Private Money: An Idea Whose Time Has Come

Richard W. Rahn

Introduction

For a number of years I have argued that the development of global futures markets and the information revolution have made private money a practical as well as theoretical possibility (see Rahn 1986). I had expected private money to serve as a superior surrogate to government monopoly monies in international trade among traders from the developed nations and as an inflation hedge for more affluent individuals around the world. It seemed to me that when even the strongest government currencies lose their purchasing power at the rate of 3 or more percent per year and that when exchange rates between major currencies can vary by as much as 30 percent or more within six months, there had to be a better private alternative.

Since the breakdown of the Bretton Woods system in 1971, individuals making long-term international contracts and investments have had to go to considerable expense to hedge against currency losses, in addition to ordinary business risks. The increased instability of government monies is directly related to the fact that they are now all fiat monies—currencies that are issued without any tangible backing such as gold, but instead derive their value from the good faith and credit of the issuing governments. For instance, by the end of 1988 the U.S. dollar was worth only 30 percent of its 1971 value, when the United States severed its last tie of the dollar to gold.

To correct the erosion of monetary value, many critics of the current regime have proposed anchoring the monetary system to something real. Proposals include a return to the gold standard, some type of commodity basket standard, or the use of price and quantity rules to

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determine appropriate money growth. Any of these proposals could provide greater price stability than the existing monetary system, provided they were properly enforced.

But the fatal flaw in all reform proposals that depend for their implementation on governments is that short-term political considerations often force monetary authorities to alter the rules. The U.S. government abandoned the gold standard in 1917, in 1933, and again in 1971. In addition, British and French monetary authorities and others also have a long history of abandoning the gold standard when it became potentially inconvenient.

Despite the obvious shortcomings of government fiat currencies, I clearly underestimated the ability of market participants under conditions of substantial financial market deregulation to create vehicles—such as money market funds, variable rate mortgages, indexed bonds, and an increased variety of financial futures markets contracts—that largely protect individuals and institutions against both moderate rates of inflation and currency fluctuations. Despite the fact that central bankers, no matter how competent and honorable, often find it difficult to resist short-term political pressures to debase the value of the currencies they control, it also appears to be true, at least in the developed countries, that very rapid debasement is also politically unacceptable.

This combination of semi-responsible monetary policy and financial deregulation in the major developed countries has reduced the competitive advantage of private money to such an extent that it is unlikely to emerge under present circumstances. In sum, private money is an idea whose time has come and passed, but only in the major developed countries.

In my judgment, we are most likely to see the use of private money in the most unlikely of places—the statist countries of Eastern Europe, beginning in Hungary, Yugoslavia, and Poland. The reason, quite simply, is that the present government monopoly monies are failing to provide the basic functions of money. National currencies in Eastern Europe are not freely convertible into other currencies, they suffer from high rates of inflation, and they cannot be used to purchase many desired goods. The administered price structure in these countries means there are shortages of many goods at the official prices using government money, but these goods are frequently available if the purchaser has a convertible currency such as the U.S. dollar or West German mark.

To correct the problems of the existing Eastern European currencies, the governments would have to institute radical price reform and alter monetary relationships among Eastern European govern-

ments and with the Soviet Union. The political cost of these necessary changes is likely to be so high that they will not occur. Thus, the only way out of this dilemma for those governments seeking to increase their citizens' standard of living is to move toward a real market system and expanded trade and investment with the West by allowing the development of a parallel system of competing private currencies. Obviously, Eastern European governments could decide to use existing convertible currencies such as the U.S. dollar. To some extent this is already happening. In Poland, for example, prices are frequently quoted in dollars and many citizens hold dollar balances.

Using another country's currency, however, does have a number of obvious disadvantages. There is the loss of national prestige and the risk of being subject to adverse political actions by the issuing country. This risk is particularly high for a nondemocratic country using the U.S. dollar. Recall, for instance, the damage the United States did to Panama's economy with currency restrictions, which was possible because Panama was using the U.S. dollar as its domestic currency.

This paper describes how private money can be established in a practical way, rather than presenting the theoretical case for it. Implicitly, however, the paper accepts Menger's and Mises's insights into the origin of money. In particular, as Murray Rotland (1987, p. 419) notes, "The demand for money can be pushed back logically to the 'day' before the money-commodity became money, when it had purchasing power only as a commodity valuable in barter. Hence, every money must originate on the market as a valuable, non-monetary commodity and cannot begin as being imposed by the state, or in ad hoc social contract." The argument made by Mises and others that fractional reserve banking tends to be inherently inflationary even though individual banks are necessarily restricted in expanding credit is also accepted in this paper. It is, therefore, supposed that the abolition of central banking would likely result in the reduction of inflation.

Before describing the mechanics of establishing a private money suitable for use by the Eastern Europeans and others, I shall briefly review the general case for private money and some of the relevant history.

Why Private Money?

Private issuers of money have stronger incentives than governments to maintain the real purchasing power of a currency because

the only way to make a profit by issuing money would be to provide a currency that people consider superior to government money. People making long-term contracts or investments would be eager to rely on a private currency only if they thought it would maintain its value better than the U.S. dollar or Japanese yen or other currencies.

Proponents of competitive currencies and free banking do not suggest that decisionmakers in the private sector are more honest and responsible than those in the public sector, only that competition ultimately would weed out the crooked and incompetent. Superior money will drive out inferior money. This is the reverse of Gresham's law, "bad money drives out good," which refers to situations in which debtors have an after-the-fact choice of payment. Buyers, sellers, and lenders all have an incentive to make long-term prospective contracts in a currency that will not lose its value.

There is considerable evidence in support of competitive currencies and free banking. Experience demonstrates that the value of money is less stable and cyclical downturns are more severe under government monopoly regimes than under free-banking or competitive-currency regimes.

U.S. monetary history is a good example. From 1839 to 1913, between the demise of the Second Bank of the United States and the establishment of the Federal Reserve System, most money in circulation consisted of privately issued bank notes. The quality of these bank notes varied; those issued by many large Eastern banks were often as "good as gold," and in fact could be redeemed for gold. Many Western bank notes, however, sold at deep discounts, which helped give entrepreneurs the money they needed to finance their businesses. As would be expected, some issuers of money cheated their customers, but these acts seldom had a notable effect on the economy. Every 20 years or so from 1840 to 1913, the economy was hit by sharp downturns, known as "panics." But the period of competitive bank notes coincided with the period of the most spectacular and sustained economic growth in American history. From the end of the Civil War to the establishment of the Federal Reserve, real personal per capita income rose on average by about 10 percent per year faster than in any subsequent period.

The economy also has been much less stable since the establishment of the Federal Reserve, which restored government's monopoly over currency. The wholesale price index in 1913 was 87 percent of what it had been 76 years earlier, and over this period it never varied by more than 100 percent, not even during the Civil War. By contrast, in the 76 years since the founding of the Federal Reserve, the wholesale price index has risen to 854 percent of its 1913 level. Economic

downturns have been far more severe in terms of lost output and unemployment since the formation of the Fed than in any of the pre-Fed panics. Only 1,748 banks failed in the 20 years before the founding of the Fed, compared with 15,502 in the 20 years afterward.

If competitive currencies is such a good idea, why has it not been tried? Experiments to establish private currencies have so far been hampered by a maze of government restrictions. Since World War I, the currencies of all major countries have been monopolized by their national governments. Central banks such as the Bank of England, the Bank of Japan, and the Federal Reserve Board of the United States have had sole authority to produce both paper money and metallic coins used as a medium of exchange and legal tender for the discharge of debts and payment of taxes. In the United States, this monopoly has continued in practice even though Congress established the "gold clause" in 1977. This clause makes contracts based on gold values of the dollar legally enforceable. Unfortunately, money surrogates such as gold coins, money market funds, or indexed bonds are not truly competitive with government money because any change in their values (even if induced by inflation) is subject to the capital gains tax.

The absence of a gold standard for major currencies adds a further difficulty for private gold-backed monies. When most of the industrial world was on a gold standard, the price of this metal was a fairly reliable proxy for the real value of goods and services produced and consumed around the world. In recent years, however, gold prices have fluctuated wildly and been subjected to speculative and political manipulation, making gold an unstable base for a private currency.

The Time for Private Money Is Now

The time is ripe for the creation of a private money. There is a clear market need in the Eastern European countries for a currency that serves the basic functions of money, such as being a store of value, and that is freely convertible into other currencies. The political climate also appears to be changing sufficiently in Eastern Europe to allow the introduction of a private currency. The development of a free-market economy in parallel with the existing socialist economies is likely to be the least destabilizing way to achieve satisfactory rates of economic growth to provide for the basic needs of the citizens in the Eastern European countries without directly attacking the existing political order. And a convertible currency is a necessary

condition to allow a free-market economy to grow and operate in parallel successfully with the existing socialist economies.

Several technical and financial innovations have occurred that make the creation of a private currency practical. Specifically, a private money can be established that is backed by a basket of real goods, that is, tradeable commodities and high-grade securities issued by companies and governments from around the world, where the rate of return on the securities will exceed the rate of inflation on the currencies they are denominated in.

There are four developments that make the creation of a private currency possible. The first is the proliferation of organized commodity exchanges where both the cash and futures prices of many different commodities are determined by supply and demand in open auction. Organized commodity futures exchanges began in the United States and England in the late 19th century and dealt exclusively with agricultural commodities and metals. Today more than three dozen commodities, ranging from heating oil to gold to wheat, are traded daily on more than two dozen commodity exchanges from Singapore to Winnipeg to Sao Paulo to Milan. A futures contract is essentially a contract in which the buyer agrees to accept delivery at a specified price from the seller at a designated time in the future. A private issuer of a commodity-basket-based currency, therefore, no longer has to store the commodities, but merely has to hold a future contract.

The second development is the emergence of truly international markets, in which each commodity has a "one-world price." Instant worldwide communication by satellite enables market participants to know the prices in any convertible currency of all traded commodities at the same time, thereby preventing major price differentiation in various locales, except those based on transportation costs. Similarly, since the breakdown of the Bretton Woods system, freely fluctuating exchange rates have eliminated the price distortions that frequently occurred in basic commodities whenever speculators anticipated a reevaluation of a currency. The emergence of a "one-world price" helps the issuer of a commodity-based currency by eliminating arbitrage opportunities.

The third is the development of money market funds throughout the world. Money market funds enable investors largely to insure themselves against increases in inflation or changing rates of inflation in the currencies in which the money market funds are denominated. The existence of these money market funds enables the producer of a competitive currency in part to back his currency by the acquisition of money market assets in a variety of funds based in different nations.

The final development is the creation of tax havens where bank secrecy laws prevail. People will be inhibited from using a commodity-backed or financial-asset-backed money where changes in the price of a commodity or financial assets relative to a given currency are subject to capital gains or income taxes. Fortunately, a number of small countries such as Switzerland, the Bahamas, the Cayman Islands, Hong Kong, and Liechtenstein have found that they can strengthen their economies by providing greater freedom from regulation and heavy taxes than their bigger competitors. None of these countries impose an income tax or capital gains tax on the purchase and sale of commodities, and all have bank secrecy laws to protect the privacy of legitimate users of financial instruments (such as money market funds).

It is now possible, therefore, to envision a private organization issuing a currency with stable purchasing power. The issuing body would be a private bank based in a country without capital gains taxes and with bank secrecy laws. The bank would back the currency, in part, with a basket of commodities whose historic price increases have equaled or exceeded the rate of inflation. To ensure that no one commodity would have a disruptive influence, as a result of an extreme price change, the basket would contain perhaps a dozen different commodities. In addition to the commodity basket, the currency would also be backed with high-grade financial paper, that is, stocks and bonds and money market funds based in a number of politically and economically stable countries.

Establishing a Private-Money Bank

The goal, quite simply, is to provide an alternative private money that is freely convertible into established convertible currencies and that retains its purchasing power. A money that meets these simple conditions should be able to gain ready acceptance among individuals and businesses in countries that suffer from an inconvertible currency or from monetary instability.

Fortunately in recent years a number of financial innovators have developed various stock and bond mutual funds, money market funds, and commodity funds that have consistently provided investors with rates of return well above the rate of inflation. For instance, Steve Hanke, chief economist at Friedberg Commodity Management, Inc. (FCMI), in Toronto, has developed an inflation hedge account that FCMI has successfully traded since February 1987. The stated objection of this account is to create "an unleveraged account which will invest in a diversified basket of internationally traded

commodities whose price appreciation will be higher than that of the cost of living and, thus, provide protection against inflation."

The new bank initially would operate much like a mutual fund except it would be a fund of funds. The bank managers would accept any convertible currency, which in turn would be used to buy shares in commodities, stocks, bonds, and money market mutual funds in a variety of countries. The bank's managers would have the responsibility for determining what share of the assets would go into each different type of fund. They would have to select the specific funds and to make sure that they were widely diversified by location and by currency in which they were denominated. The bank managers would have a very simple operational goal: at a minimum to make certain that the rate of return is higher than the rate of inflation for whatever currency the funds investment is denominated in. Obviously it would be desirable if they could achieve rates of return substantially higher than the rate of inflation as long as the rates of return were commensurate with a very high degree of safety and liquidity. The bank would quite clearly fail if its noteholders were not protected against inflation, and if its depositors did not receive returns in excess of the rate of inflation. Hence, it would be necessary for it not only to have competent money managers but to have a board of directors of impeccable reputation and expertise. Specifically, the board should be drawn from a number of leading economists and financiers from around the world, with perhaps no one nationality having any more than 30–40 percent of board representation, and where it would be unambigously clear that the self-interest of the directors would be in making the bank succeed. A compensation formula for both managers and directors should contain explicit monetary incentives for long-term success and profitability, for example, over a 10-year time horizon. Subsidiary boards would need to be established to represent the primary users and depositors in the bank. Again, the compensation for subsidiary board members ought to be based on long-term profitability and success.

Individuals or business people wishing to use the bank would bring any convertible currency to the bank and exchange it for a bank note, which might be called the "reale." On the opening day of the bank, an exchange ratio for the "reale" would be set for each currency in line with its respective rate in the world market. For instance, somebody bringing in $1,000 and assuming the exchange ratio was set at $10.00 for each "reale" on the opening day would get 100 "reales." The customer could then either hold the "reales" or deposit them in the bank and receive dividends depending on the bank's earnings. If the holder of the 100 "reales" were to hoard them at

home, one year later that person would receive $1,050 from the bank if the rate of inflation were 5 percent. On the other hand, if the "reales" were deposited in the bank, they would grow to $1,050 *plus* whatever dividend the bank had declared. For instance, if the dividend were 3 percent, the original deposit of $1,000 would become $1,080.

The same process would basically hold true for every other currency in which deposits were accepted. A problem would emerge in that exchange rates between currencies do not move at the same rates as the rate of inflation. So the bank managers would actually have to post the exchange rate between the "reale" and any given currency on the basis of market rates of exchange between the existing convertibile currencies rather than inflation rates. Hence depositors could be subject to foreign exchange losses or gains if they decided to take their funds out of the bank in the same currency as the original deposit. But, in fact, they would be allowed to draw their deposits in any convertible currency. The bank's managers, to protect themselves from people depositing in what they believed would be depreciating currencies and withdrawing in what had become appreciating currencies, would have to hedge their investment portfolio against foreign exchange risk. This would tend to encourage depositors toward having a substantial portion of their investment portfolio in commodity contracts for commodities that have a "one-world price."

Individuals and businesses would have an incentive to use the new bank provided they are convinced that the bank notes they hold will largely protect them against inflation and that the bank's assets are sound and sufficiently liquid. A large demand can be evisioned for such bank notes by people who are able to obtain foreign exchange that is convertible but who are located in countries without a convertible and stable currency. As an example of this type of demand, the government of Singapore prints some bank notes in very high denominations. These notes are not used for day-to-day trade but are held by individuals in safe deposit boxes and elsewhere as a store of value, since there is a high degree of faith in Singapore's monetary authority. Moreover, these notes are viewed as assets that are very easy to hide from the tax collector. In similar fashion, private bank notes, "reales," would be strictly bearer notes and largely impervious to the clutches of the tax collector, provided the bank was established in a tax haven.

There would be a great incentive for state-operated companies in Eastern Europe to make long-term contracts that are quoted in "reales" and are with Western firms or individuals, since this arrange-

ment would help safeguard against the risks associated with foreign-exchange fluctuations and inflation. It may even be useful to allow state-owned companies to enter into such contracts with each other, given that the existing price mechanism often fails to function. As more and more market activity is allowed in the statist countries of Eastern Europe there would be a great incentive to quote prices in "reales" to avoid the price distortions caused by the existing state pricing mechanisms. Individuals could then chose to buy or sell at what they believed was the true market rate for the existing state currency in terms of the set "reale" price.

"Reales" would be widely circulated and prices would be widely quoted in "reales" only if the political authorities in any country viewed such circulation as a superior alternative to their citizens trying to hold U.S. dollars, Swiss francs, West German marks, or other convertible foreign currencies. The private bank—by having an international board of directors, by being organized essentially as a mutual fund, and by being able to provide reasonable financial incentives to individuals who would be major users of the bank—could quite clearly be seen as a superior alternative to the use of some other government's currency. It is not inconceivable that if the bank succeeded in one country it could succeed in a number of countries and perhaps become the issuer of a major and stable international currency for a number of smaller countries.

The bank's income would come from transaction fees resulting from the sale and purchase of "reales." Interest would be earned on deposits, free reserves, loan fees, and foreign-currency-exchange market fees. The bank's expenses, in addition to its initial capitalization, would include normal operating overhead plus the fees, commissions, and transactions costs for the purchase and rollover of the fund's various investments.

Private money is no longer just an abstract idea; it is an idea whose time has come. It has gained the support of Nobel Prize-winning economists such as F. A. Hayek and Milton Friedman. It is now legally feasible and it provides an enormous opportunity to assist in raising the standard of living of Eastern European countries as well as all countries with a failed monetary system.

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Central Bank Credibility: An Alternative to Private Money

Stephen H. Axilrod

When I saw the title of Richard Rahn's paper, I thought that I would have a chance to use an obvious opening line in my comments: Private money may be an idea whose time has come—but not to me. However, on reading his paper, I find that being a citizen of a major developed country, I have simply been bypassed by the idea—a victim of "semi-responsible" monetary policy and financial deregulation. I also find that if I could transpose myself into an Eastern European, I could have a more partisan interest in denying the practicability of private money as an idea whose time has come.

Unfortunately, I hardly know enough about the economic and financial situation in those countries for such a transposition, so I will make my argument on more general grounds. I do have some sympathy with what I take to be Rahn's underlying theme: More or less complete confidence in the currency is required if an economy is to function effectively. If governments are basically irresponsible toward the economy, the central bank will also be. In that situation, according to Rahn as I understand him, the only way to get around the problem is to fence off the government sphere with a private sphere whose payments mechanism is based on, for example, privatized money—or failing that, is based on hard foreign currencies, as in any event generally happens to some degree when confidence in the home currency and economic system disappears.

Private Money as an Investment Opportunity

Rahn's paper has outlined a scheme that could, he avers, lead to privatized money in those countries whose central banks and

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governments perform less than "semi-responsibly." His particular proposal, which I would characterize as a world money market fund, might well, if developed, represent a good *investment* opportunity. It might offer, as in the example he gives, a real rate of return of about 3 percent if the "currency" issued by the fund is invested in the fund rather than used for circulation or hoarding. As a former bureaucrat, one indicated advantage of the proposed fund does not really appeal to me, namely, the ability to avoid taxes from holding the notes of the fund because they would be in bearer form and the fund's office could be established in a tax haven. That is carrying privatization a bit far in my view. On the other hand, to show that I am quite unbiased on the general subject, I would also strenuously object to governmental efforts to impose a tax on currency holders by abusing its monopoly on money through deliberately creating inflation.

Importance of a Responsible Central Bank

However interesting Rahn's practical proposal might be as an investment opportunity, I doubt that it, or some variant of it, will lead to privatized money in circulation and the abandonment of central banking and fiat currency—even in those countries where the financial system presently is in a state of disrepair and disruption. It is more likely, I should think, that public economic and monetary policy will make an effort to turn more responsible, depending largely on how the political situation evolves, although admittedly the political difficulties are massive.

A responsible central bank and a responsible note-issuing authority are, in my view, integral to the development of a sound, viable financial structure and are most likely to develop when the private sphere of the economy is active and strong. When the government is pervasive, any positive influence for monetary responsibility from a private sphere with strong survival instincts is diluted and very often lost, not merely in Eastern Europe but also in many developing countries where the economies do have a fairly large private sector.

In many such countries, governmental fiscal policy has often been so irresponsible that the private sector has refused to finance the government and has to a great extent walked out of the economy. Large investors have moved funds abroad, and many small businesses or entrepreneurs have at times shifted to a gray or underground market detached from the mainstream economy. With private lenders unavailable and tax receipts eroded, central banks in consequence have been forced to finance the government through inflationary money creation. The result, of course, has been the further

flight of private funds. Stabilization in such an environment will come when the political will exists to cut the governmental deficit and restore the ability of the central bank to conduct monetary policy with a view to long-term economic stability rather than as a way of bailing out the government and other institutions from a continuously threatening bankruptcy.

A responsible central bank and note-issue authority provide the foundation for an effective private sector. In my view, privatized money cannot provide such a base. Zero or relatively low inflation is only one aspect of that fundament. The other is securing the economic system against failures in the payments mechanism and pervasive liquidity crises. Such security can be uniquely provided by a central bank whose credit and reliability are not subject to the vicissitudes of the market. With a stable central bank at the heart of the payments mechanism, and available as a lender of last resort, there is little chance of a domino effect of failures—an effect that might call into queston the ability of even good checks drawn on basically good banks, but which may not receive incoming payments, to serve the purpose of paying for goods and services.

The whole economic system could grind down should doubts about the basic payments system ever spread. Under that circumstance, of course, barter or some sort of privatized money system might evolve as a necessity to keep the real economy functioning in some fashion. However, I would regard such a system as inherently fragile because it lacks an ultimate and unquestioned guarantor of financial stability whose creditworthiness and ability to function are not themselves dependent on the private system. Of course, once a central bank becomes involved in inflation or doubtful credit advances, its role as guarantor can become attenuated through loss of confidence, which would increase fragility in a system like our own. The good functioning of our economy in the past few years—even when it has been subject to debt problems, bank and thrift institution failures, and so on—is in no small measure owing to confidence in the central bank, including its ability to lend but not to overlend. Excessive lending could have the counterproductive effect of tending to dilute confidence in both the central bank and the financial system as a whole. The stability of the U.S. economy in the last several years is also attributable to deposit insurance, which does have certain widely discussed disadvantages (such as the moral hazard problem) but which has so far forestalled any widespread runs out of deposits (into such places as the mattress or foreign currencies) and has provided time for both the market and regulators to work out orderly solutions to troubled situations.

Movement toward Private Money?

In any event, so far as I can tell, the development of deposit banking essentially privatizes a good part of money, though I grant it is not full privatization in what I take to be the Rahn sense. That is, in this country, the U.S. dollar is the unit of denomination; there are no such things as Citibank or Chase dollars in circulation. Still, private banks do compete in their deposit issue function on the basis of the public's assessment of their creditworthiness, although deposit insurance admittedly homogenizes institutions to some degree but by no means entirely. With the introduction of foreign currency deposits here, the practical meaning of privatization is being extended a bit, of course.

Some deposits are connected to governmental fiat money in a way through Federal Reserve requirements. Reserve balances at the Fed in a sense might be considered a form of fiat money. Reserve requirements are more useful than not for monetary control. But conceptually a central bank could function without them—so that deposits could be detached from that direct link to the government. But even so, I would still want the central bank to be at the heart of the clearing mechanism, hold clearing balances, and be available as lender of last resort for the reasons noted above.

In my emphasis on the key role of a central bank with unquestioned integrity, perhaps I am no more than restating why Rahn sees no future for privatized money as he conceives it in the United States and other advanced industrial countries. But I think I am saying more. Because a fully privatized system lacks a core institution such as a central bank, whose credit and soundness are impervious to fluctuations of business within the private system, I do not accept the view that a fully privatized system will be adequately stable. It goes without saying, also, that the sustainability of privatized money in the form we now have—featuring a diverse structure of private despositories and other financial institutions—depends on the solid foundation given by a central bank and a government whose credit is absolutely beyond question. I would bend my efforts toward such a system in Eastern Europe and elsewhere.