THE FAILURE OF STATE MONEY AND THE CASE FOR MONETARY INDIVIDUALISM

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Once again the spectre of inflation haunts our land and is wreaking economic havoc. This has lent a renewed urgency to the analysis of the nature, cause and effects of inflation and the quest for a definitive solution.

WHAT INFLATION IS

First of all, it is essential to understand that individual price rises cannot cause inflation. It is not only natural, but essential, that prices fluctuate freely in a market economy, as they provide information to entrepreneurs about potential surpluses and shortages, and reflect changes, not only in the subjective valuations of consumers, but also, in the availability of given resources, final goods, or services.

Increases, therefore, in the price of oil, or in mortgage interest rates, cannot cause inflation. As Milton Friedman has pointed out, if individual prices rise, then provided that the quantity of money remains constant, consumers will have less to spend on other items, the prices of which are depressed accordingly. Individual price rises, including increases in the price of labour, can only be inflationary if consumers are given more money by means of expansion of the money supply, to buy the goods or services in question.

Inflation is a *general* rise in prices caused by over-expansion of the money supply, in other words, a rate of increase in the money supply faster than the rate of growth of the production of goods and services.

Axel Leijonhufvud[1] has neatly summarised the adverse effects of inflationary monetary policies on microeconomic coordination:

> Transactors will not be able to sort out the relevant "real" price signals from the relative price changes due to ... inflationary leads and lags. How could they? Messages of changes in "real scarcities" come in through a cacophony of noise signifying nothing ... and "sound" no different. To assume that agents generally possess the independent information required to filter the significant messages from the noise would ... amount to assuming knowledge so comprehensive that reliance on market prices for information should have been unnecessary in the first place.

Inflation does *not* raise all prices simultaneously and by the same percentage. Hayek has observed that:

> ... the real harm is due to the differential effect on different prices, which change successively in a very irregular order and to a very different degree, so that ... the whole structure of relative prices becomes distorted and misguides production into wrong directions.

The misallocation of resources caused by inflation causes immense medium and long-term economic damage, and requires careful conceptual analysis.

Market interest rates tend toward a level at which the amount of funds that savers are willing to invest in production equals the amount that entrepreneurs/producers are willing to obtain and use for productive purposes. Saving and investment means that purchasing power is used so that a certain amount of resources are directed towards the production of capital as opposed to consumer goods, thus lengthening the production process and entailing a lateral expansion of production in the form of additional plant and equipment similar to existing ones, with labour being allocated accordingly.

Spontaneously prevailing market interest rates indicate the extent to which capital goods production may be undertaken without frustrating the demand for consumer goods.

The expansion of credit through the *joint* action of government and a fractional reserve banking system tends to lower the interest rate below a level that would otherwise prevail. In the early stages of expansion of the money supply interest rates actually drop.

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As inflation works its way through the system, a price premium is added to the interest rate to protect savers from the harmful impact of expected price increases. The problem is that such a price premium is retrospective and therefore lags behind what would be adequate to cover further price increases under continuing inflation. As inflationary expectations become built into the lending system with continuing additions to the money supply, the "interest rate" rises over time. The *real* interest rate, after deduction of the essentially retrospective price premium, is dampened by further doses of money and remains relatively low. Entrepreneurs are thus unable to differentiate between additional funds artificially created, and those derived from real savings. Decreased interest rates in the early stages of credit expansion provide faulty signals to businessmen about the real savings available for the purposes of entrepreneurial investment. Resources are diverted into the production of capital goods, which broaden and lengthen the structure of production, and the prices of such resources are bid up in the process.

The differential effect of inflation on different prices means that the price signals to producers, telling them what to invest and where, become more and more misleading, and the longer inflation continues the greater the misallocation of resources. Unemployment and bankruptcy are thus invariably greater at the end of each bout of inflation than at the start.

Inflation has been described as a two-stage process. In stage one, the money supply increases at a rate faster than prices rise; in stage two, prices rise faster than increases in the money supply. It commonly takes about eighteen months to two years for inflation to work its way through the system. Robert Moss, in *The Collapse of Democracy*,[2] has compared the first stage with intoxication and the second with the hangover.

Shopkeepers and manufacturers gain in the short term from the "boom", but later discover that they cannot replace the goods sold or raw materials processed without paying out vastly more paper money.

THE MISERY AND INJUSTICE CAUSED BY INFLATION

Inflation turns normal economic life on its head. It favours the borrower and discourages the saver. In Weimar Germany, Hugo Stinnes became the richest man in Europe by buying anything he could, with borrowed money. He systematically bankrupted his creditors by repaying them in valueless marks a few weeks later. In Britain in the later 1960s and early 1970s property speculators played off depreciating loans against appreciating real assets. Centrepoint on Charing Cross Road is a monument to that inflationary period and is emblematic of the flight into real values which occurred at that time. Whilst the saver is ruined, the profligate can sell his acquisitions for a profit. The misery and injustice caused by inflation are all too easily disregarded.

It hits hardest those who live on savings and those on fixed incomes. It has often been described as a "hidden tax". It is the mainstay of spendthrift governments which, in order to finance their own profligacy, lack the honesty to raise taxes by open, clear and "honest" (if theft can ever be committed honestly!) means. Instead politicians hope that the people will not notice the stealthy erosion of the value of their currency. Moreover, as nominal wages increase with inflation, workers find themselves forced into a higher tax bracket and with less purchasing power than they would have enjoyed if government had engaged in overt, as opposed to covert, taxation.

Any investments with a fixed monetary value, such as a life assurance policy, treasury bond or loan to someone else, may well become worthless. It has been quite common for people to retire to live on their savings, only to find these savings rendered worthless by a government putting too much money into circulation.

Any short term increase in employment can only be maintained by means of ever increasing levels of inflation, leading ultimately to hyperinflation and monetary and economic collapse.

When the credit expansion stops, the malinvestment of resources is revealed. The healthy corrective process is called a recession. A prudent government should let the recession rip, as the market has a remarkable aptitude for rejuvenation. The Wall Street Crash of 1929 was entirely inflation induced: the Depression of the 1930s was in fact made far *more* acute and long-lasting by Hoover's dilatory approach to the curtailment of the money supply.

Inflation cuts at the very heart of the economic process: the price mechanism. There is no such thing as a "beneficial mild reflation" as a stimulus to economic growth. It is no substitute for genuine economic growth which can only result from increased productivity, the only real source of wealth. Once inflation starts, there is always the temptation for politicians and state bankers to engage in even greater inflation.

The "boom/bust" phenomenon is not a feature of a true free market: it is instead a result of the vicissitudes of governmental expansion and contraction of the money supply.

There is a moral issue involved in inflation as well as an economic one. S. Herbert Frankel[3] has desecribed state manipulation of the money supply as a "conflict between money as a tool of state action and money as a symbol of social trust". By printing what economic actors discover to be an increasingly and exponentially worthless currency, Keynesian legislators and administrators not only defile this instrument of social trust, but reveal themselves as morally no better than counterfeiters. The only difference is that in this case, politicians and state bankers are above the law and immune from prosecution. Yet these officials do infinitely more economic damage than small groups of private forgers.

MONETARY INCONTINENCE MASKED BY ARBITRARY MEASUREMENT

The problem with the quantity theory of (state) money is that governments have no way of knowing in advance what the optimal quantity of money is: this can only be established by selling and buying at a fixed price a collection of commodities the aggregate price of which we wish to keep stable.

This can be illustrated by the fact that the Conservative British Government (thanks largely to the destructive policies of Chancellor Nigel Lawson) has not only changed its means of measuring the money supply over the past few years - it has used, variously, "M3" (all cash deposits of the private sector, and notes and coins in circulation), "M2"

(bank current accounts, bank deposit accounts, and notes and coins in circulation), "M1" (notes and coins in circulation, and bank current accounts) and "M0" (notes and coins in circulation) - but also seems now to have given up any serious attempt to measure and/or control the growth of the money supply.

These measurements are of course arbitrary and statist. The constant tergiversation of the Treasury must lead to the suspicion that the Conservatives hope to mask their monetary incontinence by blaming the method of measurement and in so doing, to blind the electorate to the central fact that government, in the context of a fractional reserve banking system, is the *sole* cause of inflation.

In any event, the (perceived) "need" to use such measurements as M0, M1, M2 or M3 derives from the severing of the link between what the state is pleased to call "money" and any kind of commodity standard.

As a result, a unit of (state) money is no longer a true measure of value in the way that a litre is a measure of quantity. With state central banks divorced from any link between printed or otherwise-created money and a given unit or units of a desired commodity, politicians will tend to succumb to the dangerous temptation to expand the money suuply instead of balancing the budget. Whatever method of monetary denationalisation or individualism is chosen, a pound of sterling should again represent a quantity of some commodity or commodities.

THE HISTORY OF THE GOLD STANDARD

Money, as an acceptable medium of exchange, is a prerequisite of the division of labour and hence of an advanced market economy. The alternatives are either primitive barter or even more primitive self sufficiency.

Carl Menger, writing in 1892 on "The Origin of Money",[4] showed how the emergence of money was an unplanned or "spontaneous" event. It gradually *evolved*. Individuals, seeking to minimise the number of barter transactions necessary to obtain the commodities they wanted, learned that certain goods were more marketable than others and began to accumulate trading inventories for the exclusive purposes of exchange. The evolution of money eliminates the would-be trader's need to search among the sellers of the commodities he wanted to acquire in order to find those few sellers who, in turn, wanted to acquire the particular commodity or service that he had to offer.

Without an effective means of storing value (i.e. saving), long-range planning and exchange would be impossible. The acceptability of a given medium of exchange to all the participants in an economy depends on several factors.

The first is that of durability. In a primitive society, something like wheat, for instance, might be sufficiently durable to serve as a medium of exchange. However, in more advanced societies, where store of value considerations are important, the medium of exchange must be a more durable commodity, characteristically a metal. A metal is generally favoured because of its homogeneity and divisibility, whereas jewels have neither of these attributes.

Secondly, and more importantly, the commodity chosen as an exchange medium must be a luxury. As human desires for luxuries are unlimited, luxury goods are always in demand and therefore always acceptable. Having the attributes of great relative scarcity and a high unit value, a luxury metal is easily portable.

As if following a sort of Gresham's Law in reverse, preferences as to the commodity to hold as a store of value tend to shift to the most widely acceptable commodity, making it, in turn, still more acceptable. Through this process, gold emerged as a particularly favoured medium of exchange, being a durable, portable, homogeneous and divisible luxury good with a variety of uses and considerable relative scarcity.

However, if all goods and services were to be paid for in gold, large payments would be difficult to execute, thus tending to restrict the division of labour. This is where the banking system steps in, creating credit instruments such as bank notes and ledger deposits, which, historically, were convertible into gold.

A free banking system based on gold is able to extend credit and create banknotes and deposits according to the production requirements of the economy. Individual owners of gold are induced, by payments of interest, to deposit their gold in a bank, and draw cheques against such deposits. As it is very rare for all depositors to wish to withdraw all their gold at the same time, a banker need keep only a fraction of his total deposits in gold as reserves. This enables him to lend out more than the amount of his gold deposits. The amount of the loans that he can afford to make is not arbitrary but is regulated by his reserves and the status of his investments.

When banks lend money to finance productive and profitable endeavours, the loans are paid off fairly quickly and bank credit continues to be generally available. When, however, the business ventures financed by bank credit tend to be marginal and slow to pay off the loans, bankers soon find that their loans outstanding are excessive relative to their gold reserves and begin to curtail new lending, usually by charging higher interest rates.

This raising of interest rates is, in a *free* banking system, beneficial, as it tends to restrict the financing of new ventures, and forces existing borrowers to improve their profitability before obtaining credit for further expansion. When gold was accepted as the medium of exchange by most or all nations, an unhampered free international gold standard served to promote the worldwide division of labour. Alan Greenspan has argued that the tendency was for all the economies, in the absence of restraints on trade or the movement of capital, to act as one, with similar worldwide patterns in credit, interest rates and prices, even though the customary name given to the unit of exchange (mark, pound, franc, dollar, etc.) might vary from country to country.

The Gold Standard was the basis of British monetary policy from the Glorious Revolution until the First World War, with one or two intervals, such as during the Napoleonic Wars, when it was abandoned with an inevitable increase in inflation.

During the nineteenth century average prices in the United Kingdom actually *fell*, attesting to the greater efficacy of a commodity standard in safeguarding the economy against inflation than methods such as measuring the desirable quantity of fiat money.

Greenspan has noted that a (state) gold standard is incompatible with chronic deficit spending, "the hallmark of the welfare state". He goes on to argue:

> Under a gold standard, the amount of credit that an economy can support is determined by the economy's tangible assets, since every credit instrument is ultimately a claim on some tangible asset. But government bonds are not backed by tangible wealth, only by the government's promise to pay out of future tax revenues, and cannot easily be absorbed by the financial markets. A large volume of new government bonds can be sold to the public only at progressively higher interest rates. Thus government deficit spending under a gold standard is severely limited.
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> The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit. They have created paper reserves in the form of government bonds which, through a complex series of steps, the banks accept ... as if they were an actual desposit ... of gold.
>
> ... the fact is, that there there are now more claims outstanding, than real assets.[5]

THE SUPERIORITY OF THE LIBERTARIAN MONETARY PARADIGM

I hope that the above will provide some insight into how a free market banking system, based on a commodity standard, might work.

A gold-backed state currency, however, is still a long way from the libertarian paradigm. The reason for this is that in such a system the state assumes a monopoly (or near monopoly) of issue of the currency. It does not allow the banks to issue their own notes on the basis of their own commodity reserves, or allow the note issuance of one such bank to "float" against the note issuance of a competitor bank.

This is combined with heavy regulation by the state of the banking system and a requirement that banks maintain a reserve at the state central bank. Indeed, the private holding of gold may be restricted or outlawed. This has the disadvantage of removing the competitive factor which, in addition to the redeemability of notes or deposits for a commodity, also promotes currency stability. (For example, in a free banking system, if one bank were to make a mistake and overissue notes, consumers and producers would tend to prefer another bank's currency, with, in a system of "floating" exchange rates, the "*good* driving out the bad".)

Another problem is that, if currency issue is the monopoly of the state, there is no effective safeguard against the state taking its currency off the commodity standard. A lot of nonsense has been talked about the USA abandoning the Gold Standard in the 1970s. Effectively the Gold Standard ended in 1914 when the major combatants abandoned it on the outbreak of World War I. A half-hearted attempt was made to restore it after that war, but this broke down in 1931 and the post World War II Bretton Woods system was a gold standard in name only.

There more historical evidence to justify the creation of conditions permitting the provision of money by the market, as opposed to government, than is usually realised. From an historical perspective, private money was the *natural* order, until it was suppressed by governments for political reasons. These included the financing of wars, overseas adventurism, or simply the enhancement of a ruler's prestige and domestic power.

More recently, in the eighteenth century, there is the experience of the Scottish free banking system, under which Scottish banks issued their own gold-based "pound" notes which floated against Bank of England pounds.

There is also the experience of the Suffolk Bank in New England in the nineteenth century, documented by George Trivoli.[6] The Suffolk Bank experience indicates how a free enterprise clearing system and market "central" bank not only operated profitably, but also brought stability to note issuance.

In New England, banks issued their own notes (redeemable in gold) and eventually a free market note clearing system evolved, known as the Suffolk Bank. This originated in the attempts of city banks to curtail the issues of out-of-town banks whose notes circulated widely in the cities of New England. The city banks were anxious to increase their market share, so the Suffolk system was established in order to clear the notes of member banks and collect out-of-town notes for redemption.

With the benefit of economies of scale the Suffolk Bank reduced the costs of redeeming out-of-town notes and curtailed the note issue of those banks. Member banks kept interest-free deposits of gold or silver at the Suffolk Bank, which was able to make profits by offering loans from these deposits and by charging interest on overdrafts. Whilst member banks in need of excess reserves could obtain overdrafts on the reserves on deposit at the Suffolk Bank, the Suffolk Bank had the power to insist on immediate payment of notes sent home for redemption in gold or silver coin. This encouraged member banks to maintain conservative lending policies. As a final resort, in cases of mismanagement, the Suffolk Bank could always remove the name of the offending bank from its list of New England banks in good standing. This was, Trivoli tells us, "an action greatly feared by banks since it would immediately force its notes to a discount even though they were still redeemable in specie at the counter of the bank".[7] Although overissue was curtailed, the Suffolk system was sufficiently flexible to allow a gradual increase in the money supply as the New England economy expanded.

THE THREAT OF A BANK RUN CREATED DISCIPLINE

A common objection to free banking is that banks issuing their own notes in the absence of state regulation would be susceptible to runs which would spread throughout the banking system.

But, as Dr Kevin Dowd has shown, in a free banking system:

> A bank facing a run and [with] insufficient reserves to meet the demands to cash in notes and deposits ... has two possible sources of extra liquidity. One is to borrow on the open market. If potential [lenders] ... consider the bank to be sound it should have little difficulty in obtaining funds from this source ... Unless they had reason to doubt the soundness of the banking system as a whole, those who cashed in their notes and

> deposits would transfer them elsewhere, and hence other banks would experience a greater demand for notes and deposits. These banks would therefore have more funds to lend and be able to make an extra profit by lending them to the banks experiencing the drain.[8]

In an unregulated banking system, bank managements, being aware that the arousal of the suspicions of note and deposit holders would precipitate a run, would have strong incentives to maintain adequate liquid reserves and an adequate capital base. According to Professor George Kaufman, in a memorandum published by the Federal Reserve Bank of Chicago:

> The very threat of a run served as a powerful source of market discipline.[9]

There is no historical evidence to suggest that, in a free market, bank runs are contagious. On the contrary, bank runs have spread as a result of the actions of state central banks over-expanding the money supply, by guaranteeing banks' deposits or by imposing inflexible reserve requirements on private banks.

According to Kaufman

> Bank runs and bank failures were the effect and not the cause of aggregate economic constraints and hardships.[10]

In fact, the historical record suggests that state banks acting as lenders of last resort (as opposed to private clearinghouses so functioning *promote* the taking of wild risks by private bankers.

In short, therefore, in a truly free market, bankers, seeking to act in their own rational self-interest, would be subject to all sorts of disciplines and competitive pressures, which in fact would tend to *promote* stability in the monetary system.

There can be little doubt, for example, that abolition of exchange controls in 1979 has resulted in competition at the margin, without which the current rate of inflation would very probably be still higher.

HAYEK'S MONETARY SUGGESTIONS

Having established therefore the historical superiority of free market monetary and banking systems, the obvious next question is how a return to such an order could be achieved.

Hayek[11] has suggested that, if the state were abandon the current regulatory system, a private currency could develop in the following way. A banker would announce his readiness to issue notes and to open current accounts denominated in "ducats" or "standards" and would redeem these notes and deposits on demand with, for example, five Swiss francs per ducat. At the same time, he would promise to regulate the quantity of the new currency so as to keep its purchasing power constant in terms of a basket of raw materials at spot prices determined at the international commodity exchanges and measured by a weighted index.

The weighted index number of whole prices would be based on up to forty different quotations of internationally traded raw materials and foodstuffs, weighed according to the approximate value of their turnover at the commodity exchanges. The weight on which the index number would be based would vary with changes in the relative volume of these transactions, on condition that any such change would involve the substitution of a "basket" of the same aggregate value as that which it replaced.

Deposits received by the bank would be invested in highly liquid securities or other assets bringing net real returns or in loans expressed in "ducats". The bank would have to be able to accept deposits of any amount of the currencies it was willing to accept and would have to be able to redeem on demand any amount likely to be requested in the currencies that would be needed to buy at the commodity exchanges the quantities of the different commodities stated, in the definition of the new currency.

There would be a constant small premium on the selling price of the new "ducat" over its redemption value, to reflect the advantages of having an extremely stable unit of currency. It would also be possible to offer higher yielding accounts which did not promise immediate redemption.

The bank would at first keep in cash a 100% reserve of the currencies in terms of which it had undertaken to redeem its issue and would use the selling premia received for general business. As the state currency continued to depreciate in real terms this premium would increase.

The real value at which the ducats were first sold would serve as the standard which the issuer would have to try to keep constant. As demand for the new free-market currency increased, competing enterprises offering similar commodity-linked units would emerge and would at the same time relieve the new bank of the fear of a rapid growth of demand beyond the limits it would like to handle.

The bank would, of course, so as to maintain the value of the new currency, have to be prepared to buy back at the prevailing higher rate of exchange after the substantial depreciation of the state currency or currencies. Whilst the bank would have to be able rapidly to liquidate very large investments it would have stable assets in the form of loans in its own currency. The bank would of course keep its own accounts in terms of its own currency. Naturally, so long as the new institution remained trustworthy, most of its balances would be used chiefly for transfers from one account to the other and only a small amount would have to be repaid in terms of the state currency or currencies.

As state money became superseded by commodity-linked currencies, competition between similar institutions would tend to dissuade individual banks from overissuing their respective currencies. If a given currency began to depreciate, consumers would increasingly switch to a more stable unit, driving the rejected currency unit out of circulation unless the issuing bank in question took corrective action to maintain the purchasing power of its currency.

Any additional lending by the banks would, therefore need to be based on a corresponding increase in real savings. Hayek has also argued that the appearance of "parasite" surrencies would not be a problem in the event of monetary individualism, *provided* that primary issuers made it clear (unlike government banks) that they would not be prepared to bail out secondary issuers by supplying the original notes they would need to redeem their obligations and provided further, that secondary issuers made it clear that they were simply issuing *claims* for the original primary currency issue. The primary issuers would be able to make it clear in advance that they would not be prepared to provide the notes needed to redeem "parasitic" issues, except by sale against some other reliable currency.

Currency individualism would, according to Hayek, assist long term financial planning and business accounting. It would also be desirable as the monetary basis for medium and long-term contracts.

MONETARY FREEDOM DOES NOT CAUSE OVERISSUE

Hayek's proposals, and indeed the question of choice in currency, raise several issues.

The first issue is whether competition in currency would result in the overissue of currency, and hyperinflation.

John Stuart Mill, in his *Principles of Political Economy* (1848), reviewed the actual experience of free banking:

> The reason ordinarily alleged in condemnation of the system of plurality of issuers ... is that the competition of these different issuers induces them to increase the amount of their notes to an injurious extent ... [But] the extraordinary increase in banking competition occasioned by the establishment of the joint-stock banks a competition of the most reckless kind, has proved utterly powerless to enlarge the aggregate mass of the bank-note circulation; that aggregate circulation having on the contrary actually decreased.[12]

The final blow to the "overissue" argument against choice in currency was delivered by Benjamin Klein in the November 1974 edition of the *Journal of Money, Credit and Banking*. Klein demonstrated that inflation due to overissue could only be expected when the "brand names" or "trademarks" of the various privately issued token monies are not protected from counterfeiting:

> It is true that if, for example, a new money producer could issue money that was indistinguishable from an established money, competition would lead to an overissue of the particular money ... The new firm's increase in the supply of money would cause prices in terms of that money to rise and, if anticipated, leave real profits derived from the total production of the money unchanged.
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> But there has been a distribution effect - a fall in the established firm's real wealth. The larger the new firm's money issue, the greater its profit, therefore profit maximization implies that the new firm will make unlimited increases in the supply of money, reducing the established firm's profit share close to zero (unless it too expands).
>
> If the established firm legally possesses a trademark in its money ... the new firm's production represents a violation of the established firm's property right and is called counterfeiting, lack of enforcement of an indivual firm's property right to his particular name will permit unlimited competitive counterfeiting and lead to an infinite price level.
>
> This merely points up the difficulties in the usual specification of competitive conditions. If buyers are unable to distinguish between the products of competing firms in an industry, competition will lead each firm to reduce the quality of the product it sells since the costs of such an action will be borne mainly by the other firms in the industry ... indistinguishability of the output of competing firms will lead to product quality depreciation in any industry.[13]

The competitive system, it can confidently be said, would punish a money producing firm that attempted to cheat its customers by deceitfully manipulating the supply of its brand of money, and, correspondingly, would reward a firm that operated to preserve its customers' choice.

THE OUTCOME OF MONETARY FREEDOM IS NOT FULLY PREDICTABLE

Secondly, in analysing the issue of choice in currency, arguments have raged over the question of the commodity standard to be applied.

Economists such as Rothbard and Hazlitt advocate the only "true" money as being that redeemable in specie, into gold, and attack Hayek's proposal for a token currency, tied in valuation terms to a basket of commodities on the basis that it would not be accepted as "true money" by market participants.

It is not too hard to have sympathy for the (free market) gold standard argument. The issue of what store of value should underly the market currency has generated enough literature to comprise a separate discussion paper of its own.

Supporters of Hayek's proposal for a currency whose value would remain constant in terms of a "basket" of commodities counter the "Gold is the one true money" argument by pointing out that gold is a very widely traded commodity whose value fluctuates so wildly that it would be a thoroughly unstable currency standard.

The argument that only a currency redeemable into a precious metal would be accepted as "money" rests, I think, on several misconceptions.

Firstly, it fails to take account of the fact that once a legal framework had been created for choice in currency new currencies in their own right would not appear or be accepted overnight. During the gradual process of establishing a private currency, the issued certificates would not immediately be greeted by money users as currency. Initially, they would be supplied to the public in the form of money *substitutes*, supplied under an explicit contract guaranteeing the bearer a minimum rate of exchange between these certificates and one or more commodities or pre-existing currencies. Currency entrepreneurs would of course decide which commodities or monies to use in this process, and money users would then choose from among the alternatives offered.

Only later, after the issuing firm had fostered sufficient consumer confidence in its trademarked tokens by making the necessary investments in the firm's "brand name capital" (Klein), would the issued notes begin to take on a monetary life of their own. This point would be reached when currency users, instead of routinely demanding that the new currency be converted into another more liquid asset, acknowledged it as "monetised" by circulating the notes as an independent exchange medium in their daily business.

Secondly, to attempt to predict what sort of market currencies "would" be accepted by currency users in the context of an analytical discussion of the issue of private money against state money, when the state currency has a monopoly of currency issue, is dangerously misguided. While the *pattern* of market activity can be predicted, the *outcome* cannot. To (attempt to) predict the outcome of economic action is the function of the *entrepreneur*, *not* the economist.

It must be borne in mind that Hayek's discussion is an illustration of a type of market currency which *could* emerge. Hayek emphatically does *not* seek to exclude the possibility of alternative, competing currencies circulating - including currencies redeemable into gold or other precious commodities.

My own guess is that there would be competition among a variety of currencies based on different standards of value. Tastes might differ with respect to the index of commodity prices devised to monitor deviations from the desired level or rate of change of the purchasing power of a "Hayekian" token currency. Gold standard aficionados would be free to - and probably would - deal in gold specie currencies. Some degree of specialisation and heterogeneity in the currency industry's supply of monetary services may in fact persist indefinitely, because of the persistence of differences in the needs and purposes of the various money using members of a community. We might well see several different issues circulating side by side, each servicing the individual demands of a separate subset or "neighbourhood" of the "global" transactions domain.

For example, as Roland Vaubel has pointed out, while purchasing power appreciation tends to enhance a currency's desirability as an asset (or "store of value") purchasing power constancy may enhance its desirability as an accounting device.

The exact configuration therefore of the resulting monetary mosaic is unpredictable under a competitive monetary arrangement since each currency consumer's choice from among the array of currencies available to him or her is made according to purely subjective cost-benefit calculations. The aggregate impact of consumers' choices in determining a given currency's domain will be revealed only *after* the execution of the particular plans that are based upon these calculations. Since their requirements may, for example, be highly localised geographically, it is quite apparent that a system of several concurrently circulating currencies is likely to be of indefinite duration.

The money standard - or standards - which would prevail would do so as a result of trial and error in the marketplace. Consumers would discover which currencies had the best track record for retaining their value - and would act accordingly.

The market being a continuous discovery process, over time those issuers who most effectively satisfied the demand for monetary services would profit and expand their services.

MONETARY VARIETY IS NOT A PROBLEM

One final criticism of choice in currency with which I will deal is that currency users would find a diverse plethora of private currencies greatly inconvenient.

Once again, the issue of whether several concurrently circulating exchange media would present an inconvenience to currency users depends on the individual users' subjective evaluations of the benefits and costs involved. The outcome cannot be conclusively determined *a priori* by the economic theorist.

Moreover, the economic historian Hugh Rockoff has offered evidence which suggests, by analogy, that the benefits of a multi-issuer system may in fact *outweigh* the possible inconvenience in the estimations of consumers:

> ... it seems unlikely that the heterogeneous nature of the currency (of the 19th century) was a major brake on economic growth, for in many crucial respects the system was little different from that which prevails today. Locally, we use demand deposits. But these are not generally acceptable as a means of payment. Each time we wish to make a purchase by check from a businessman we force him to make some judgement about the quality of the money we are offering. Instead of having to worry about different kinds of bank notes, a merchant today must worry about different kinds of deposits which could be as numerous as his customers counterfeiting currency is now rare, but forged checks and insufficient balances are a constant irritation. Yet no one today would argue that the heterogeneity of our deposit money is a serious impediment to the growth of national income ... the inefficiency of a heterogeneous currency should not be exaggerated.[14]

Recently appointed British Prime Minister John Major's suggestion that there be a "hard ECU" circulating alongside, and competing with, national currencies, has opened up the scope for a meaningful debate on the whole issue of choice in currency.

Under competitive conditions, the monetary standard, the monetary rule, and the purchasing power behaviour of money, are all determined by expressed choice in the marketplace, rather than by the arbitrary command of politicians.

Politicians and state bankers cannot provide us with sound money. Only the market can perform this task.

NOTES

1. Quoted from *Information Co-Ordination*, Oxford University Press, New York, 1981, p. 259.
2. Robert Moss, *The Collapse of Democracy*, 2nd edn., Abacus, London, 1977, Chapter 4.
3. S. Herbert Frankel, *Money: Two Philosophies*, Basil Blackwell, Oxford, 1977, p. 86.
4. Carl Menger, "The Origin of Money", *Economic Journal* 2, June 1892, pp. 239-255.
5. Alan Greenspan, "Gold and Economic Freedom", in Ayn Rand ed., *Capitalism: The Unknown Ideal*, New American Library, New York, 1967, p. 100-101.
6. George Trivoli, *The Suffolk Bank: A Study of a Free Enterprise Clearing System*, Adam Smith Institute, London, 1979.
7. Ibid., p. 19.
8. Hobart Paper No. 112, IEA, London, 1988, p. 31.
9. George Kaufman, "The Truth About Bank Runs", *Staff Memorandum* SM-87-3, Federal Reserve Bank of Chicago, 1987, p. 13.
10. Ibid., p. 12-13.
11. Friedrich Hayek, *The Denationalisation of Money: The Argument Refined*, IEA, 1976.
12. John Stuart Mill, *Principles of Political Economy*, John W. Parker, London, 1848, p. 675.
13. p. 429-430.
14. Hugh Rockoff, "The Free Banking Era: A Re-examination", *Journal of Money, Credit and Banking*, 6, May 1974, p. 144-145.

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