BREAKING THE STATE MONOPOLY ON MONEY

Technology means that we should revisit the arguments for the 21st century

Dave Birch
Consult Hyperion
http://www.chyp.com

Prepared for *SPEED* magazine, Vol. 3, No. 3 (Spring 2009).

People tend to assume that the way that money works is just the way it is. They see current monetary arrangements as being akin to a law of physics, like the speed of light. But they are not. The way that money works (by which I mean, essentially, national fiat currency) is the culmination of hundreds of years of evolution in response to particular sets of circumstances that have led us to where we are. Generally, in times of low inflation people are broadly content to allow the system of fiat currency to function unquestioned. People are content to use money that has no real existence: a Pound is worth a Pound because that's what the government says and it's been a long time since you have been able to go down to the Bank of England and hand over your banknote in return for gold. You are perfectly entitled to go down to the Bank of England and hand over a £10 note if you want, but all the Old Lady will give you for it is two £5 notes. It sounds odd to say it, but in a way this kind of money is no more or less real than *World of Warcraft* (WoW) gold pieces!

When inflation begins to creep up, however, people begin to question whether the fiat currency arrangement is necessarily best for our modern economy and, by extension, modern society. They will (rightly) wonder if it makes sense for the issuers of the fiat currency (ie, governments) to be allowed to denominate their own debt, because the ability to inflate away that debt reduces their incentive to maintain sound money. This may lead them to question other aspects of current arrangements.

If it is time to ask these kinds of questions then perhaps it is time to rethink money more fundamentally, by considering the requirements for money in the modern world, and then using new technology to rebuild money, as technology has always done in past.

THE ARGUMENT REVISTED

The last time that inflation was really out of control in the U.K., back in the 1970s, the Nobel prize-winning economist Friedrich Hayek wrote a pamphlet for the Institute of Economic Affairs (IEA). It was called *The Denationalisation of Money—The Argument Revisited* [1]. In it, he put forward the proposition that the provision of private currency would be more likely to result in sound money than state currency because the issuers of that private currency would have to compete in order to keep the value of their currency up. Now that inflation is beginning to creep up once again, this proposition deserves to be reconsidered, this time in a technological environment (our world of smart cards, PCs and worldwide networks) that is more than capable of making it a reality.

What I mean by this is that in the 1970s, walking into a shop and paying with one of a number of competing private currencies, however economically desirable, would have been practically impossible. The costs of the issuing of the notes and coins, managing them in circulation, handling them at point of sale (retailers would have needed enormous tales to store all of the different kinds of money) and mentally calculating the exchange rates were just too great. It was an interesting thought experiment, but it was difficult to see it as anything more. Hayek himself discussed the practical difficulties [1], noting the problem of "cash registers" or "vending machines", where issuers might mint coins of differing denominations, size or weight, and where in any case their relative values would fluctuate. Hayek foresaw that:

> *Another possible development would be the replacement of the present coins by plastic or similar tokens with electronic markings which every cash register and slot machine would be able to sort out, and the 'signature' of which would be legally protected against forgery as any other document of value.*

We now have the digital money and digital identity technologies to make this vision both real, cost-effective and desirable and the "tokens with electronic markings" that Hayek predicts are the mobile phones that all of us now have. We may also have a test bed for Hayek's ideas.

THE CURRENT SITUATION

In times and places of hyperinflation, where inflation has got so far out of control that the circulating medium of exchange is rendered useless, people have been forced to search for ad hoc alternatives themselves. They might use the currency of a neighbouring country, or cigarettes, or they might even (as they did in Ireland at the time of a bank strike in the 1960s) simply begin to circulate each other's IOUs.

One particular example of note is the case of Argentina. When Argentina underwent devastating hyperinflation in a decade ago, it turned to a currency board to restore confidence in the currency but in some States the local governors began issuing their own "currency" in the form of bonds.

The current example that we are all aware of is that of Zimbabwe. It recently recalibrated the currency shaving a few zeros off of the banknotes (one of which, the Z$50 billion, was worth less than 10 U.S. cents), but this of course had no effect on the underlying dynamic. You would only imagine that the number of zeros on a banknote defines its real value if you know nothing about economics (or history). The predictable impact of this recalibration was none at all and the currency lost another half of its value on the very morning that the new banknotes were issued.

In order to rebuild Zimbabwe and return it to prosperity, something will have to be done about the currency. A recent article in the *Times of South Africa* neatly set out the three alternatives open to the country to stabilise its currency [2]. Steve Hanke, the author, began by pointing out that the hyperinflation is because of, and not despite of, the central bank. Since the Reserve Bank of Zimbabwe has no choice but to issue currency when instructed to by the government, this system can never deliver the monetary stability that is required to improve the lives of the citizens. Therefore, to reboot the Zimbabwean economy, the central bank's currency should be scrapped and the circulating medium of exchange provided by either dollarisation, a currency board or what is known as "free banking".

The first two options have been used in other countries and there are pluses and minuses that are well understood. Probably the easiest option is to simply replace the collapsed Zimbabwe dollar with the South African Rand, or the US dollar or even the Euro. The next possibility means creating a new kind of Zimbabwean dollar that is fully backed by a reserve currency (again, perhaps the South African Rand) and underwritten by the international community for at least three years, the option favoured by Stephen Chain in *Prospect* [3]. But it is the third alternative that I think deserves more attention, because new technology is changing the cost/benefit equation around free banking.

Traditionally, free banking has meant the unrestricted competitive issue of currency and deposit money by private banks on a convertible basis [4]. Historically, the base against which private banks issued their currencies was specie (gold or silver), but I think that today there might be other bases for private currency and organisations other than banks that might it.

Structure

In Europe, there is something called the Payment Services Directive (PSD) that the Commission hopes will create a harmonised payment market across the EU. Under the provisions of the PSD, three kinds of organisation will compete to create the new pan-European payments businesses. These are banks (well, credit institutions in general), specialist payment institutions (PIs) and electronic money institutions (ELMIs). In the U.K., organisations ranging from Barclays Bank to Starbucks are already registered as ELMIs and therefore allowed to issue their own electronic money. In the future, organisations from Nike to Orange might decide to become PIs and therefore be allowed to issue their own electronic money.

If these institutions could simply issue their own currency, then the exchange rates between those private currencies would be a reflection of confidence in the banks and institutions. If an institution began to over-issue money (in theory there would be appropriate regulation) then it's money would fall in value compared to the money of other banks. No big deal: as David Riccardo (1772-1823) noted in his *Proposals for an Economic and Secure Currency* way back in 1816, "In the use of money, everyone is a trader".

The X Factor

It may seem like a really big step to go down the route to free banking and private currency but the ability of new technology fulfil Hayek's prescription is the "X Factor" in the emerging environment and, what's more, it is already starting down that road in developing countries.

Throughout Africa the key new money technology, the mobile phone, is already a practical route to stability. Suppose the competing money issuing institutions did not actually have to issue expensive notes and coins? Suppose the new currency is a choice on a mobile phone menu rather than banknotes with different pictures on them? The incredible success of Safaricom in Kenyan has demonstrated clearly that mobile phones are a viable alternative to physical cash in developing countries. Indeed, in some African countries it is the mobile phone top-up vouchers that already four kind of distributed currency bought, a means of exchange for consumers and merchants, precisely because they are tied to a reserve currency: in some cases mobile phone minutes, and in some cases US dollars.

It would be a small step to implement a mobile scheme such as M-PESA with an additional menu to offer a choice in currencies. While I'm sure that most people would tend to hold only a single pre-paid account in one currency, others might want to hold two or three for whatever reason. The phone would give them the ability to shift between currencies in an instant, allowing them to develop their own individual strategies: Someone who is planning a trip to South Africa, for example, might want to build up some Rand whereas someone who is saving to buy a card might want to build up Zimbabwe Dollars.

Thus, taking note issue away from the central bank and adopting a regulatory structure along the lines of Europe's PSD could provide a straightforward way to make a real difference to the lives of million. This, incidentally, doesn't mean abolishing the central bank. Central banking is not just about price stability: It has historically also had a vital concern for the stability of the financial system as a whole, and particularly for the banking and payments systems within that [5], so there would still be plenty for them to do.

WHERE NEXT?

World mobile phone penetration has just reached 50% and the rate of increase is not slowing down. We are really not that far away from everyone have one. The ability of these phones to replace wallets (and, with more strategic impact, tills) is a genuinely novel aspect to the world of money. It's time to try something genuinely new. Many years ago, I said that [6]:

> *In a strange way, however, a scheme like Mondex is essentially very conservative: its purpose is to make the use of familiar national currency more efficient and cost–effective for consumers, retailers and banks. Similar technologies could, however, be used to create wholly private currencies.*

At the time, I thought (incorrectly) that a smart card was all that was needed to revolutionise money, when it's actually a smart card with a keyboard, screen and local and global connectivity.

REFERENCES (OPTIONAL)

[1] F. A. Hayek. *Denationalisation of Money*, Profile (London: 2007).

[2] S. Hanke. *Kill central bank to fix inflation* in *The Times-News* (13th Jul. 2008).

[3] S. Chan. *The tragedy of Tsvangirai* in *Prospect* (Aug. 2008).

[4] L. White. *Free Banking as an Alternative Monetary System* in *Competition and Currency—Essays on Free Banking and Money*, New York University Press (New York: 1989).

[5] M. Friedman and C. Goodhart. *Money, Inflation and the Constitutional Position of the Central Bank*, IEA (London: 2003).

[6] D. Birch and N. McEvoy. *DIY Cash* in *Wired UK* (Apr. 1996).