

# **How Privatized Banking *Really Works***

*Integrating Austrian Economics with  
the Infinite Banking Concept*

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## Chapter 4

### Losing Our Spirit

*The most efficient organization in the world is not any group of people but a single person. A normal person can conceive a plan, figure out how to carry it out, and communicate the orders to do the task to his faculties instantly, with minimum likelihood they will be misinterpreted... Moreover, an individual who owns his own material, has put up the investment for an undertaking, and stands to gain whatever profits arise from the enterprise, must have the greatest incentive to do the job well.*

—Clarence B. Carson<sup>i</sup>

**I**n a country such as ours, with some 300 million inhabitants, it is important to realize that not all people produce during their entire lifetime. For example, infants certainly do not produce. The elderly or otherwise incapacitated, do not produce. We can say that the unemployed, while they remain unemployed, are not producers. And then there is that large segment of society which depends entirely on government support. These people are obviously not producers either. But, although we are all not producers, we are all *consumers*. No one knows this better than the *entrepreneur*.

Entrepreneurs are those unique individuals who are constantly assessing human *wants* and formulating ideas to meet those wants. They pay special attention to the most urgent wants

and determine the best means and uses of scarce resources to satisfy them. They are unique people in that their unusual personality, their creativity, their use of imagination is not learned nor can it be taught, but is rather inherently possessed and cultivated. Their judgment of the facts of an uncertain future is a cut above the rest of society. They act on their strong opinions of what *could be*, many times against great odds and risk! They are always on the alert for a means of making *profit* in areas where they can earn more than the going rate of *interest*. Our world's superior standard of living is a direct result of what these entrepreneurs have set in motion. These men and women are the true stimulus to an economy. In fact, they are the economy's ***life blood***.

The term entrepreneur is derived from the French word which means "*a person who organizes and manages a business undertaking, assuming the risk for the sake of profit.*" More specifically, his role is that of the individual who brings together the various means of production to their final useful end. In essence he takes the elements of production which are *land, labor* and *capital* and "mixes" them in such a way that a product or service results. The entrepreneur can be a great industrialist or he can be a farmer operating on a parcel of land.

One thing is certain: producing a product or service is not for the faint of heart. The endeavor is filled with uncertainty, beginning first with the simple fact that the product or service may not sell! The idea of having to gauge wants and needs from infinite human desires is all calculated guess work! The quantities, categories, styles, size, weight—an endless variety of considerations like these, can easily be overestimated. Plus, undertaking production may be on borrowed money or credit and interest rates may rise. What about competition? All of these factors are uncertainties. Obviously, one prominent characteristic of the entrepreneur is that of risk taker. Without question he is an individual who operates one step away from total failure, a lifestyle not for everyone in society. To the outsider the entrepreneur appears to be a person of great independence with power to wield in an organization. In reality the entrepreneur is at all times keenly aware of the perilous risks he must take in making his decisions. As Rothbard explains:

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The entrepreneur is not creating uncertainties for the fun of it. On the contrary, he tries to reduce them as much as possible. The uncertainties he confronts are already inherent in the market situation, indeed in the nature of human action; someone must deal with them, and he is the most skilled or willing candidate.<sup>ii</sup>

## **The Market**

The entrepreneur's arena is the market place. Anywhere two or more people meet to engage in buying and selling is a market. Economists refer to "*the market*" as a concept, knowing that markets exist everywhere in great varieties and numbers, with things common to all. The varieties and kinds of products and services in a nation such as ours are complex and extensive. It boggles the mind to gauge the demand for such products and services against existing or non-existing supplies.

And what about setting prices for all these goods and services? Who or what determines price? Certainly, the cost of production will play an important role in pricing, but since people acting in the market tend to buy the highest quality goods at the lowest prices possible, cost of production is always subordinated to supply and demand. In effect, cost of production is irrelevant to the buyer.

Another factor to consider, is that all markets will invariably have competition. A successful product or service will quickly have many imitators. Competitors can run away with much needed sales! This phenomenon is most clearly seen in fads, trends, and styles that can create windfall profits for some producers while completely destroying others. An entrepreneur enters this arena and carefully calculates the pros and cons of his planned innovation. It is the action he takes that starts the whole ball rolling. It is a most courageous undertaking. The environment is filled with uncertainty. Yet, this is what he does and society reaps the rewards.

All things being equal, the unhampered market has always been seen by classical theorists as a mighty and efficient instrument of social order. For example: with regards to prices, the market itself eventually dictates the "*going price*" because a price in a free market is the amount a willing seller will take and willing buyer will pay. In other words,

prices are arrived at by agreement between buyer and seller. Even the simplest purchase involves an unspoken agreement. This market price is the result of the interplay of a changing supply and demand because these elements are dynamic. Nothing in the free market stands still for long. And as far as competition goes, it and it alone is the stimulant to market efficiency, both in price and quality. Competition keeps producers from charging exorbitant prices. It is actually the friend of the consumer. Therefore, in what can only be explained as a true marvel, the free and unhampered market operates like an “invisible hand,” as Adam Smith described it, or in Rothbard’s description:

[T]he “free market”...creates a delicate and even awe-inspiring mechanism of harmony, adjustment, and precision in allocating productive resources, deciding upon prices, and gently but swiftly guiding the economic system toward the greatest possible satisfaction of the desires of all the consumers.<sup>iii</sup>

## Malinvestments

Every entrepreneur invests in a process of production because he expects to make a profit; however, it is an error to think of the economy in which he operates as being made up of only profits. In reality it is a profit *and loss* economy. A loss occurs when an entrepreneur has made poor judgments in estimating his future prices and sales. He understands that a free market rewards its efficient entrepreneurs and penalizes its inefficient ones. His goal is to be efficient; however, his biggest problem is that profit and losses are intertwined with the going *interest returns*. It is this **rate of interest**, especially when artificially manipulated, which ultimately creates the greatest threat to his success. This process of artificial manipulation is hidden. He does not see it coming. In effect he is tricked! The results, of course, are always disastrous—business losses, business failure or bankruptcy. For society at large the results are massive unemployment, recessions, depressions and the dangerous possibility of a complete collapse of the monetary system. As Austrian economist Hans Sennholz writes:

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Inflation and credit expansion always precipitates business maladjustments and malinvestments that must later be liquidated. The expansion artificially reduces and thus falsifies interest rates, and thereby misguides businessmen in their investment decisions. In the belief that declining rates indicate growing supplies of capital savings, they embark upon new production projects. The creation of money gives rise to an economic boom. It causes prices to rise, especially prices of capital goods used for business expansion. But these prices constitute business costs. They soar until business is no longer profitable, at which time the decline begins. In order to prolong the boom, the monetary authorities may continue to inject new money until finally frightened by the prospects of a runaway inflation. The boom that was built on the quicksand of inflation then comes to a sudden end.<sup>iv</sup>

## **Capital Formation**

It is difficult for entrepreneurs to put enough money aside to invest in even a small business enterprise. In this century, entrepreneurs have learned to organize in order to raise enough money to go into business. Aside from borrowing, the most common way is partnering with others who have saved money to put up for capital. However, the greatest limitation to partnerships is that there is no shield against creditors in case of business failure. The individual partners can be held individually liable for all debts of the partnership. Consequently, partnerships are most often very small enterprises. In fact most businesses in the United States are small: The latest figures from the U.S. Census Bureau list 25,409,525 businesses in the United States, of which only 5,885,784 have one or more employees. All the others do not report a payroll.

The most widely used method for raising money for a business is the *corporation*. A corporation is an independent entity created by individuals—an agreement recognized by law. Interestingly, corporations at one time were instruments of the King. It was not until the mid 19<sup>th</sup> century that corporations were first used for means of raising capital. Initially, however, corporations were solely a privilege of powerful families or politically connected individuals.

Today, the selling of stock for purposes of raising capital is commonplace. The corporation's greatest attraction is the opposite of the partnership. The liability of the corporation's investors is *limited* to the extent of the amount invested. In other words, if the corporation should go bankrupt, the investors can just walk away without any harm to their reputation or personal pocketbook. A stockholder, if he is not an officer or director, may not even need to concern himself with the business enterprise or its production. For this reason many investors can and do own shares of stock in corporations.

We should point out that because of the manner in which stock shares are owned, there is an overly concentrated emphasis on profitability—the “bottom line”—above anything else. To the stockholder the dividend per share and the price each share will bring in the market are the main concerns. This fact is proven repeatedly in the stock market.

In addition to selling stock shares, corporations can also raise money through the issuance of debt instruments, such as bonds or debentures. These types of securities, as well as the shares of stock, can be transferred at will.

Of prime importance to this discussion is the enormous growth in the buying and selling activity of these securities since the corporation has become the dominant force for raising money. In modern economies this activity has become one of the largest forms of concentrated funds. Two other forms of concentrated funds are banks and insurance companies. Banks are depositories for money and are generally understood to be lending institutions, but their financial activities extend beyond these simple limits. A closer look at banks and how they operate will be examined more carefully in the next chapter. What is important to note here is that banks are themselves corporations.

Insurance companies may also be corporations, some are privately owned, some owned by a large number of stockholders. Mutual insurance companies are exclusively owned by the policy holders. The point is that insurance companies, like banks, take in enormous amounts of money. This money comes in the form of

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premium payments. A portion of this money is not expected to be paid to beneficiaries for many years, therefore, the money is kept invested in short and long term investments. Consequently, insurance companies, like other large corporations, are a major source of capital. We will also explore insurance companies in more detail later. But we begin to get a picture of the vastness and complexity of our capitalistic system, the flow of money and where its areas of concentration can be found.

## **The Stock Market**

There is a strange phenomenon with regards to corporations, securities and the stock market which merits discussion here: Americans hold a belief that the stock market is the driving force behind corporations and American industry. Many believe declining stock prices on the New York Stock Exchange or NASDAQ and other exchanges signifies that the entire national economy is declining, and that rising stock prices indicate that prosperity is ahead. This is indeed a strange reaction to the stock market. Most Americans do not feel that way about other products and services when they go up or down in price. Why should stocks be any different? Clearly it is the manner the stock market news is reported by the media, however, the major culprit is misinformation about the stock market and how it functions.

The New York Stock Exchange, the NASDAQ and the several other stock exchanges in the United States, including those abroad, are just that, *exchanges*. As Professor Carson notes, the entrepreneur would more properly refer to it as the *used stock market* because that is all that is offered for sale, ***used stock!*** New stock issues that are sold in return for money are not offered on these types of exchanges. Actual wealth or capital is transferred to the corporation at the time of the initial public offering of the stock, or IPO. This is a one-time event. It represents the true stock market for the corporation, occurring whenever IPOs are offered to the public for sale. Some financial firms specialize in these special securities, but the point here is that the stock exchanges, as in the New York Stock Exchange or the NASDAQ, for all the daily trading they do, provide no capital whatsoever for American industry.



Also, individuals who buy and sell stocks are frequently referred to as “investors.” This too, can be confusing. We must not forget that these individuals are only buying and trading shares. Although they may be purchasing a return in dividends, their real motivation to buy a stock is for the opportunity to sell at a profit when prices rise. In effect, they are really *speculators*. They are primarily focusing on the *exchange value* of the commodity. This is why purchasers of stocks only want *bull markets*. On the stock exchanges, speculation is rewarded by the rising price of a stock. When prices fall, all those who bet on the increase will lose. It is this anticipatory element that defines speculation.

For example: On the famous “*Black Monday*,” October 19, 1987, the stock market was shocked by the loss of \$500 billion in one day. In reality this colossal amount of wealth simply vanished into thin air because it existed only in the quoted price of the stocks on the stock exchange. Factories and computers didn’t disappear on Black Monday; doctors and engineers didn’t forget their skills. All that happened on Black Monday was that the prices of many corporations’ shares of stock plummeted.

Do not misunderstand; stock speculators *do* serve a social purpose. By selling (or “shorting”) overvalued shares and buying undervalued ones, speculators help correct mispriced stocks. It is important for stocks to have the “right” market price, because the stockholders are the actual owners of the corporation and are ultimately responsible for its fate. With accurate share prices, these owners understand just how socially valuable their property is, and will have the incentive to exercise the appropriate amount of oversight.<sup>v</sup>

However, important as stock speculation is, *it is not an activity for the average household*, and certainly should not be confused with old-fashioned *saving*. The typical American has been conditioned to believe that investing in the stock market is *the same thing as* “saving for retirement.” Americans have been lulled into a false sense of security, in which investing in tech stocks is admittedly classified as “speculative” and “risky,” while investing in the whole S&P 500 is considered the epitome of caution. But even people with a “diversified” portfolio can lose 40 percent in a single year, as recent events have shown!

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Additionally, we are pointing to the fact that stock trading can be a highly emotionally charged activity. False signals are frequently sent into the economy by either overvaluing or undervaluing particular stocks. Naturally, when prices start to rise, trading tends to become irrational. Predictably, people panic when prices fall. Much of the liquidity crisis created during the Crash of 1929 was that the irrational thinking created by skyrocketing prices made a lot of stock speculators borrow on credit (margin), or from other lenders, in order to buy stocks. Buying stocks on credit has the potential to achieve greater gains, however, as prices plummeted, speculators who did not get out in time scrambled for cash to meet their obligations. Of course the cash was nowhere to be found and huge losses were incurred by many.

A similar situation occurred during the recent inflation of prices in the housing market. Many borrowed from their home equity on home prices that were overinflated in order to buy even more real estate. Great losses were suffered by those who did not flip those purchases fast enough before market prices on homes crashed.

Erratic movement in the stock market is prompted by other outside forces which we know to be artificial bubbles in the economy, caused by monetary policy. Austrian economists refer to them as “*boom and bust business cycles*.” Nevertheless, one still wonders why people speculate on stocks? What is the attraction? While it is true that some professional traders have the ability to profit on prices going up or down and can exit the market quickly, not everyone has this advantage. Furthermore, it is still *speculation*. No one can predict with accuracy each and every time. Many have discovered too late that speculation in stocks can be an extremely risky endeavor especially if one’s entire life’s savings are vested in it.

Unfortunately this has become a large problem for many middle class Americans. Huge losses have been suffered by individuals who unknowingly were driven into the stock market via their employment benefits, disguised as their retirement savings. These good people, who for the most part are living from paycheck to paycheck, are taking great risks with what they believe is their retirement savings. Individual retirement accounts, the 401(k), 403(b), and other government sponsored programs, all have their underlying assets invested in the

stock market mostly through mutual funds. Furthermore, these allocated funds are virtually untouchable till age 59½ unless one is willing to incur a 10% penalty, plus pay the federal income tax which has only been deferred.

All this has presented an unpleasant dilemma for Americans and their dreams for retirement. To put this in perspective, we should not overlook the fact that the median income for a working couple in the United States is only \$47,500! That means that half of this nation's working couples make less than this! Only 2% of the entire nation's population makes an income larger than \$355,000. This means that the margin for financial planning error for virtually 98% of Americans is nil. Any type of financial setback or losses in the market or anywhere else for that matter can be financially catastrophic. Somehow the definition of real savings has been obscured.

There is absolutely no way to retire from work without first having stockpiled a substantial amount of *real savings*. For an average annual retirement income of \$60,000 to \$100,000, this means a stockpile of several million inflation-plagued dollars! It simply cannot be done by the average citizen in today's economic environment. As it now stands, most Americans live day to day buried in a mountain of debt and with an ever rising cost of living. Most of that cost is taxes, not only direct taxes, but *indirect taxes* caused by inflation. Americans know they need to save and want to save, they simply cannot. Unless they can become fully informed of the real source of their money problem, they will not be able to solve this dilemma. Mises explains:

Everything that is done by a government against the purchasing power of the monetary unit is, under present conditions, done against the middle classes and the working classes of the population. Only these people don't know it. And this is the tragedy....

These people can only provide for their old age practically by either entering into labor contracts that give them a pension for their later age, or they can save a part of their income and invest it in such a way that they can use in later years. These investments can either be either simple savings deposits with banks, or they can be life insurance policies or bonds...<sup>vi</sup>

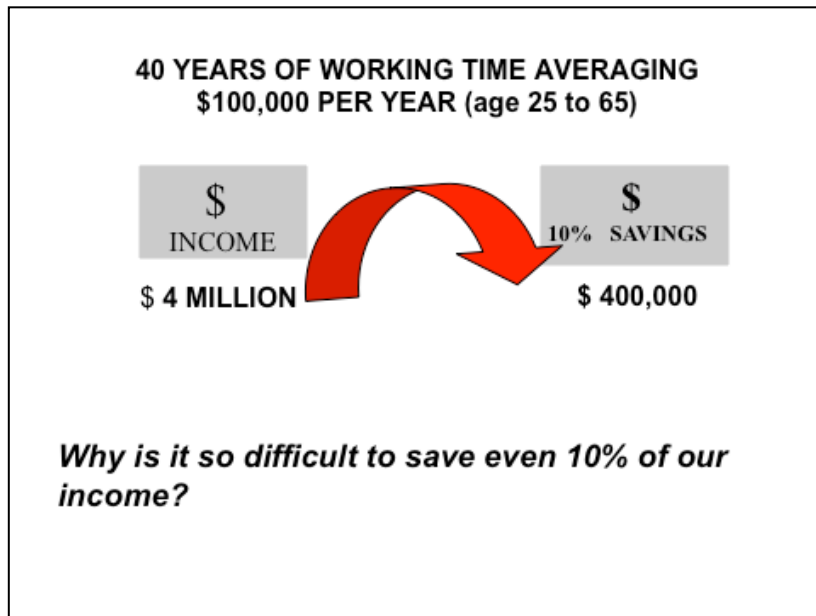
There is a different position to consider when analyzing the middle class employee to that of the business owner. Mises clarifies this distinction:

The man who owns an agricultural estate, the producer of oil or foods, or the businessman who owns a factory is in a different position. When the prices of the products that he is selling go up on account of the inflation, he will not be hurt in the same way in which other people are hurt by the inflation. The owner of common stock will see that, by and large, most of this common stock is going up in price to the same degree as the prices of commodities are going up on account of the inflation.

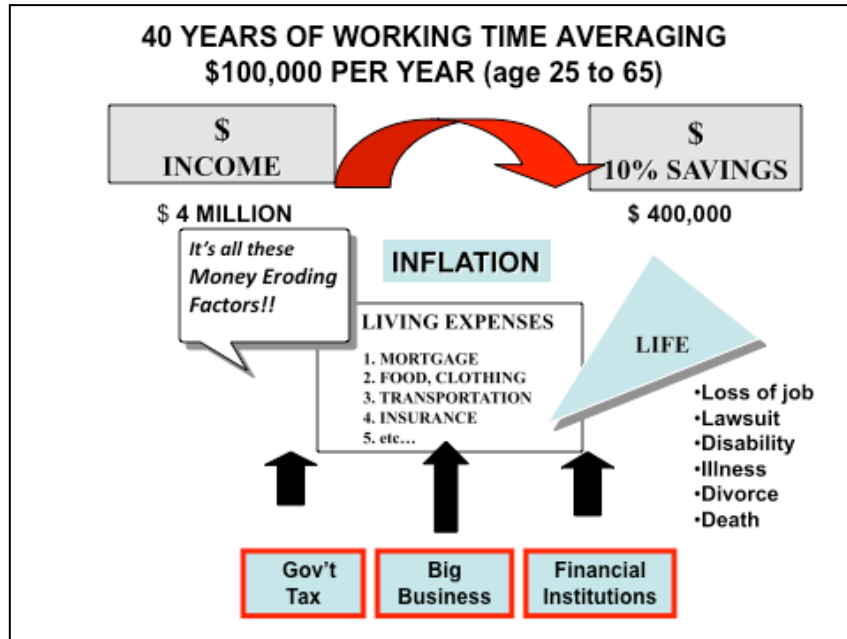
But it is different for people with fixed incomes. The man, who retired 25 years ago with a yearly pension, let us say of \$3,000, was by and large in a good situation or was believed to be in a good situation. But this was at a time when prices were much lower than they are today....

What I want to point out is that the greatest problem today is precisely this, although the people don't realize it. The danger is due to the fact that people consider inflation as something that hurts *other* people. They realize very well that they too have to suffer because the prices of the commodities they are buying go up continually, but they don't realize fully that the greatest danger for them is precisely the progress of inflation and the effect it will have on the value of their savings.

...We should not forget that over and above the consequences of destroying a country's monetary standard, there is the danger that depriving the masses of their savings will make them desperate.<sup>vii</sup>



In addition to this problem, is the fact that *life* has a way of completely derailing the best and most disciplined savings plan. For example, the fear of losing one's employment is a constant threat to individuals these days, particularly during recessionary times. An accident or illness that incapacitates the breadwinner for extended periods of time can deplete savings and limit income. Since statistics show that Americans can continue to pay living expenses for no more than three months without income, bankruptcy is many times inevitable under any one of these circumstances. The same is true in the case of divorce or other form of lawsuit. What about the untimely death of the bread winner? Yes, life, as we all know, is fragile and filled with uncertainties. When these life events are coupled with severe money problems, is there any wonder why Americans are forced to turn to the government as the ultimate care giver?



Finally, the current housing crisis has added insult to injury. The American home, one of the most sought after dreams and storehouse of savings for all Americans, has been completely undermined. Americans are reaching levels of complete exasperation, a sense of total defeat and hopelessness.

### Abuse of the Citizen

Unfortunately, today we are living in a world of increasing economic illiteracy, increasing visible poverty and increasing visible excess. The rich do seem to be getting richer, the poor even poorer. Consequently, there is a lot being said about *greed*. It seems we cannot enter into conversation, pick up any sort of publication, watch the news on television, or check our e-mails without the mention of this one human character defect and its influence on our current world crisis. What actually lies behind all of this rampant corruption particularly on the part of the financial elite?

To approach this question correctly, it's important to note that man has been oppressed by those who govern for most of history. Slavery and peasantry have been the norm. Professor Clarence Carson points out in his economic text that

the vast wealth of Louis XIV was mostly wrung from the poor peasants and squandered on his projects and mistresses....[H]ardship and suffering have been the common lot of most men throughout the ages. Hours of work have been long and often unremitting for [most people] throughout history. The disparities between the wealthy and the poor have always been very great.<sup>viii</sup>

Also, we must not forget that while man is certainly capable of reason and can do so much good for society, there is another side to man's nature that is dark and bent on his own destruction. Man preys upon his kind. He commits all sorts of crime. He can be aggressive and destructive. He may cheat, trespass, steal, and conspire with others to do great harm. Man is also said to love power over others and, if he attains it, may exercise it in dictatorial fashion.

For this reason man sets up the institution of government not only to protect private property, but in order to protect man from man. When government is acting in its proper role it allows economic activity to take place. Since all economic activity involves either the production or transfer of property, government should step in when private property is trespassed upon, stolen, abused, or destroyed. It is needed to handle disputes, enforce contracts and other similar duties of private property protection, but what happens when government turns on its people in the manner we see happening today?

The fundamental problem with government is that it is monopolistic by nature. The power it has in its use of legal force makes keeping government strictly limited impossible. Excessive tampering with money and the market began during World War I, and increased substantially during the Roosevelt "New Deal" years. Once this happened all constraints were removed. Today money

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inflation and deficit spending is done with such impunity that the national debt has reached staggering proportions! The affinity that exists between power and wealth, a most fearful combination, has been unleashed in the most impoverishing way on our society. The recent bank bailouts and the nationalizing of much of American industry has enriched the politically connected at the expense of everyone else, and has only added to the common man's abuse. The American citizen has been left virtually imprisoned. His spirit has been deeply wounded and many are feeling they have reached the point of no return.

### **The Solution**

What if there was a solution to this madness? Would you hesitate one minute in wanting to know what it is? Of course not! No one would. This problem is so pervasive in nature that a solution also seems impossible and yet, there is a solution. It's called the "*Sound Money Solution*." It is not new. It's actually been around for centuries. Austrian economists spoke and wrote about it. What is amazing is that a revolution or uprising is not required in order to change the insanity of the world around us. It can be implemented regardless of what government and the politically connected are doing right now. There is no need to picket the streets, hold huge rallies, or storm Washington demanding changes. Not a single shot needs to be fired. This solution's only requirement is the action of a single person acting in a manner to help only himself, but in so acting ultimately he helps all of society. It is the most natural and innocent action a human being can do, and yet the idea is so powerful that as it spreads from one individual to another, a massive movement silently develops and gains velocity. Once it spreads to the masses, nothing will be able to prevail against it! Government and destructive monetary policy will be forced to change. History will be recorded differently.

The Sound Money Solution's key action is in "*Privatized Banking*." How it specifically works will be explained in greater



detail in Parts II and III of this book. This author strongly admonishes the reader not to jump ahead to examine those sections until he has a firm grasp of the quandary that is being explained in this section. In particular he must understand money and banking from the points of view being explained here. This request is not intended to intimidate nor slow down the reader, but rather to urge him to follow these instructions for his ultimate benefit. The reader will quickly realize that most of the explanations in the next four chapters are easy to understand with the use of a bit of pure common sense. However, without this understanding, the Sound Money Solution cannot be fully grasped. Needless to say, old ideas and incorrect perceptions will need to be set aside. The reader will need to adopt a completely new paradigm. A thorough examination of the remaining chapters of this section will allow for the necessary shift in thinking required and the reader will experience the full impact of Parts II and III. The motivation to act in the manner prescribed will be natural.

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<sup>i</sup> Clarence B. Carson, *Basic Economics* (Phenix City, AL: American Textbook Committee, 2003), p. 185.

<sup>ii</sup> Murray Rothbard, *Man, Economy, and State* (Auburn, AL: The Ludwig von Mises Institute, 2004), p. 555.

<sup>iii</sup> Rothbard, *Man, Economy, and State*, p. 1024.

<sup>iv</sup> Hans Sennholz, "The Great Depression," reprinted from a *Freeman* article from October 1969, posted June 24, 2009 at: <http://mises.org/daily/3515>. Accessed June 3, 2010.

<sup>v</sup> See Robert P. Murphy's "The Social Function of Stock Speculators," November 22, 2006, at: <http://mises.org/daily/2381>. Accessed June 2, 2010.

<sup>vi</sup> Ludwig von Mises, "Inflation Destroys Savings," excerpted from a speech given circa 1960s, posted May 18, 2010 at: <http://mises.org/daily/4408>. Accessed June 3, 2010.

<sup>vii</sup> Mises, "Inflation Destroys Savings."

<sup>viii</sup> Carson, *Basic Economics*, p. 263.