THE WALL STREET JOURNAL, FRIDAY, AUG. 19, 1977

Toward Free Market Money

By Friedrich A. Hayek

I have always defended the gold standard, and later fixed exchange rates, not because I thought they resulted in particularly good money but because they provided the only effective protection from government abuse of its monopoly to issue money.

But now, when this discipline has broken down, I see no hope of its being ever restored.

Therefore, unless we fundamentally change things, our prospect seems to be for indefinite accelerating inflation worsened by price controls, followed by a rapid breakdown of the market, of democratic institutions and ultimately of civilization as we know it.

But, as Shakespeare taught us: "diseases desperate grown, by desperate appliance are relieved, or not at all."

Two years ago I suggested a radical cure—i.e., taking from government the monopoly of issuing money, and handing the task to private industry—partly as a bitter joke.

However, thinking further about it I became increasingly fascinated by this idea. For it now appears to offer an effective remedy to our monetary troubles and opens a new and unexplored chapter of monetary theory.

Not only our troubles with money but the instability of the capitalist economy and the growth of government are wholly due to governments denying free enterprise the right to supply the good money it needs, money which competition would undoubtedly long ago have provided if it had not been prohibited by government.

Ever since Bodin in the 16th Century first declared the right of coinage one of the essential attributes of sovereignty, the contention has been that government needed that power to supply itself with money. Yet there have been few attempts to justify the government's money monopoly on grounds that it would provide better money, at least not since the issue of money referred solely to coinage. And even that prerogative was generally abused by governments.

But things have become entirely hopeless since modern economists began teaching governments that they were doing good by spending more than citizens were prepared to give them in taxes.

Two Misunderstandings

I have no doubt that competition would be much more inventive in providing the kind of monetary institutions needed for the proper functioning of markets. But two misunderstandings would have to be dealt with.

The first is that there must be a legal tender. In fact there is no need for it at all. The liberal economists of the 19th Century understood that "legal tender" meant simply that government forced parties to a contract to discharge their obligation in a manner they had not intended when concluding the contract.

As Carl Menger pointed out 85 years ago, economists inexplicably allowed themselves to be persuaded by lawyers that legal tender was an essential attribute of perfect money. Yet the financial expert of 100 years ago, who reported that after centuries of abuse the Chinese had recovered their confidence in paper money "because it is not legal tender and it is no concern of the state," understood things much better than most of the lawyers.

Of course in China the state soon again interfered and spoiled it all.

The second objection is, what about Gresham's Law? Would not the bad money inevitably drive out the good?

But Gresham's Law does not apply to competition between money of different denominations, the rate of exchange between which is currently determined by the market. It is only when people have the choice of paying in either good or bad money that they will inevitably choose the bad one and keep the good one for other purposes.

But if the rates of exchange between different media of exchange are variable, people will (as has been shown at the end of all great inflations) refuse to sell for the bad money. They will insist on being paid in the good.

If I were in charge of one of the big joint stock banks in Zurich, and assuming there were no legal prohibitions, I would announce that I would issue certificates and open checking accounts in terms of some new monetary unit. I would claim exclusive rights for it, holding myself responsible to redeem on demand, at the option of the holder, for a specified number of U.S. dollars, Swiss francs or D-Marks.

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I would further announce my intention, although without assuming a legal obligation, to control the quantity of this issue so as to keep its purchasing power as nearly constant as possible (measured against a specified list of commodities).

I would add to this announcement that I fully understood that the success of my business, which should be very profitable since I would lend money, depended on my meeting the public's expectation that I maintain my currency at the announced real value. I am convinced that I could satisfy this expectation.

All executive officers of the issuing bank would be guided in their decisions about lending and the purchase or sale of currencies or other assets by a guide number, the current value of which a computer would constantly flash before them.

The guide number would be, in effect, an appropriately weighted average of the monetary prices—probably of raw materials and internationally traded foodstuffs, taken in the first instance in terms of the currencies in which they were traded, and converted at the current rate of exchange.

In other words, it would be an index number continuously computed on the basis of the latest arrived price and exchange quotation. If the basis of this index number were, say, 1,000, a rise to 1,003 would instantly inform all officers of the bank that they would curtail their lending and purchases slightly. Similarly, a fall to, say, 998 would tell them that they could relax slightly.

The same information would of course be used by the market and the media, with the result that any deviation from the announced standard would rapidly be brought to public notice.

Individual consumers would probably be content to be paid in any generally accepted money that did not depreciate noticeably. But the large manufacturing firms and trading corporations would choose money that made a reliable capital accounting possible, minimized as much as possible uncertainty about the future movement of particular prices, and was internationally acceptable. Eventually a common commodity standard would develop, represented by a number of different specified currencies.

Since the assets of any such bank would consist chiefly of short term loans in terms of its own stable currency, there should be no problem about its being able to control amounts outstanding. For purposes of instant liquidity it would have to hold a certain limited reserve in other currencies, but its situation would be exactly that of all other banks that have ever existed – namely, that it could not meet all its demand obligations if they were required at the same time.

Successful pursuit of such a policy would mean that if the national currency into which the private one was legally convertible continued to be inflated, the private currency would come to float higher and higher. From the beginning it would have been valued more highly than any of the currencies in which it was redeemable at the option of the holder, simply because thanks to that option it was less risky.

But as official currencies continue to depreciate, the difference would steadily grow, and with it public awareness of the advantages of stable currency.

The apparent profitability of this business would obviously attract competitors.

What Will the Public Prefer?

This raises the question: What money will the public prefer if it can choose among several kinds, differing in character and stability?

The answer will depend upon the success or failure of the competing currencies, which may be based on different standards. That is, there could be differences between the different commodities to which the monetary index is pegged, differences in the degree of stability and differences in bank growth.

But once the public shows preference for a particular standard (or perhaps several standards), nothing can prevent other banks from basing their own currency (although under another name) on that same standard.

I anticipate that ultimately a single or a very few standards would prevail, certainly in large regions and perhaps worldwide. I also anticipate that currencies aiming at the same standards would be issued under different names by many different banks, which would continue to compete as to the reliability of their faithfulness to those standards and as to all the other services they would offer users of their currency.

Removing government's monopoly on issuing legal tender would not only provide us with stable money, it would also do away with those credit pyramids in particular countries where a fractional reserve system makes it equally impossible for the central bank and the commercial bank to exercise effective control over the quantity of all money of a particular denomination.

The absurdity of this system with its "inherent instability" and "perverse elasticity" of credit has long been understood, but men like Walter Bagehot and Ludwig von Mises felt that it must be tolerated for the time being because people had become adapted to it.

We now have no choice but to change our money and currency system, sooner or later. And one of the prime needs, if we are to eliminate the great fluctuations of credit, is to do away with the distinction between the cash issued by government and the monetary credit which banks create.

I believe we shall yet understand that the one thing the government of a free country must not be allowed to possess exclusively is a printing press for money. The sooner we learn that the better for a[ll] of us and our free institutions.

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