

## Diskussion

### Competing Currencies: The Case for Free Entry

#### Reply to Martin Hellwig

By Roland Vaubel

In his recent comment on my paper (Vaubel, 1985), *Martin Hellwig* (1985) has criticized me for views which I do not hold and which I have not expressed. I also believe that some of the conclusions which he draws from his model are invalidated by crucial circumstances which his model ignores and that one of his conclusions is inconsistent with assumptions he uses elsewhere in his comment.

1. The distinction between inside and outside money is clearly important. That is why I have emphasized that “value guarantees ... are likely to be a necessary condition for acceptance of a competing money” (p. 559, quoted from my 1977 article)<sup>1</sup>; i.e., I predict that competitive private money would be inside money. The reason is the problem of time inconsistency which I note on page 554 (“profit snatching”). Hence, Hellwig’s sections 4 and 5 (pp. 574 - 582) do not concern my paper, and his critique (especially on p. 577, in footnotes 8 and 24 and in the summary) is fundamentally misguided.

2. Contrary to Hellwig (p. 566), I do not claim that “unregulated currency competition would lead to the disappearance of outside money and its replacement by inside money as a superior asset”. We cannot predict whether the governmental outside money would stay in circulation or not. As the title of my paper indicates, I merely plead in favour of free entry. Since, contrary to Hellwig’s footnote 3, I have never asserted that the governmental outside money would disappear, I do not have to “prove” the point (Hellwig, p. 566). Nor do I think (as I indicate on p. 558) that a theoretical proof is possible. The proof of the pudding is in the eating.

3. Hellwig (p. 583) believes that the value guarantee I have in mind does not “involve a legal claim of the money holder on the money issuer. Instead,

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<sup>1</sup> Hayek also suggests that private issuing banks should offer to redeem their money on demand in guaranteed amounts of major national currencies (1978, p. 43). In his most recent article, he – like myself – predicts that competing private currencies would emerge, if at all, in the form of “current accounts in a stable unit – redeemable on demand in such amounts of the currencies generally used as are required to buy a ‘basket’ of raw materials and food stuffs . . .” (1986, p. 9).

the value guarantee is publicly announced as the guiding principle for future policy". How can value guarantees serve as a safeguard against profit snatching if they are not legally enforceable? In what sense could they be called guarantees at all? Where do I say that they do not involve a legal claim?

4. According to Hellwig, I do "not see that such guarantees themselves might be subject to moral hazard and therefore might not be credible" (p. 585). I refer Hellwig to my work on private currency competition in monetary history (1978, pp. 387 - 41) in which I deal with this problem. But is the fact that private suppliers can and do default under certain conditions, a sufficient condition for nationalizing the industry?

I agree with Hellwig that, in this case, "there is no presumption that the market outcome has any nice welfare properties" (p. 584). I would not even object to his statement that "we cannot make any firm assessment about the welfare properties of the outcomes in such markets" (p. 586). But does that justify restrictions on entry? Where in the real world do we observe nice welfare properties? The nirwana is not among the options. Precisely because nobody can make any firm assessment, Hayek and I want to use (potential) competition as a mechanism of discovery. Let each individual decide whether the government's outside money or some private inside money is more stable, remunerative and secure.

5. Although he feels unsure about the welfare properties of the private alternative, Hellwig believes that "the existence of an outside money without a backing is desirable on welfare grounds" (summary, p. 587); "even in those instances in which a non-interest-bearing outside money is displaced by an inside money with a value guarantee or repurchase clause, this result is socially undesirable" (p. 568). His reason is that "it involves an over-accumulation of real assets" (p. 567).

It is by no means clear that private suppliers of inside money would have to hold real assets as reserves. Take my example of an indexed private money that is guaranteed to appreciate vis-à-vis the governmental outside money at the rate at which the latter loses purchasing power. The issuer may only hold indexed loans and a small cash reserve of outside money. But even if he held commodity inventories as reserves, this loss of social seigniorage might be the inevitable cost of producing a superior money. Price theory does not tell us whether more monetary stability would be worth that price. Once more: who is to decide? Some enlightened monetary economist and planner or the users of money?

But let us assume with Hellwig (section 1) that the government's outside money would be of at least the same quality as the private inside monies. Hellwig argues that if precautionary savings take the form of money (rather than bond) holdings and if the money is – at least partly – backed by claims to real capital, the capital stock will be too large. This argument is of dubious relevance. As Feldstein (1977) has pointed out, such overaccumulation theories ignore that, in the world in which we live, capital earnings are subject to high tax rates which drive the pre-tax rate of return on capital above

the rate of time preference. If Feldstein's analysis is correct, our capital stock is too small, and more private inside money backed by claims to real capital could also be an improvement on this count. Of course, this is a second-best consideration; it would be desirable to eliminate the tax distortion in the first place. But it shows that we cannot simply jump from overaccumulation models to policy conclusions and, in particular, that these models are not likely to be effective in criticizing the "policy recommendations" (p. 565) which Hayek and I have submitted.

There is another assumption which the various overaccumulation models make and which is by no means self-evident: they assume an infinite time horizon; at the very least, to derive their conclusions, they *have to* assume that, if time is finite, the last generation does not expect to be the last. If the "doomsday generation" does not commit this error, intergenerational redistribution by a government that issues fiat money or public debt, is not Pareto-efficient; for it makes the "doomsday generation" worse off than it would otherwise (i.e., with a larger capital stock) be.

6. Hellwig believes that in a world with real capital, "money must ... be subsidized to bring the common rate of return on money and real capital up to the rate of time preference" (n. 17), and he objects to my statement (1984, p. 33, n. 17) that "no subsidy is involved ... (in paying) ... a market rate of return on base money". If, owing to the taxation of capital earnings, the rate of return on real capital is not below the rate of time preference, Hellwig's subsidy proposal is, of course, not relevant. But even if it were relevant, his criticism of my statement would be misplaced; for I was not denying that there might be valid arguments in favour of subsidies to money holding (I explicitly admit two such arguments on p. 41 and p. 47). What I wanted to stress in that context was that the case for paying (some) interest on outside money is independent of any subsidy arguments if the (private) opportunity cost of holding money rather than other assets exceeds the (government's) opportunity cost of producing money because of monopoly.

7. One of Hellwig's "problems" with my analysis is that "there are Pareto-relevant externalities in money demand decisions" (p. 565). In the section on externalities (which I decided to omit in my 1985 article because it was identical with pp. 31 - 45 of my 1984 article), I explained at length that the demand for a money does generate potentially Pareto-relevant transaction cost externalities. Contrary to Hellwig (p. 574), I also devoted two sections (pp. 41 - 45) to transaction cost externalities in the choice among currencies. My conclusion there is that the externalities are neither merely pecuniary nor necessarily Pareto-relevant (pp. 41 - 44).

With respect to potential price-level externalities, Hellwig suggests that "contrary to Vaubel's claims then, the demand for outside paper money involves a Pareto-relevant externality which justifies the creation of a real return that is financed from lump sum taxation" (p. 573). I agree with Hellwig (p. 572) that my discussion of price-level externalities was confined to the static aspect. This was because the argument I was criticizing had been couched in static terms (as Hellwig agrees) and because dynamic

pecuniary externalities need not be Pareto-relevant either.<sup>2</sup> It is also possible to object that pecuniary externalities may be Pareto-relevant if we are very far from the Pareto-optimum or if there are indivisibilities or distortions elsewhere in the system. To affect my policy conclusions, these imperfections and their implications for the free-entry issue would have to be specified.

Is it true that, in a non-static rational-expectations model, the payment of a real return on money is justified by Pareto-relevant price-level externalities? Clearly, the answer depends on how the supplier of outside money reacts, and is expected to react, to changes in the actual or expected demand for real balances. If he is known to have a target for the rate of change of the price level (zero?) and if, according to Hellwig's assumption, the money demand change has been rationally expected, the supplier of outside money will change (and be expected to change) the supply of money correspondingly. Hence, the rate of price level change, the quality of money and the rate of return on outside money remain unaffected by the change in money demand (except for possible non-price externalities). The same would be true in the case of private inside monies subject to value guarantees. Yet, even in the absence of price-level externalities, the payment of a real rate of return on (inside or outside) money would be justified and necessary to avoid a divergence between the opportunity cost of holding and producing money. Thus, the assumption of non-static price-level externalities is not only of doubtful relevance, it is also unnecessary to justify the payment of a real return on money.

8. According to Hellwig, Hayek's and my own view that more currency competition among central banks would encourage less inflationary monetary policies, rests on the "invalid premise" that "each issuing bank can at least partially control the inflation rate of its own currency through its supply behaviour" (p. 569).

Hellwig considers this premise "invalid" because he believes that, if the "Hayek-Vaubel proposal (of) lifting those restrictions which limit the use of dollars in Germany and marks in the United States ... is realized, then the two currencies will circulate side by side and their relative acceptability in an individual transaction will depend only on the participants' expectations and their relative resale value in future transactions" (p. 571). As I pointed out at our meeting, Hellwig's conclusion is invalid because he ignores money's role as a standard of value. As I indicate in my paper (p. 560) and have elaborated in detail elsewhere (Vaubel 1978), different groups of people who consume different baskets of commodities prefer different standards of value; since money serves as a standard of value, they would insofar prefer different monies – i.e., monies that are stable in terms of different commodity baskets. If, for this reason, different monies can coexist under

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<sup>2</sup> Scitovsky's argument to the contrary, which Hellwig (p. 572 and n.14) emphasizes, has been criticized by McKean in the passage which I have quoted (McKean, 1958, p. 142). In the case of dynamic pecuniary externalities, investors should try to anticipate the adjustment of others and the repercussions for themselves, but they should still be guided by their own expected profits.



free competition, currency transaction costs will reinforce the tendency towards the formation of (overlapping) payments circuits or currency domains. (In the specific case of the mark and the dollar, such currency transaction domains even exist to start with). Thus, if money is not only a store of value (an asset) but also a standard of value and a means of payment, it is misleading to assume that two outside monies could ever come close to being perfect substitutes. The Kareken-Wallace view, which Hellwig presents, is not relevant to this world. Indeed, Haberler (1980, p. 44), in paraphrasing Keynes, has called it “an extraordinary example of how remorseless logicians can end up in Bedlam, if they get hold of the wrong assumptions”.

9. A final hint: neither Hayek nor I do believe that “everything would be for the best of all possible worlds if only the government ceased interfering” (Hellwig, p. 586). We do not engage in nirwana economics.

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