Currency options: Hayek and competing currencies

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While monetary theory indicates the advantages of a single currency, there are compelling arguments for the UK to remain outside the euro-zone.

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The 1999 Annual IEA Hayek Memorial Lecture[1] examines the European Monetary Union (EMU) in the context of proposals for the denationalisation of money and for the inauguration of competition between currencies.[2] These particular concerns are recent manifestations of the quest for 'neutral' money. Conceptualised by the Swedish economist Knut Wicksell in 1898, 'neutrality' has featured crucially in monetary policy debates between Friedrich Hayek and John Maynard Keynes (and Keynesians). It is also relevant to the currency options facing the UK: sterling or the euro? Neutral money refers to a monetary system that does not destabilise any detail of real economic activity.

In rejecting the principle of neutral money, Keynes was a staunch advocate of independent monetary systems. He believed that monetary policy could be used to achieve positive economic goals. In the depression of 1930s, he argued that a 'policy of an autonomous rate of interest, unimpeded by international preoccupations, would restore economic health and strength internationally.'[3]

In a thinly-guised response to Keynes, Hayek gave a series of lectures in Geneva in 1937,[4] in which he condemned the baseless promise that an independent currency affords protection against external financial shocks. Since these are rarely, if ever, all-embracing in their effects, Hayek argued that external shocks call for particular (microeconomic), rather than economy-wide (macroeconomic), readjustments.

Hayek insisted that monetary nationalism delivers the potential for international instability, the discouragement of long-term investments, and a threat to the benefits from an international division of labour. His analysis – which draws from the theoretical issues by which monetary autonomy should be judged – is relevant to current concerns in respect of the EMU. Hayek discussed three possibilities for currency regimes: fixed exchange rates, flexible exchange rates and a single currency.

Exchange rate regimes

With fixed exchange rates, domestic deflation is necessary whenever devaluation (because of, say, poor international competitiveness) threatens. The exchange rate must be defended. This means that adjustment costs (the contraction of economic activity) are borne by every industrial sector. All sectors of the economy are directly affected, rather than only those that are in trouble. So, a fixed exchange rate regime requires an economy-wide deflation when only a selective adjustment of prices would otherwise be required. The necessary *relative* price adjustments are achieved only as prices in uncompetitive sectors fall further than prices in relatively prosperous industries.

Under flexible exchange rates, a decline in international competitiveness weakens the currency and causes a general rise in prices (inflation). Instead of wages and prices falling in the particular sectors that are uncompetitive, adjustment costs under flexible exchange rates are again borne by every sector. The necessary *relative* price adjustments are achieved only as prices in uncompetitive sectors rise by less than prices in relatively prosperous industries.

Within a single currency system, poor economic performance of (say) bobbin manufacturers in the north-west of England and (say) a rising demand for haggis produced in central Scotland are accommodated by differential changes in prices, wages and profits in those two sectors (with secondary effects upon their suppliers), all of which give incentives to appropriate structural 'supply-side' changes. Sectors which, for whatever reason, are unable to stem a decline in their competitiveness, must either accept lower prices and reduced rates of remuneration, or else go out of business.

So, the three options are clear. Relative wage and price adjustments (within a single currency area), an economy-wide deflation (under fixed exchange rates) and a currency depreciation (under flexible exchange rates) are the means to effect structural adjustments to accommodate changes in demand patterns. Within a single currency area, these adjustments are more likely to take place without general deflation/inflation.

Although an exchange rate readjustment of a sovereign currency is often presented as a panacea to boost international competitiveness, the option of an independent monetary policy affords no means to re-equip the unemployed with saleable skills; nor can it bring cheap credit to industries that are unable to compete for funds; nor can it bring affluence to poor regions; and from those conclusions it follows that the option of an autonomous monetary policy delivers no useful macroeconomic options.

The interest rate option

To this point, the analysis favours a single currency system, which implies a centralised monetary policy and a uniform interest rate. This means that, for any member state of a single currency area, there is no 'interest rate option.' The perceived implications of this sacrifice are hotly disputed, with the alternative scenario of a range of interest rates – 'variously sized

to fit all' – as a key issue in respect of the UK's membership of the EMU.

The interest rate would be a non-issue if the economies of the EMU member nations were in similar shape. Where they are, say, at different phases of the business cycle – the relevant questions are: How might this have happened? And why should it matter? Is it not possible for economies in recession to sell into those enjoying boom conditions?

If structural differences and natural disasters are ruled out (which would imply a need for supply-side adjustments), differences in the general state of business prosperity are most plausibly explained by different histories of attempts at demand management. Undoubtedly, this is part of the explanation for business cycle differences across the EMU. Given time, such differences would dissipate under a common monetary policy regime. Indeed, this was the rationale for the pre-entry convergence criteria. Had those criteria not been 'fudged' in the interests of political expediency, fewer states would have been admitted to the EMU and the euro would have been a stronger currency.

Of course, that fudge is symptomatic of a general tendency for the most appropriate economic policies to be thwarted by the need for politicians to appease their electorates. So there is ever-likely to be a clamour for (say) an interest rate cut/rise (depending upon who is clamouring), with the blame for inaction inevitably falling upon the monetary authority. Such circumstances provide the rationale, not for active demand management via the interest rate option but, either for a politically independent central bank or, alternatively, for competition between privately issued currencies.[5] In other words, there is a need to shield the authorities from recurring demands for monetary panaceas that are born of an ignorance of sound economics.

Competitive currencies

The tendency to achieve mutual compatibility across the decisions of countless economic agencies is a function, not of a 'policy of an autonomous interest rate,' but of an institutional environment that is founded upon the discipline, either of a resolute monetary authority or of currency competition. The practical problem of achieving the most effective monetary discipline is an issue to which Hayek returned on a number of occasions.[6] The position that he finally reached is that governments should surrender their monopoly of the note issue: '[a]ll history contradicts the belief that governments have given us a safer money than we would have had without their claiming an exclusive right to issue it.'[7]

Given an inherent political conservatism and the reluctance of the state to relinquish monetary control, Hayek suggested that a feasible first step towards competition between currencies would be for the monetary authorities of other nations to be allowed to compete against the domestic provision of currency. To this end, he proposed that nations should 'mutually bind themselves by formal treaty not to place any obstacles in the way of free dealing throughout their territories in one another's currencies, or of similar free exercise of banking business.'[8]

Without competition, a sole supplier of currency has no incentive to defend its value. On the contrary, in making first use of every new currency unit, a monopolist enjoys enhanced profits from a continuous currency depreciation. When nation states were constrained by gold convertibility and by the requirement to bridge international net transfers with gold, an orderly money regime was sustained. Nevertheless, Hayek discounted the possibility of a return to gold, arguing that its viability had rested upon 'the general opinion that to be driven off the gold standard was a major calamity and a national disgrace.'[9] That constraint cannot be re-imposed. So, Hayek reached the conclusion that an alternative discipline needed to be instigated; that is, the discipline that is imposed by the presence of rivals.

Hayek described the manner in which competition between state currencies might be augmented by the entry of new private currencies. Joint-stock banks could issue non-interest-bearing certificates denominated in new units (registered as trade names) and announce a readiness to open cheque accounts in terms of those units. The publicly-stated policy of each bank would be to maintain the purchasing power of its unit in terms of a basket of commodities, whose composition would be altered periodically, 'as experience and the revealed preferences of the public suggested.'[10] New currencies – issued through lending and sale against other currencies – would be distinct, and each competitor would regulate his supply so as to maintain the competitiveness of its own brand. Hayek anticipated that the currencies to command the greatest confidence would be those to give the most secure expectation of purchasing power. Others would be driven into disuse. Consumer sovereignty would determine the characteristics of private currencies just as it determines the quality and

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composition of other goods supplied under competition. Private currencies would displace state currencies entirely only if the latter were perceived to be inferior.

The euro

Although the Maastricht Treaty (1) guarantees the independence of the European Central Bank (ECB) 'to pursue its mandated ultimate objective, that is, price stability, without interference from government,'[11] and (2) prohibits 'any monetary financing of the pubic sector or privileged access to financial institutions' (*ibid.*), it is inconceivable that events will not test those features as, indeed, German unification showed how the allegedly independent Bundesbank could be moved by political pressure. So, although Otmar Issing rightly suggests that Hayek's practical suggestion – 'under present conditions we have little choice but to limit monetary policy by prescribing its goals rather than its specific actions'[12] – has already been achieved, there can be little doubt that Hayek would have been appalled by the EMU, the ECB and the euro: 'a new European currency … would ultimately only have the effect of more deeply entrenching the source and root of all monetary evil, the government monopoly on the issue and control of money.'[13]

The demise of the gold standard robbed the world of the benefits of a single currency regime; it had provided

> 'in effect an international currency without submitting national monetary policy to the decisions of an international authority; it made monetary policy in a great measure automatic and thereby predictable; and the changes in the supply of basic money which its mechanism secured were on the whole in the right direction.'[14]

The fixed exchange rate system, agreed at Bretton Woods in 1945, provided a surrogate in the immediate postwar period; but that system collapsed in the late 1960s, as profligate US budgets dissipated trust in the US dollar as the international reserve standard. Most recently, the early optimism, that the euro might achieve a status even to rival that of the blemished US dollar, has been dashed. The currency markets are rightly sceptical of the claim that the ECB and the euro are free of political machinations. Most certainly, there is trouble ahead and the UK would be well-advised to retain its monetary autonomy. The euro cannot survive by its present constitution. Can anyone doubt that the ECB will receive new treaty instructions when – without a sovereign currency and the debasement option to turn to – insolvent members of the EMU find themselves bereft of new credit opportunities?

Neutral money: the future

It is reasonable to expect that innovations in electronic communications and exchange will continue to shape the provision of financial services. In keeping with Hayek's theme of currency competition, those developments might embrace registers of individuals' asset portfolios (comprising not only financial assets of every kind, but also real assets) with opportunities to make virtually instantaneous withdrawals and deposits. These would facilitate market transactions and transfers across the complete liquidity spectrum. Such asset portfolios might be interlinked with others that incorporate contracts to secure goods and services to meet future demands. It is a plausible supposition that advances in communications, information technology and financial services will raise the advantages and reduce the hazards of a money economy to the point where – in effect – arrangements will allow the *barter* of assets and commodities alike. And this, too, raises questions. Would this constitute the ultimate practical achievement of a neutral money? And would it not undermine a monetary monolith, such as that envisaged by the European centralists?

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13. Hayek (1976) op. cit., p. 126.
14. Hayek (1943) op. cit., p. 176.