Free Life The Journal of the Libertarian Alliance
Vol. 1 : No.4 Winter 1980 - *Article 5 of 7*

Money without the state

By Lauri Rantala

Much has been written about a state without money, but very little has been written about money without the state. The two most prominent advocates of a free market in money are Murray Rothbard and F. A. Hayek, whose views can be found in short pamphlets on this subject: *What has Government Done to Our Money?* and *The Case for a 100 Per Cent Gold Dollar* by Rothbard, and *Denationalisation of Money* by Hayek.

The 100% metal money

A follower of Mises in monetary theory, Rothbard accepts Mises' *Regression Theorem*, which shows how money spontaneously and unintendedly evolved out of market exchanges.

Money arises when people start to hold some particular commodity not because they wish to consume it, but because they know that there is always likely to be a demand for that commodity, so that by holding it they increase the chance of being able to get by exchange what they wish to consume. (The *Regression Theorem* explains the purchasing power of money by its value at a slightly earlier time, eventually tracing it back to the stage where money was just a commodity).

Thus money is a spontaneous product of market anarchy, and does not require governmental backing. Rothbard sees money as always having originated in a commodity with an independent use: the first paper money consisted of paper receipts for real money, gold or silver. Rothbard argues that in a free market, non-commodity currencies would be considered a joke. Only a commodity with independent desirability would engender sufficient confidence to emerge as money, and Rothbard expects precious metals to be the only candidates.

The system envisaged by Rothbard is not a gold standard" in which a government central bank has a monopoly on issuing notes, and agrees to give gold coins in exchange for those notes, at a fixed rate, to any person who asks. Instead, gold and silver would actually be money: the only monetary unit would be a weight of gold or silver. Any bank would be free to accept deposits of gold or silver and to issue notes in exchange, but the notes would be simply receipts for the gold, rather like transferable safe deposit receipts.

Mining and minting would be performed privately, with demand and supply pressures determining the amount of new metal placed on the money market, and competition in coinage placing a check on the quality of coins. Banks would have none of the present state protection, such as deposit insurance, but would go out of business if they were unable to hand over the gold whenever anyone presented notes for conversion.

Historically, what happened was that banks issued more notes than they had gold to support, which enriched them and did them no damage unless there was a "run", with all the note-holders turning up and demanding their gold at once. This is "fractional reserve banking". Competition and the fear of runs tend to keep fractional banking within limits. However, Rothbard takes the view that any fractional reserve banking is fraudulent and immoral and should be outlawed. Not all commodity-money theorists are so strict.

Competing paper currencies

In contradistinction to Rothbard, Hayek envisages a system of competing paper monies, with no convertibility into real commodities. Each issuing bank would maintain the value of its private currency (such as a "ducat") by expanding or contracting the supply on the market. Stability would be maintained by reference to an index of prices of a basket of widely-traded commodities. The basket of goods would not necessarily be the same for each currency, but would generally include raw materials, agricultural products and standardised semi-finished industrial

products. Trading in these commodities is extensive, regular and widely reported, and the price movements are sensitive. When the index rose, an issuer would decrease the amount of that currency, and when the index dropped would increase it. At the outset the paper currencies would have a redemption value in terms of existing currencies, a guaranteed floor below which the value of the paper currency would not be permitted to fall. Hayek gives the example of one ducat being redeemable for five Swiss francs, five D-marks or two dollars. Hayek's system also differs from Rothbard's in that Hayek's ducats would try for stability in purchasing power, whereas gold or silver would clearly increase its purchasing power steadily, prices falling perceptibly every year. Hayek recommends approximate stability on the basis of considerations of certainty between debtors and creditors.

Objections to Rothbard

The striking flaw in Rothbard's account is his insistence on 100 per cent reserves as a moral and legal necessity. Rothbard would even seem to condemn fractional reserves where the bank openly proclaims its policy. It is difficult to see what would be immoral about a bank promising its depositors a certain rate of interest, on condition that some specified length of time must elapse between a request for withdrawal and the withdrawal itself. This would give the bank time to liquidate assets to meet its obligations. Alternatively, a bank might accept gold deposits, and issue notes normally convertible on demand, except that in the event of a run those near the front of the queue would get gold, those in the middle would receive promissory notes to be redeemed in gold in a week's time, and those at the end would receive stock to the value of their deposits. This condition could be printed on the notes. Where then would be the fraud?

Banks might vary in such policies. Some people place high importance on immediate availability of deposits, and will patronize "conservative" banks, some of which might conceivably assume as much as a 100 per cent reserve. Those with a taste for risk could bank elsewhere at a higher rate of return. The market, and not Dr Rothbard's personal moral views, will determine what fraction of deposits may be re-invested.

Rothbards suggests that 100 per cent reserves follow from treating the banks just like any other businesses, but this is incorrect. Businesses in other industries follow "fractional reserve" practices every day. A firm may experience a cash-flow difficulty due to an erroneous estimate of the term-structure of its liabilities. For instance, it receives an invoice of considerable value a month after its estimate. The firm is just able to scrape together the money to pay the invoice before it is due, but had it fallen due a week earlier, the firm would have been embarrassed. This situation is commonplace. It is unlawful not to pay your debts (though usually a period of grace is permitted, in effect), but there is nothing unlawful in being in a position where you could not have paid your debts, but didn't have to.

Objections to Hayek

Prior to Hayek's proposal, some economists had offered arguments against a free market in paper currencies. It has been contended that (with zero marginal costs of producing currency) competition would lead to an unlimited quantity being produced, leading to an infinite price level. This argument assumes that all the money produced is the same, but if the various currencies are clearly distinguishable then a firm which practised inflation would lose its customers, who would switch to a more sound money.

A more serious objection to Hayek however, stems from Mises' argument that no fiat money could come into existence without first having a commodity value of its own. A paper currency without commodity backing would have no previous exchange-value. It has been suggested that instant purchasing power for a paper currency could be created. A prospective currency issuer might persuade a number of firms to trade in a new currency, by arguing that each participating firm would have the advantage of trading more conveniently with the others. But this begs the question. As Gordon Tullock has said, money's "wide acceptability, paradoxically, depends upon its wide acceptability."

Another objection to Hayek is his refusal to imagine that even one of his competing currencies might be a commodity money. He seems, in general, always to argue against the classical gold standard, and never to seriously consider the Rothbardian arrangement. Hayek maintains that there is “not enough gold”, but this overlooks the possibility of parallel gold and silver monies. It also overlooks the reply which was given to precisely this objection by David Hume: that gold could be mixed with some base metal (openly, not as fraudulent debasement), which is advisable anyway to get greater hardness in the coins. Of course, the higher the value of gold, the greater the incentive to bring new stocks of gold into the market.

Equally misconceived is Hayek's objection to gold on the grounds that the move to gold would involve a wild and dizzy climb in the value of gold. As soon as it was realised that gold was finally replacing the discredited fiat currencies, speculators' demand would be very high, and would later decrease slightly over time. As in other cases speculators would bring stability and order into the market. The price of gold could reach something very close to its enduring monetary value within a few weeks.

Less clear are some of the “Austrian” indictments of Hayek's proposal. It is claimed that “the price level” is a meaningless concept, and the pursuit of stability a wild goose chase. But presumably it cannot be denied that “stability” according to a well-chosen index is genuine stability of a rough-and-ready sort, compared with the present inflationary intoxication. It is also contended that preventing prices from falling generally must result in malinvestment, according to the Austrian Theory of the Trade Cycle which Hayek himself did so much to develop. Since money can never be neutral, any new influx of money must have distorting effects on production. However, similar objections could be lodged against new influxes of commodity money. Also, it is arguable that net distortions may be greater from insisting that the whole market system go through a downward price adjustment.

Reconciling the two systems

For all their apparent incompatibility, there is a fundamental agreement between Rothbard and Hayek. They both agree about what should be done: the government should get out of issuing and controlling currency. (Though Hayek takes a more gradualist approach, proposing as a first stage a European treaty to permit every EEC citizen to hold and deal freely in any EEC currency). Where they differ is in predicting what would happen and perhaps also in their moral judgements on what is proper behaviour for banks.

If we had a free market in currency it is possible that neither system would prevail in its purest form, but that a hybrid would emerge. Hayekian paper currencies would express their floor value in terms of other currencies. As fiat money was replaced by gold and silver, these commodities would be included in the redemption floors. Hayekian ducats could actually be secondary forms of commodity money. The experience of pre-nineteenth century Scottish banks, which needs to be more thoroughly investigated, may show that unbacked free market paper currencies cannot be ruled out.

There is no reason why several currencies cannot exist side by side in the same community, as on the border between the UK and Irish Republic, the West Bank of the Jordan and Hong Kong. In the age where everyone possesses an electronic calculator, the convenience of a single monetary unit may be less decisive than it used to be.

Free Life