtedness and of the system of public expenditure; it must be based on the executive authority of the state as controller of the mint and as issuer of claims to money, payable on demand, that can take the place of money in commerce. The necessary measures must not merely be passively recorded in the protocols of legislative assemblies and official gazettes, but—often at great financial sacrifice—must be actually put into operation.

A country that wishes to persuade its subjects to go over from one precious-metal standard to another cannot rest content with expressing this aspiration in appropriate provisions of the civil and fiscal law. It must make the new money take the commercial place of the old. Exactly the same is true of the transition from a credit-money or fiat-money standard to commodity money. No statesman faced with the task of such a change has ever had even a momentary doubt about the matter. It is not the enactment of a legal ratio and the order that taxes are to be paid in the new money that are the decisive steps, but the provision of the necessary quantity of the new money and the withdrawal of the old.

This may be confirmed by a few historical examples. First, the impossibility of modifying the monetary system merely by the exercise of authority may be illustrated by the ill success of bimetallistic legislation. This was once thought to offer a simple solution of a big problem. For thousands of years, gold and silver had been employed side by side as commodity money; but the continuance of this practice had constantly grown more burdensome, for the parallel standard, or simultaneous employment as currency of two kinds of commodity, has many disadvantages. Since no spontaneous assistance was to be expected from the individuals engaged in business, the state decided to intervene in the hope of cutting the Gordian knot. Just as it had previously removed certain obvious difficulties by declaring that debts contracted in terms of thalers might be

discharged by payment of twice as many half-thalers or four times as many quarter-thalers, so it now proceeded to establish a fixed ratio between the two different precious metals. Debts payable in silver, for instance, could be discharged by payment of 1 : 15½ times the same weight of gold. It was thought that this had solved the problem, while in fact the difficulties that it involved had not even been suspected; as events were to prove. All the results followed that are attributed by Gresham's law to the legislative equating of coins of unequal value. In all debt settlements and similar payments, only that money was used which the law rated more highly than the market. When the law had happened to hit upon the existing market ratio as its par, then this effect was delayed a little until the next movement in the prices of the precious metals. But it was bound to occur as soon as a difference arose between the legislative and the market ratios of the two kinds of money. The parallel standard was thus turned, not into a double standard, as the legislators had intended, but into an alternative standard.

The primary result of this was a decision, for a little while at least, between the two precious metals. Not that this was what the state had intended. On the contrary, the state had no thought whatever of deciding in favor of the use of one or the other metal; it had hoped to secure the circulation of both. But the official regulation, which in declaring the reciprocal substitutability of gold and silver money overestimated the market ratio of the one in terms of the other, merely succeeded in differentiating the utility of the two for monetary purposes. The consequence was the increased employment of one of the metals and the disappearance of the other. The legislative and judicial intervention of the state had completely failed. It had been demonstrated, in striking fashion, that the state alone could not make a commodity into a common medium of exchange, that is, into money, but that this could be done only by the common action of all the individuals engaged in business.

But what the state fails to achieve through legislative means may be to a certain degree within its power as controller of the mint. It was in the latter capacity that the state intervened when the alternative standard was replaced by permanent monometallism. This happened in various ways. The transition was quite simple and easy when the action of the state consisted in preventing a return to the temporarily undervalued metal in one of the alternating monometallic periods by rescinding the fight of free coinage. The matter was even simpler in those countries where one or the other metal had gained the upper hand before the state had reached the stage necessary for the modern type of regulation, so that all that remained for the law to do was to sanction a situation that was already established.

The problem was much more difficult when the state attempted to persuade businessmen to abandon the metal that was being used and adopt the other. In this case, the state had to manufacture the necessary quantity of the new metal, exchange it for the old currency, and either turn the metal thus withdrawn from circulation into token coinage or sell it for nonmonetary use or for recoinage abroad. The reform of the German monetary system after the foundation of the Reich in 1871 may be regarded as a perfect example of the transition from one metallic commodity standard to another. The difficulties that this involved, and that were overcome by the help of the French war indemnity, are well known. They were involved in the performance of two tasks—the provision of the gold and the disposal of the silver. This and nothing else was the essence of the problem that had to be solved when the decision was taken to change the standard. The Reich completed the transition to gold by giving gold and claims to gold in exchange for the silver money and claims to silver money held by its citizens. The corresponding alterations in the law were mere accompaniments of the change. [3]

The change of standard occurred in just the same way in Austria-Hungary, Russia, and the other countries that reformed their monetary systems in the succeeding years. Here also the problem was merely that of providing the requisite quantities of gold and setting them in circulation among those engaged in business in place of the media previously employed. This process was extraordinarily facilitated and, what was even more to the point, the amount of gold necessary for the changeover was considerably decreased, by the device of permitting the coins constituting the old fiat money or credit money to remain wholly or partly in circulation, while fundamentally changing their economic character by transforming them into claims that were always convertible into the new kind of money. This gave a different outward appearance to the transaction, but it remained in essence the same. It is scarcely open to question that the steps taken by those countries that adopted this kind of monetary policy consisted essentially in the provision of quantities of metal.

The exaggeration of the importance in monetary policy of the power at the disposal of the state in its legislative capacity can only be attributed to superficial observation of the processes involved in the transition from commodity money to credit money. This transition has normally been achieved by means of a state declaration that inconvertible claims to money were as good means of payment as money itself. As a rule, it has not been the object of such a declaration to carry out a change of standard and substitute credit money for commodity money. In the great majority of cases, the state has taken such measures merely with certain fiscal ends in view. It has aimed to increase its own resources by the creation of credit money. In the pursuit of such a plan as this, the diminution of the money's purchasing power could hardly seem desirable. And yet it has

always been this depreciation in value which, through the coming into play of Gresham's law, has caused the change of monetary standard. It would be quite out of harmony with the facts to assert that cash payments had ever been stopped; that is, that the permanent convertibility of the notes had been suspended, with the intention of effecting a transition to a credit standard. This result has always come to pass against the will of the state, not in accordance with it.

Business usage alone can transform a commodity into a common medium of exchange. It is not the state, but the common practice of all those who have dealings in the market, that creates money. It follows that state regulation attributing general power of debt liquidation to a commodity is unable of itself to make that commodity into money. If the state creates credit money—and this is naturally true in a still greater degree of fiat money—it can do so only by taking things that are already in circulation as money substitutes (that is, as perfectly secure and immediately convertible claims to money) and isolating them for purposes of valuation by depriving them of their essential characteristic of permanent convertibility. Commerce would always protect itself against any other method of introducing a government credit currency. The attempt to put credit money into circulation has never been successful, except when the coins or notes in question have already been in circulation as money substitutes. [4]

This is the limit of the constantly overestimated influence of the state on the monetary system. What the state can do in certain circumstances, by means of its position as controller of the mint, by means of its power of altering the character of money substitutes and depriving them of their standing as claims to money that are payable on demand, and above all by means of those financial resources which permit it to bear the cost of a change of currency, is to persuade commerce to abandon one sort of money and adopt another. That is all.

---

[1] Knapp, *Staatliche Theorie des Geldes*(3d. ed., 1921); trans. into English by H. M. Lucas and J. Bonar as *The State Theory of Money* (London, 1924).

[2] See Helfferich, *Das Geld*, 6th ed. (Leipzig, 1923), p. 294; English trans., *Money* (London, 1927), p. 312.

[3] See Helfferich, *Die Reform des deutschen Geldwesens nach der Gründung des Reiches* (Leipzig, 1898), vol. 1, pp. 307 ff; Lotz, *Geschichte und Kritik des deutschen Bankgesetzes vom 14. März 1875* (Leipzig, 1888), pp. 137 ff.

[4] See Subercaseaux, *Essai sur la nature du papier monnaie* (Paris, 1909), pp. 5 ff.

--

THE STATE

Unless it resorts to outright socialism, the State must conform to the market. Its actions in the market are governed by the Laws of Price. In this respect, the State has more influence than any other entity, but this is due to the State's enormous budget.

In economics, money is a common medium of exchange. But from the legal point of view, money is a common medium of payment or debt settlement. Money can only serve this function (as a medium of debt settlement) because it is a medium of exchange. This is clear when we consider cases where a contract cannot be fulfilled as written, and so the court specifies a monetary payment instead.

Government cannot force people to attribute a certain exchange value to a good. The legal system can certainly allow debtors to "satisfy" their contractual liabilities by paying with items at a face value higher than what the creditors actually believe they are worth, but this merely means a partial repudiation of the debt.

Originally the State's only role in the monetary sphere was to supply recognizable coins that were hard to counterfeit and that were very similar in appearance, weight, and fineness. By producing suitable coins, the State was merely facilitating commerce, because merchants wouldn't need chemical tests and scales to evaluate the gold or silver their customers presented in payment.

The State's influence in the monetary sphere has grown because its size has grown, but also because of its control of the mint: The State can withdraw coins of one metal and replace them with coins of a different metal. The State also influences the monetary sphere through its ability to suspend the immediate redemption of money substitutes, converting them into credit money or even fiat money.

1. The Position of the State in the Market

Although it commands a large influence because of its power to tax, ultimately the State must conform to the market. Unless it completely abolishes private property and forms a socialist State, the government can only successfully change market prices through its own decisions to buy and sell. The same is true of money: mere government edicts cannot explain the purchasing power of a common medium of exchange.

2. The Legal Concept of Money

In economics, money is a common medium of exchange. But from the legal point of view, money is a common medium of payment or debt settlement. If a contract calls for one party to pay back a loan of "100 ounces of gold, plus 5 ounces in interest" in one year, the legal

system must specify what types of goods are acceptable to satisfy the contract. (For example, must it be done in physical gold, or can a banknote or a check written on a bank account—denominated in gold—satisfy the debt? What about token coins that can be exchanged for gold?) However, money can only serve this function (as a medium of debt settlement) because it is a medium of exchange. This is clear when we consider cases where a contract cannot be fulfilled as written, and so the court specifies a monetary payment instead.

Government cannot force people to attribute a certain exchange value to a good. The legal system can certainly allow debtors to "satisfy" their contractual liabilities by paying with items at a face value higher than what the creditors actually believe they are worth, but this merely means a partial repudiation of the debt.

3. The Influence of the State on the Monetary System

Originally the State's only role in the monetary sphere was to supply coins of the greatest possible degree of similarity in appearance, weight, and fineness. Furthermore, to do its task well the State would manufacture coins that were hard to counterfeit, and that bore a recognizable stamp. In this regard, the State wasn't *defining* money, but was instead merely taking what *the market* had chosen as the money—for example, gold—and then producing hunks of the money in convenient shapes. By producing suitable coins, the State was merely facilitating commerce: if everyone recognized the State's one-ounce gold coin, and knew that it was genuine, then merchants wouldn't have to resort to chemical tests and scales to evaluate the yellow metal their customers presented in payment.

The State's influence in the monetary sphere has grown because its size (relative to the economy) has grown, but also because of its control of the mint. The State can exert great power over what its subjects choose as the common medium of exchange, since it can (for example) withdraw coins of one metal and replace them with coins of a different metal. Even so, the State cannot avoid the laws of economics. The failed attempts at **bimetallist legislation**—where the government established a fixed ratio between the value of gold and silver—showed the operation of **Gresham's Law**.

That is, when the actual market values of gold and silver deviated from the legal ratio, people would hoard the undervalued metal and try to spend the overvalued metal.
The State also influences the monetary sphere through its ability to suspend the immediate redemption of money substitutes, converting them into credit money or even fiat money.

- Carl Menger's explanation of the origin of money (laid out inchapter) offers a satisfactory rebuttal to the "State theory of money" offered by Knapp and other theorists. (p. 73) If an Austrian economist disputes the theory that money derives its value from the State, the argument is more compelling if the Austrian can show—using Menger's approach—how money arose spontaneously on the market.

- In this chapter we already see the benefit of Mises's fastidious classification scheme regarding money. Armed with his categories of money substitutes, commodity money, and credit money, Mises can explain exactly *how* a State influences the money used by its subjects. While many others place great importance

on State legislation regarding tax payments and debt contracts, Mises instead looks at the State's role in minting coins and its power to change money substitutes into credit money (by suspending immediate redemption of the claims to money). (pp. 77 –78)

Bimetallist legislation: Efforts by the government to establish a fixed conversion ratio between gold and silver. For example, the government might require that merchants who post a price in gold ounces, also accept payment in silver ounces at a fixed multiple of the gold price.

Gresham's Law: Popularly summarized as "bad money drives out good," the phenomenon by which people will hold money that is undervalued by legislation, and will spend the money that is overvalued by legislation. For example, if bimetallist legislation requires that merchants accept silver and gold at the ratio of 16 -to-1, when in fact the actual market exchange rate is 20 -to-1, then everyone will try to buy with silver, and no one will use gold for making purchases. Gold will seem to disappear, and only silver will be used in commerce. For a different example, if the government passes legal tender laws on all government-stamped coins, then coins with low metal value (such as U.S. quarters minted in the year 2000) will circulate in trade, whereas coins with high metal content (such as U.S. quarters minted in the year 1950) will be hoarded by people who recognize the value of the silver.

. . . .

Explain: "When notes that are appraised commercially at only half their face-value are proclaimed legal tender, this amounts fundamentally to the same thing as granting debtors legal relief from half of their liabilities." (p. 71)

Explain: "State declarations of legal tender affect only those monetary obligations that have already been contracted." (p. 71)

What are the two mechanisms through which the "State's influence on commercial usage, both potential and actual, has increased"? (pp. 72 –73)

Explain: "A country that wishes to persuade its subjects to go over from one precious-metal standard to another cannot rest content with expressing this aspiration in appropriate provisions of the civil and fiscal law." (p. 74)

Explain: "The parallel standard was thus turned, not into a double standard, as the legislators had intended, but into an alternative standard." (p. 75)