Toward a Free Market Monetary System*

by F. A. Hayek
Nobel Laureate in Economics, University of Freiburg

When a little over two years ago, at the second Lausanne Conference of this group, I threw out, almost as a sort of bitter joke, that there was no hope of ever again having decent money, unless we took from government the monopoly of issuing money and handed it over to private industry, I took it only half seriously. But the suggestion proved extraordinarily fertile. Following it up I discovered that I had opened a possibility which in two thousand years no single economist had ever studied. There were quite a number of people who have since taken it up and we have devoted a great deal of study and analysis to this possibility. As a result I am more convinced than ever that if we ever again are going to have a decent money, it will not come from government: it will be issued by private enterprise, because providing the public with good money which it can trust and use can not only be an extremely profitable business; it imposes on the issuer a discipline to which the government has never been and cannot be subject. It is a business which competing enterprise can maintain only if it gives the public as good a money as anybody else. Now, fully to understand this, we must free ourselves from what is a widespread but basically wrong belief. Under the Gold Standard, or any other metallic standard, the value of money is not really derived from gold. The fact is, that the necessity of redeeming the money they issue in gold, places upon the issuers a discipline which forces them to control the quantity of money in an appropriate manner; I think it is quite as legitimate to say that under a gold standard it is the demand of gold for monetary purposes which determines that value of gold, as the common belief that the value which gold has in other uses determines the value of money. The gold standard is the only method we have yet found to place a discipline on government, and government will behave reasonably only if it is forced to do so.

I am afraid I am convinced that the hope of ever again placing on government this discipline is gone. The public at large have learned to

* A lecture delivered at the Gold and Monetary Conference, New Orleans, La., November 10, 1977.

understand, and I am afraid a whole generation of economists have been teaching, that government has the power in the short run by increasing the quantity of money rapidly to relieve all kinds of economic evils, especially to reduce unemployment. Unfortunately this is true so far as the short run is concerned. The fact is, that such expansions of the quantity of money which seems to have a short run beneficial effect, become in the long run the cause of a much greater unemployment. But what politician can possibly care about long run effects if in the short run he buys support?

My conviction is that the hope of returning to the kind of gold standard system which has worked fairly well over a long period is absolutely vain. Even if, by some international treaty, the gold standard were reintroduced, there is not the slightest hope that governments will play the game according to the rules. And the gold standard is not a thing which you can restore by an act of legislation. The gold standard requires a constant observation by government of certain rules which include an occasional restriction of the total circulation which will cause local or national recession, and no government can nowadays do it when both the public and, I am afraid, all those Keynesian economists who have been trained in the last thirty years, will argue that it is more important to increase the quantity of money than to maintain the gold standard.

I have said that it is an erroneous belief that the value of gold or any metallic basis determines directly the value of the money. The gold standard is a mechanism which was intended and for a long time did successfully force governments to control the quantity of the money in an appropriate manner so as to keep its value equal with that of gold. But there are many historical instances which prove that it is certainly possible, if it is in the self-interest of the issuer, to control the quantity even of a token money in such a manner as to keep its value constant.

There are three such interesting historical instances which illustrate this and which in fact were very largely responsible for teaching the economists that the essential point was ultimately the appropriate control of the quantity of money and not its redeemability into something else, which was necessary only to force governments to control the quantity of money appropriately. This I think will be done more effectively not if some legal rule forces government, but if it is the self-interest of the issuer which makes him do it, because he can keep his business only if he gives the people a stable money.

Let me tell you in a very few words of these important historical instances. The first two I shall mention do not refer directly to the gold standard as we know it. They occurred when large parts of the world were still on a silver standard and when in the second half of the last century silver suddenly began to lose its value. The fall in the value of silver brought about a fall in various national currencies and on two occasions an interesting step was taken. The first, which produced the experience which I believe inspired the Austrian monetary theory, happened in my native country in 1879. The government happened to have a really good adviser on monetary policy, Carl Menger, and he told them, "Well, if you want to escape the effect of the depreciation of silver on your currency, stop the free coinage of silver, stop increasing the quantity of silver coin, and you will find that the silver coin will begin to rise above the value of their content in silver." And this the Austrian government did and the result was exactly what Menger had predicted. One began to speak about the Austrian "Gulden", which was then the unit in circulation, as banknotes printed on silver, because the actual coins in circulation had become a token money containing much less value than corresponded to its value. As silver declined, the value of the silver Gulden was controlled entirely by the limitation of the quantity of the coin.

Exactly the same was done fourteen years later by British India. It also had had a silver standard and the depreciation of silver brought the rupee down lower and lower till the Indian government decided to stop the free coinage; and again the silver coins began to float higher and higher above their silver value. Now, there was at that time neither in Austria nor in India any expectation that ultimately these coins would be redeemed at a particular rate in either silver or gold. The decision about this was made much later, but the development was the perfect demonstration that even a circulating metallic money may derive its value from an effective control of its quantity and not directly from its metallic content.

My third illustration is even more interesting, although the event was more short-lived, because it refers directly to gold. During World War I the great paper money inflation in all the belligerent countries brought down not only the value of paper money but also the value of gold, because paper money was in the large measure substituted for gold, and the demand for gold fell. In consequence, the value of gold fell and prices in gold rose all over the world. That affected even the neutral countries. Particularly Sweden was greatly worried: because it had stuck to the gold standard, it was flooded by gold from all the rest of the world that moved to Sweden which had retained its gold standard; and Swedish prices rose quite as much as prices in the rest of the world. Now, Sweden also happened to have one or two very good economists at the time, and they repeated the advice which the Austrian economists had given concerning the silver in the 1870s, "Stop the free coinage of gold and the value of your existing gold coins will rise above the value of the gold which it contains." The Swedish government did so in 1916 and what happened was again exactly what the economists had predicted: the value of the gold coins began to float above the value of its gold content and Sweden, for the rest of the war, escaped the effects of the gold inflation.

I quote this only as illustration of what among the economists who understand their subject is now an undoubted fact, namely that the gold standard is a partly effective mechanism to make governments do what they ought to do in their control of money, and the only mechanism which has been tolerably effective in the case of a monopolist who can do with the money whatever he likes. Otherwise gold is not really necessary to secure a good currency. I think it is entirely possible for private enterprise to issue a token money which the public will learn to expect to preserve its value, provided both the issuer and the public understand that the demand for this money will depend on the issuer being forced to keep its value constant; because if he did not do so, the people would at once cease to use his money and shift to some other kind.

I have as a result of throwing out this suggestion at the Lausanne Conference worked out the idea in fairly great detail in a little book which came out a year ago, called *Denationalisation of Money*. My thought has developed a great deal since. I rather hoped to be able to have at this conference a much enlarged second edition available which may already have been brought out in London by the Institute of Economic Affairs, but which unfortunately has not yet reached this country. All I have is the proofs of the additions.

In this second edition I have arrived at one or two rather interesting new conclusions which I did not see at first. In the first exposition in the speech two years ago, I was merely thinking of the effect of the selection of the issuer: that only those financial institutions which so controlled the distinctly named money which they issued, and which provided the public with a money, which was a stable standard of value, an effective unit for calculation in keeping books, would be preserved. I have now come to see that there is a much more complex situation, that there will in fact be two kinds of competition, one leading to the choice of standard which may come to be generally accepted, and one to the selection of the particular institutions which can be trusted in issuing money of that standard.

I do believe that if today all the legal obstacles were removed which prevent such an issue of private money under distinct names, in the first instance indeed, as all of you would expect, people would from their own experience be led to rush for the only thing they know and understand, and start using gold. But this very fact would after a while make it very doubtful whether gold was for the purpose of money really a good standard. It would turn out to be a very good investment, for the reason that because of the increased demand for gold the value of gold would go up; but that very fact would make it very unsuitable as money. You do not want to incur debts in terms of a unit which constantly goes up in value as it would in this case, so people would begin to look for another kind of money: if they were free to choose the money, in terms of which they kept their books, made their calculations, incurred debts or lent money, they would prefer a standard which remains stable in purchasing power. I have not got time here to describe in detail what I mean by being stable in purchasing power, but briefly, I mean a kind of money in terms which it is equally likely that the price of any commodity picked out at random will rise as that it will fall. Such a stable standard reduces the risk of unforeseen changes in the prices of particular commodities to a minimum, because with such a standard it is just as likely that any one commodity will rise in price or will fall in price and the mistakes which people at large will make in their anticipations of future prices will just cancel each other because there will be as many mistakes in overestimating as in underestimating. If such a money were issued by some reputable institution, the public would probably first choose different definitions of the standard to be adopted, different kinds of index numbers of price in terms of which it is measured; but the process of competition would gradually teach both the issuing banks and the public which kind of money would be the most advantageous.

The interesting fact is that what I have called the monopoly of government of issuing money has not only deprived us of good money but has also deprived us of the only process by which we can find out what would be good money. We do not even quite know what exact qualities we want because in the two thousand years in which we have used coins and other money, we have never been allowed to experiment with it, we have never been given a chance to find out what the best kind of money would be.

Let me here just insert briefly one observation: in my publications and in my lectures including today's I am speaking constantly about the government monopoly of issuing money. Now, this is legally true in most countries only to a very limited extent. We have indeed given the government, and for fairly good reasons, the exclusive right to issue gold coins. And after we had given the government that right, I think it was equally understandable that we also gave the government the control over any money or any claims, paper claims, for coins or money of that definition. That people other than the government are not allowed to issue dollars if the government issues dollars is a perfectly reasonable arrangement, even if it has not turned out to be completely beneficial. And I am not suggesting that other people should be entitled to issue dollars. All the discussion in the past about free banking was really about this idea that not only the government or government institutions but others should also be able to issue dollar notes. That, of course, would not work. But if private institutions began to issue notes under some other names without any fixed rate of exchange with the official money or each other, so far as I know this is in no major country actually prohibited by law. I think the reason why it has not actually been tried is that of course we know that if anybody attempted it, the government would find so many ways to put obstacles in the way of the use of such money that it could make it impracticable. So long, for instance, as debts in terms of anything but the official dollar cannot be enforced in legal process, it is clearly impracticable. Of course it would have been ridiculous to try to issue any other money if people could not make contracts in terms of it. But this particular obstacle has fortunately been removed now in most countries, so the way ought to be free for the issuing of private money.

If I were responsible for the policy of any one of the great banks in this country, I would begin to offer to the public both loans and current accounts in a unit which I undertook to keep stable in value in terms of a defined index number. I have no doubt, and I believe that most economists agree with me on that particular point, that it is technically possible so to control the value of any token money which is used in competition with other token monies as to fulfill the promise to keep its value stable. The essential point which I can not emphasize strongly enough is that we would get for the first time a money where the whole business of issuing money could be effected only by the issuer issuing good money. He would know that he would at once lose his extremely profitable business if it became known that his money was threatening to depreciate. He would lose it to a competitor who offered better money. As I said before, I believe this is our only hope at the present time. I do not see the slightest prospect that with the present type of, I emphasize, the present type of democratic government under which every little group can force the government to serve its particular needs, government, even if it were restricted by strict law, can ever again give us good money. At present the prospects are really only a choice between two alternatives: either continuing an accelerating open inflation, which is, as you all know, absolutely destructive of an economic system or a market order; but I think much more likely is an even worse alternative: government will not cease inflating, but will, as it has been doing, try to suppress the open effects of this inflation; it will be driven by continual inflation into price controls, into increasing direction of the whole economic system. It is therefore now not merely a question of giving us better money, under which the market system will function infinitely better than it has ever done before, but of warding off the gradual decline into a totalitarian, planned system, which will, at least in this country, not come because anybody wants to introduce it, but will come step by step in an effort to suppress the effects of the inflation which is going on.

I wish I could say that what I propose is a plan for the distant future, that we can wait. There was one very intelligent reviewer of my first booklet who said, "Well, three hundred years ago nobody would have believed that government would ever give up its control over religion, so perhaps in three hundred years we can see that government will be prepared to give up its control over money." We have not got that much time. We are now facing the likelihood of the most unpleasant political development, largely as a result of an economic policy with which we have already gone very far. My proposal is not, as I would wish, merely a sort of standby arrangement of which I could say we must work it out intellectually to have it ready when the present system completely collapses. It is not merely an emergency plan. I think it is very urgent that it become rapidly understood that there is no justification in history for the existing position of a government monopoly of issuing money. It has never been proposed on the ground that government will give us better money than anybody else could. It has always, since the privilege of issuing money was first explicitly represented as a Royal prerogative, been advocated because the power to issue money was essential for the finance of the government—not in order to give us good money, but in order to give to government access to the tap where it can draw the money it needs by manufacturing it. That, ladies and gentlemen, is not a method by which we can hope ever to get good money. To put it into the hands of an institution which is protected against competition, which can force us to accept the money, which is subject to incessant political pressure, such an authority will not ever again give us good money.

I think we ought to start fairly soon, and I think we must hope that some of the more enterprising and intelligent financiers will soon begin to experiment with such a thing. The great obstacle is that it involves such great changes in the whole financial structure that, and I am saying this from the experience of many discussions, no senior banker, who understands only the present banking system, can really conceive how such a new system would work, and he would not dare to risk and experiment with it. I think we will have to count on a few younger and more flexible brains to begin and show that such a thing can be done.

In fact, it is already being tried in a limited form. As a result of my publication I have received from all kinds of surprising quarters letters from small banking houses, telling me that they are trying to issue gold accounts or silver accounts, and that there is a considerable interest for these. I am afraid they will have to go further, for the reasons I have sketched in the beginning. In the course of such a revolution of our monetary system, the values of the precious metals, including the value of gold, are going to fluctuate a great deal, mostly upwards, and therefore those of you who are interested in it from an investor's point of view need not fear. But those of you who are mainly interested in a good monetary system must hope that in the not too distant future we shall find generally applied another system of control over the monetary circulation, other than the redeemability in gold. The public will have to learn to select among a variety of monies, and to choose those which are good.

If we start on this soon we may indeed achieve a position in which at last capitalism is in a position to provide itself with the money it needs in order to function properly, a thing which it has always been denied. Ever since the development of capitalism it has never been allowed to produce for itself the money it needs; and if I had more time I could show you how the whole crazy structure we have as a result, this monopoly originally only of issuing gold money, is very largely the cause of the great fluctuations in credit, of the great fluctuations in economic activity, and ultimately of the recurring depressions. I think if the capitalists had been allowed to provide themselves with the money which they need, the competitive system would have long overcome the major fluctuations in economic activity and the prolonged periods of depression. At the present moment we have of course been led by official monetary policy into a situation where it has produced so much misdirection of resources that you must not hope for a quick escape from our present difficulties, even if we adopted a new monetary system.