

Getting back to real money

The problem

For decades our fiat paper money, the rand, has been falling in real value – what it can buy.

The solution

Hayek proposed in 1978 that various countries should mutually bind themselves to let people deal freely in one another's currencies (including gold coins), and to bank freely. Competition and free trade in money would impose monetary and financial discipline and result in honest money, keeping all monies tolerably stable and as reliable and useful as each other. This would be more practical than agreeing upon a common European (or global) currency. Free trade in banking would prevent the political lobbying for monetary and financial favours which is currently unavoidable. It would also prevent concealed depreciation, as governments could then no longer 'protect' their currency from harmful consequences of their own measures, prevent outflows of money, capital and resources, or control prices.

To those familiar only with government monopoly money, Hayek hoped to show the feasibility of a return to legalised private money as a way of overcoming inflation. He was not immediately successful in persuading governments, and countries such as Britain and America pursued other options. Following the inflationary seventies first Paul Volcker then Alan Greenspan of the US Federal Reserve system led the developed world in largely successful efforts to bring money supply and price inflation back under better control (at least temporarily, to date).

The local scene

South Africans, who had shared in the destructive worldwide Keynesian inflationism, have not been so lucky during the eighties and nineties. Continuing monetary indiscipline has kept the rand sinking against the currencies of the developed economies. We still suffer significant rand depreciation and price inflation with all the associated malinvestment, low growth, high unemployment, and boom-bust cycles. Punitive real interest rates embody our collective lack of confidence in the rand, or rather, our confidence that the rand will keep on weakening unpredictably.

Finance Minister Trevor Manuel recently described one aspect of South Africa's monetary problem: "In other countries there are performance criteria to test the central bank's performance. Here we have nothing." Indeed, successive governments have confirmed the Reserve Bank's monopoly power to issue banknotes without having to redeem them for any other commodity, and its discretionary "independence" regarding how many to issue. Reserve Bank governors have then issued too much fiat paper money while trying to blame everyone else. The inevitable depreciation and devaluation of the Rand have held back and distorted development and growth.

The subject of money can seem complex and confusing, and opinions abound. Some still favour forcing down interest rates and pumping up the money supply. Mr Manuel says "it is quite simply a must that government should set the inflation target," and since government is one of the main beneficiaries of inflation, he may not find Cabinet support for a zero target.

But surely the sound and stable money which every individual user would prefer is possible? Is it really so complicated?

Back to basics – what money is for

Money is not a shared "public good" like defence, no "market failure" preceded its nationalisation by government, and the supply of money is not a "natural monopoly". Money is a convenient medium

of exchange for goods and services. Money is the messenger which transmits ever-changing market knowledge (the prices of all other goods) from and to us all, enabling us to discover and act upon opportunities for trade and profit.

Inflation and too many messengers

Like the commodities from which it evolved, money, even paper fiat money, loses value if there is a sudden increase in supply while nothing else changes. So if the amount of goods and services stays about the same, the rand depreciates – that is, prices in general rise (in rands).

The monetary theory of inflation is indisputable – price inflation is man-made and caused by over-issuing the currency. The words *inflation* and *deflation* once did refer precisely to the increase or decrease of the money supply – by a regrettable semantic shift they now refer to price levels instead, which has created great confusion. But the responsibility point is unchanged, as is the causal link from money supply to prices.

Who changes the money supply, and how?

The South African Reserve Bank produces the monetary base (M0), also called the cash base and high-powered money, which is all the notes and coins in circulation, plus the reserves of financial institutions held at the central bank. (As measured, it does not include government-owned deposits at the Reserve Bank, but in theory it should.)

The Bank can directly and accurately control M0 by open-market operations to buy or sell government securities which it settles by issuing or removing money (rand notes or deposits at the Bank), and by direct issue or receipt of money for goods and services.

When the Bank, on its sole responsibility, expands or contracts this cash base, the privately-produced portion of the money supply (reflected in broader measures of money such as M1A, M1, M2 and M3) also tends to expand or contract.

The broader monetary aggregates fluctuate according to market needs. When the Bank tries to react to the actions of people in the private sector and influence such aggregates, it disrupts credit markets and loses control of its own product (M0). The monetary base is its only appropriate responsibility point and efficacious target of monetary policy.

If a stable M0 were desired, the Bank would do nothing but replace old or lost notes, a simple, predictable, stable, consistent and credible approach, easy for us to monitor.

Blaming inflation on its symptoms

If economic growth slows and the Bank keeps raising the cash base, inflation may speed up (unsustainably). “Overheating”, which can prompt misguided calls to raise interest rates to prevent inflation, is a burst of unsustainable growth after artificial stimulation by monetary inflation. Such a boom is a co-symptom of rising prices, not a cause.

How well has the Reserve Bank performed?

We have erratic inflation rates, chronically high and volatile interest rates, exchange controls, a collapsing currency, little growth, and high unemployment. In its poor use of its monopoly power the Reserve Bank has proved inferior to free banking and even to other central banks. As “lender of last resort” it has given banks in trouble a false sense of security, distorting the market and wasting resources.

We would get on very well without:

- the uncertainties and economic distortions caused by government's use of inflation as an expensive and destructive form of retroactive taxation by stealth;
- destructively high market interest rates with their component of a price inflation premium for persistent and erratic monetary indiscipline;
- Reserve Bank tinkering to "improve" on the role of interest rates as market phenomena reflecting the preferences and interests of savers and borrowers;
- Reserve Bank attempts to control money demand by interest rates and thus modify the spending behaviour of millions of individuals.

Free banking as a standard of comparison

Free banking involves private banks (unrestricted, unprivileged and competitive, with minimal state involvement) with their own notes based on any money, with no central bank and no government-granted monopoly in note issue.

The self-interest of private persons in business firms and households would develop market machinery to provide stable money. Any one bank could over-issue its money-substitutes, but would do so at the risk of losing reserves and defaulting as the public accelerates redemptions. Competition (and the threat of it) would ensure stable money.

Free banking is probably the best of several alternatives which are all clearly better than the present central bank's unconstrained monopoly with notes unredeemable in gold or other commodities. Although, sadly, the discontinuous change involved in a direct move to free banking would be politically unacceptable, free banking does offer a standard of comparison for any financial and monetary policy-making.

We need some rules for stable money

Where we have a strong interest in security rather than flexibility, we build special constitutional rigidities or "rights" into the system to protect such things as life, liberty and property from government deprivations. In the same way, to escape short-term pressures to abandon a stable and predictable currency, we need monetary policy rules which are practical, find wide support, and prevent theft by governmental whim. That is, we need constitutionally entrenched rules for stable or predictable value of the monetary unit.

The lowest-cost means of ending inflation permanently and bringing net benefits rapidly is to take two concurrent actions:

1 *Impose specific rules for a monetary constitution on the Reserve Bank ...*

The Reserve Bank should control only the monetary base M0, by open-market operations (buying and selling government securities or gold). It should not manipulate interest rates, manage forex rates, or react to aggregate results of our actions such as M3 money supply, CPI inflation, GDP growth or unemployment. For one year only, it should be allowed to lend (last-resort), on a strict rising-penalty basis, to eligible private-sector financial institutions.

The specific rule to adopt for controlling the monetary base M0 could be a gold standard, a Hayek commodity standard, or a currency standard (such as the US dollar).

These rules would be enhanced by adopting a regulatory constitution that had no special status for banks, minimised protectionist rules, and a fiscal constitution limiting government's borrowing (at least for public consumption spending).

2 ... and (concurrently) remove restrictions on private entry, thus allowing private money alternatives to provide evidence of consumer preference.

Government may pursue Reserve Bank reform ("commercialisation") without allowing private entry, but it is scarcely credible that government will provide sound money (or any other cost-effective quality product) without the spur of private competition.

We need not show that private money is feasible before making it legal. If it is not feasible, it will not appear (or remain) in the market. Also, it is both impossible and undesirable to try to second-guess the market by predicting what kinds of private money might arise and survive.

Any new "need" for regulation to favour the central bank would be a signal for government to phase it out, leaving only private, unregulated competitors. But free-marketeers who expect an unprotected governmental competitor to go under could well be confounded – many former state monopolies worldwide have used their starting advantages to prosper.

Conclusion

This constitutional approach to monetary policy would reduce inflation and interest rates and open the door to freedom of choice in using any kind of money that might emerge.

Further reading

Grant, Richard (1999) *Real Money*, The Free Market Foundation, Johannesburg.

Hayek, FA (1978) *Denationalisation of Money – the Argument Refined*, Institute of Economic Affairs, London.

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