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The Denationalization of Money: A Review

by

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F.A. Hayek, Denationalisation of Money (Institute of Economic Affairs, London, 1976) pp. 107, $5.75.

In this book, F.A. Hayek proposes that governmental monopoly in the supply of money be abolished and that the provision of money be left to an unregulated private market. Hayek contends that with private provision of money, money-users would receive a better product, and the problem of business cycles would be ameliorated. The book is of interest not only because of this radical proposal and the arguments that support it, but also because it is a statement of the latest views on monetary theory and policy by a Nobel Laureate whose earlier work in monetary economics was cited as one of the reasons for his receiving the prize.

In Hayek's view, monetary disturbances are responsible for most business cycles. This view stems from his widely-accepted analysis of the information role of prices in a decentralized free-market economy. According to Hayek, changes in the supply of money affect the various (innumerable) prices in the economy in different and irregular ways, creating misinformation by disturbing the structure of relative prices, and hence resulting in a misallocation of resources. According to Hayek,

> the most important recurrent misdirections of the use of resources of this sort occur when, by the creation (or withdrawal) of amounts of money, the funds available for investment are increased substantially above (or decreased

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> substantially below) the amounts currently transferred from consumption to investment, or saved. ...this is the mechanism by which recurrent crises and depressions are caused...(p. 68).

In Hayek's monetary theory of the business cycle, it is the process by which the money supply is changed that is important since the process involved determines how particular relative prices change. Hayek's views as to the precise process involved may or may not be relevant today, but his incorporation of the money supply process--including the behavior of those who must adjust first to the changed money stock -- into his analysis would seem to be a useful approach to monetary theory, particularly for the understanding of the transmission mechanism.

In Hayek's view, the disturbing influence of money can be minimized if prices are predictable. To attain price-predictability, Hayek, in a remarkable reversal of his earlier writings, advocates a monetary policy aimed at stabilizing the price level. (For examples of Hayek's earlier criticism of such a policy rule see his Monetary Theory and the Trade Cycle, pp. 111-16, and Prices and Production, 2nd. ed., pp. 26-30.) However, since any known rate of general price inflation (not necessarily equal to zero) would improve greatly the predictability of prices and enhance the information quality of prices, it is not clear from Hayek's analysis why a zero rate of inflation should be preferred over any other (known) rate. Much of

recent analysis has centered on the rigidities (and the reasons for the rigidities) of the wage-price structure and the effects of inflationary and deflationary pressures in such an environment. To a large extent this analysis, like Hayek's, emphasizes the information role of wages and prices and the consequences when the information conveyed is faulty (i.e., when the wages and prices are or become inappropriate for market-clearing). In this book, Hayek neglects the role of rigidities in his basic analysis -- although rigidities are treated occasionally (e.g., pp. 66 (perhaps) and 87) -- and,as a result,his analysis cannot choose among predictable inflation rates. However, postulating rigidities -- upward as well as downward -- probably would have led to the conclusion that a stable price level is better than just a predictable general inflation rate as a policy target.

Hayek contends that most economists have accepted the idea that there must be a single kind of money -- supplied or regulated by the government -- in any one area without having seriously examined the issue. In support of his proposal that money be denationalized, Hayek argues that it is not necessary for there to be a single kind of money (e.g., dollars) in any one area. Rather, many kinds of money can coexist as long as their rates of exchange with each other are not fixed by law. By allowing flexible rates of exchange, Hayek disposes of the "Gresham's Law" argument for a government monopoly in the supply of money. (Hayek, on pp. 30-34, also disposes of the "legal tender" argument for a government money supply monopoly.)

Hayek proposes that all government regulation and control of the money supply business be abolished. In place of the old system, financial institutions ("banks") would arise that would provide money and monetary services in the resulting free competitive market. Competition would force these banks to offer the kind of product that their customers wanted most. Hayek then considers just what kinds of money the people would choose. He contends that users and holders of money want to reduce uncertainties about individual price movements by improving the predictability of prices in general because in this way unexpected deviations of individual prices from the predicted trend would tend to cancel out. Hayek argues further that only when the expected inflation rate is zero will there be this cancelling out. In addition, he predicts that a wholesale price index will be chosen to be stabilized. Hayek presents a very compelling and fascinating description of how a free market would be able to supply the competing monies --from the sophisticated cash registers necessary to accomodate the ever-changing exchange rates involved to how the market would force each bank to stabilize the value of its money (and how the bank would go about stabilizing its money) to how the particular price index involved might vary among banks. He even discusses various transition problems and concludes that the change to the "new order" must be made all at once not gradually.

Hayek points out two major economy-wide advantages of competitive money supply in addition to the increase in consumer choice and, hence, welfare. First, he contends, since competitive money would lead to a stable price level, it would tend to ameliorate the problem of

business cycles by improving the predictability of prices and, hence, their information value. (For example, if a particular relative price changes under a free-market regime it is more likely the result of a fundamental change in the economy, rather than simply the result of a change in the rate of monetary expansion.) Second, abolishing the monopoly of government in the supply of money would weaken government power and increase individual freedom.

Hayek's analysis can be criticized on a few points. First, his argument that people will demand a stable-valued money does not seem to be valid generally. Obviously, debtors and creditors have differing desires as to the expected value of the money in which their contracts are written and settled. Consider the case of two risk-neutral contractors -- i.e., one creditor and one debtor -- with different (incomplete) information sets. It is possible that both sides would want to write their contract in terms of a money whose value was imperfectly predictable in the sense that predictions differ across individuals. (Each side might expect to gain although at most only one would actually do so.) When at least one of the contractors is a risk preferrer, a contract in terms of an imperfectly predictable money is more likely. Thus, at least some of the population would choose to use an imperfectly predictable and, hence, unstable money. In addition, it is possible for interest to be paid on money, and

the possibility of interest rate differentials, which could compensate for differing rates of expected appreciation and depreciation, would increase the likelihood that much of the money produced by a competitive free market would be unstable. (Hayek virtually ignores rates of interest in his analysis.) Furthermore, Hayek's discussion of why people would choose a stable price level -- essentially to improve predictability -- seems actually to apply to any known price inflation path (see pp. 58-64, especially p. 62). Thus, it would appear that the price-level-stability aspects of Hayek's proposal might be better implemented by a government producer required by law -- perhaps through a constitutional amendment -- to stabilize the price level.

The second point on which Hayek can be criticized is his assumption that the results of the competitive model can be applied to the case of money production. Hayek should have demonstrated this more carefully,particularly since he often discusses his proposal in terms which seem to imply that there are only a few money producers (e.g., p. 88). Also, Benjamin Klein's analysis (Journal of Money, Credit, and Banking, 1974) suggests that a dominant money supplier might emerge from a competitive money industry. (While Klein's analysis anticipates some of Hayek's discussion -- as Hayek readily acknowledges (p. 21) -- Klein does not conclude that competition would result in a stable price level.) In Hayek's model, even if a monopoly producer did emerge, such a producer would be somewhat restrained by potential entrants into the industry. However, there might be room for the usual costs associated

with monopoly. In addition, the information costs involved in competing monies might be greater than envisaged by Hayek. Such costs would, inter alia, raise the resource costs of monetary services and increase the probability of fraud and over-production by banks.

Hayek states that the transition to a competitive-money regime must be swift. However, if one treats the government's role in money production as a social institution that may have evolved as a "result of human action but not of human design" (Hayek paraphrasing Adam Ferguson in Studies in Philosophy, Politics and Economics, p. 96), then a more reserved attitude should be taken towards changing it. This view would recognize the possibility that the institution evolved in order to meet certain needs (and survived because it did meet them), and although it may very well no longer be beneficial, care must be taken to establish the case against it. Furthermore, recognizing the limits to human knowledge, a gradual and tentative reform is probably preferable to a complete restructuring of the system. Although Hayek has made nearly all of these points in his other writings, he mostly ignores them in the present book. (The closest he comes to addressing these issues is in the material on pp. 20-26.)

To an extent, Hayek's proposal bears a family resemblance to the present international monetary system in that there are many monies and money producers coexisting in a highly integrated economy. To be sure there are various impediments to the free exchange and movement of the monies, and the money producers do not appear to be maximizing

profits or competing with one another to serve their customers better. But nevertheless, many participants in the world economy have a choice in money and exercise that choice. Many monies are used and held which have different stability and predictability properties. (See Lance Girton and Don Roper, "Theory and Implications of Currency Substitution," International Finance Discussion Papers, Federal Reserve Board, 1976.) Bearing this resemblance in mind, it would seem that merely abolishing all exchange and capital controls would go a long way toward the system that Hayek is proposing (cf. p. 17) without the necessity of allowing the unregulated private production of money. Such a limited experiment would allow people to choose among several monies and, although the producers would not necessarily have the right incentives, monies of different stability and predictability properties would be available since, based on past experience, the governments involved would not be expected to produce the same kind of money. Thus the institutions and technology needed for multi-currency internal trade would develop to the extent necessary. If all went well, the next step would be to allow private money production and the deregulation of banks, and then perhaps a final step in which all government activity in the money industry (e.g., money issue) would cease.