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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The author is Vice Chairman of The Nikko Securities Company International, Inc. Previously, he served as Staff Director for Monetary and Financial Policy for the Federal Reserve Board of Governors, and he was Staff Director and Secretary of the Federal Open Market Committee.

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.

What Kinds of Monetary Institutions Would a Free Market Deliver?

Lawrence H. White

At least since Adam Smith's *Wealth of Nations* (1776), economists have periodically debated the consequences of applying the principle of laissez faire to money. Never entirely extinguished, the debate seems to be rekindled at roughly 50-year intervals. In the late 1820s to early 1940s the advocates of "free banking" argued with some success that the monetary system would be improved by freeing entry for banks of issue, and by ending the privileges of the Bank of England and the Second Bank of the United States. In the 1880s and 1890s there was a modest revival of laissez-faire monetary thought in Great Britain, and in the discussions over remedies for the shortcomings of the regulated note-issue of the National Banking System in the United States. In the late 1920s and 1930s a still more modest revival occurred. Today we are in the midst of a large-scale resurgence of interest, dating from the mid-1970s, in competitive institutions for the supplying of money. For the first time since the 1840s a significant number of leading theoretical economists are among the proponents of monetary laissez faire.[1]

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[1]On the 1830s literature, see V. Smith (1936), L. White (1984a), and White and Selgin (1989). On the 1890s, see V. Smith (1936) again, Cowen and Kroszner (1987), and Selgin and White (1990). The important contributions of the 1930s era were Mises ([1928] 1978), Meulen (1934), V. Smith (1936), and Hayek ([1937] 1971). On Meulen, see Dowd (1988d), who also mentions the 1890s British writers. L. White (1984b) and Schuler (1988) survey old and new literature. Brown (1982) contrasts arguments for competitive money with arguments for constitutional monetary rules. Vaubel (1985) and Hellwig (1985) provide an informative clash of positive and negative views on currency competition. Dowd (1988a; 1989) and Selgin (1988) offer valuable restatements and important extensions of arguments for competitive money.