Currency Competition: The British Debate

Samuel Brittan

Earlier History

It would probably be best for me to concentrate on the recent British debate. Not only do I know it best, but I do not think that the earlier debates on free banking in previous centuries in various countries have any very direct relevance. This is because, until some time in the 20th century, it was generally assumed that money was based on an intrinsically valuable commodity, usually gold or silver, or some combination.

In earlier times freely floating paper currencies, not officially convertible into gold or silver anything else, were regarded as emergency or temporary expedients. An example was the U.S. dollar after the Civil War. During episodes of free banking the privately issued currencies had an explicit or implicit bullion value, and their success was measured by how low the discounts on them were, relative to their stated metal value.

Hayek's Proposals

The origin of the more recent British debate lies with some proposals made by the veteran Austro-British economist Friedrich Hayek. In a prewar work, *Monetary Nationalism and International Stability* (1937), he had come out in favor of a fixed international standard, which he thought would probably be gold. During the Second World War he published in the *Economic Journal* for June 1943 a proposal for "A Commodity Reserve Currency" that would be convertible into a basketful of commodities on a predetermined basis,

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Cato Journal, Vol. 23, No. 1 (Spring/Summer 2003). Copyright © Cato Institute. All rights reserved.

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following on the lines of similar proposals earlier put forward by Benjamin Graham and Frank D. Graham. Such ideas faded from public view in the post-World War II period, as the Bretton Woods system developed on the basis of national currencies linked by fixed but adjustable exchange rates.

The breakdown of that system after 1971, when President Nixon broke the last remaining link between the dollar and gold, was soon followed by the largest peacetime inflation of the 20th century (leaving aside postwar hyperinflations.) In the 1970s Hayek started to investigate free competition between both official national currencies and privately issued ones as well. It started in his own words as a bitter joke directed against what he then thought was the chronic inability of governments to provide sound money. But it soon led him into the fascinating problem of what would happen if money were provided competitively.[1]

Hayek's preliminary analysis appeared in a short paper in 1976 and a much fuller treatment followed in *The Denationalisation of Money* (1978), which was his last contribution to monetary economics. A number of authorities contributed to the subsequent discussion. Milton Friedman, for one, was thoroughly skeptical, although he avoided the subject whenever he could out of deference to Hayek's standing and age, and in order to avoid a bitter internal war among free-market inclined economists (Friedman 1984).

Enter the Euro

The issue arose again when the European Union began to develop plans for a single currency, later to be named the euro. Margaret Thatcher was bitterly opposed to the idea; but as an olive branch she suggested out of the blue at a meeting in Madrid in 1989 that the British would provide some alternative proposals for a European monetary union. There had been no earlier discussion inside the British Government. Indeed the Treasury Permanent Secretary was so astonished when he heard the notion on his car radio that he nearly bumped into a tree.

This still left the Treasury with the job of fleshing out the proposal in some way. Part of the problem was that Hayek had long been considered an outrider by establishment economists and advisers and his works were only considered if politicians pushed them down their throats. The lead was taken by the then Chancellor of the Exchequer

[1] These and related writings are conveniently collected in Kresge (1999).

(finance minister) Nigel Lawson who had for some years been an avid reader of Hayek's later works. He took the opportunity to put forward the idea of currency competition, although he only then had in mind competition among official currencies; and just after he left his post in 1989 the U.K. Treasury published a paper on competitive currencies in the European Union (U.K. Treasury 1989).

The problem with this paper, as with Hayek's original suggestion, was that there is nothing in British law to prevent people making deals or settling contracts in whatever currency they liked: dollars, Swiss francs, cowrie, shells, or anything else. The term legal tender, although sounding impressive, had little operational force. It mainly meant that if the currency in a contract was not stipulated, then it would have to be settled in pounds sterling. There was therefore nothing much to propose.

The competitive currency project was not accepted, or even understood, in most continental European countries. But the main trouble was that this—and later more complicated proposals for a so-called hard ecu—came much too late when the EU countries, led by France and Germany, had already made up their minds to create a new common currency.

The Blair Dilemma

We now have to fast forward to the more recent agonized debate on whether the Blair Labour Government (elected in 1997), which had a different agenda, should propose adopting the euro in place of the pound sterling. Opinion polls over many years have shown a persistent public distaste for giving up the pound in favor of the euro. In the year 2000, I suggested that Tony Blair give the whole subject of euro membership a rest for five years because endless discussions had not achieved anything and merely distracted attention from more important issues. For some time I had been suggesting that the most likely way for the euro to be adopted in Britain would be the parallel currency one: that is through its creeping use in ordinary business—or as it is sometimes called a membership by osmosis.

Instead of just saying yes or no to euro membership, the British government has the option of leaving it to private citizens and traders to use the euro if they wish. Some, but not all, of those who welcome the idea hope that it will lead to increasing use of the euro in the U.K. British exporters and financiers were perfectly free to make contracts in euros from the time the currency was launched in 1999; and, with the advent of euro notes and coins in 2002, visitors and returning tourists have been able to use them for payment to whomever will

accept them. Many large London stores have done so with alacrity, as they had already done for a long time with U.S. dollars.

But we should have no illusions that genuine currency competition will be easy to achieve, even though there has been long experience of parallel currencies operating in border areas such as French-speaking Switzerland or western Austria. The Canadian dollar shows little sign of being relegated to the back yard despite a 3,000-mile frontier with the United States and the fact that most Canadians live within 50 miles of that border.

The acid test of whether the euro is functioning as a parallel currency will be if some wage contracts are denominated in it. There will be a strong case for this in corporations highly dependent on exports to Europe. If sterling rose then wages would be automatically trimmed without the hard choice between negotiated wage reductions and job losses that now exist. If sterling fell then workers in such companies would automatically share in the devaluation gain without having to engage in difficult pay negotiations. By similar logic, there is a case for other corporations, more heavily dependent on export to dollar-linked countries, paying wages in the U.S. currency.

The most important single step the British Government can take to encourage the use of the euro, without jettisoning the pound sterling, would probably be to allow the euro to be employed for settling tax bills. And despite what I have said about legal tender being an archaic survival, it might make a symbolic difference if the euro were afforded that status along with sterling.

I have to admit that the currency competition idea has been seized upon by people who are extremely hostile to the euro and even to the whole European Union, as a way of making a no-vote respectable in any future euro referendum. And it is true that even pro-European supporters of currency competition would have to vote no in such a poll, as there could hardly be competition between the euro and a pound that had been abolished. This assumes, of course, that they are voting on purely economic grounds without considering the broader political implications of a yes or no vote—which will not be true in my case.

End of Bank Money?

So much for official currencies. But competitive private enterprise currencies might result from deep-seated trends in financial evolution that have little to do with government policy. The mainstream belief at present is that monetary policy exerts a big influence on output and

employment in the short-to-medium run, and on prices in the medium-to-long run.

Most central banks try to exert this influence by their power over short-term nominal interest rates, although some economists would prefer them to operate with targets for one or other definition of the money supply. They have such power because the greater part of the money supply consists of bank deposits; and banks are either obliged to, or find it prudent to, keep reserves at the central bank.

The result resembles some of the older cosmological theories in which the world rested on top of an elephant which in turn balanced upon a mouse. The supposed leverage is exercised by means of financial operations that are tiny in relation both to national and international monetary flows and in relation to total output. For instance, bank reserves in the United States account for only 0.1 percent of GDP.

This influence can only continue if the commercial banks carry on accounting for the bulk of the effective money supply and if they themselves continue to hold reserves with central banks. Both of these assumptions have been challenged, for instance, by a paper by Benjamin Friedman of Harvard. He suggests that the evolution of electronic means of payment will lead over a quarter of a century to the end of banks as we now understand them (Friedman 1999). The result is that even if the theory of how central banks influence the economy is now correct, ultimately they will lose all leverage.

Such developments were prematurely suggested when credit cards emerged some decades ago. But there is a difference this time round. In the case of most existing credit cards, at the end of the month you receive your dreaded statement, which is settled by a transfer from your bank to the credit card company. New forms of payment may not involve such transfers at all.

Smart cards—for example the single-vendor advanced-payment cards already used by many telephone services and the New York subway system—could develop into genuine private money. So long as issuers of these cards ask for settlement by transfers from bank balances, conventional sight accounts are still required. But firms and individuals might ultimately accept and swap balances on, say, the books of a transport or telephone authority. In other words they would be means, not only of payment, but also of settlement.

Another development is the proliferation of nonbank credit. At present when a bank extends credit, deposits are created on the other side of the balance sheet that have to be backed by reserves at the central bank. But bank credit has been steadily contracting as a proportion of total credit. In the United States the combined share of

banks and other depository institutions in the credit market has fallen from 50 percent in 1950 to 30 percent recently. Advances in data processing and the easier availability of information are likely to reduce still further the special advantages of banks in deciding on credit-worthiness. Moreover, even where banks still issue loans there is a trend to securitization. This means that the loans are sold to nonbank investors who are not subject to reserve requirements.

The combined results of all these developments could well be to reduce, perhaps to the point of elimination, the need for bank reserves and even the need for banks altogether. Benjamin Friedman is disarmingly frank about some of the further consequences. For instance, he cannot say what will determine the price level. Nor does he know whether national authorities will find an alternative way of limiting inflation and deflation or ironing out the worst of the business cycle.

The Friedman prognosis is not completely novel and has been partially endorsed by Mervyn King, now governor of the Bank of England (King 1999). But I still admit to lingering doubts. They center on what would be the means of settlement of last resort. There could well be money issued in the form of credits with say subway systems and telephone corporations. But these organizations are likely to have credits or debits with each other. How will these be settled?

One possibility is a return to a sophisticated form of barter. But even if this is the case for means of payment, I am sure that it will be convenient to have one, or a very small number, of standards of value for measuring indebtedness and wealth. In biblical times a person's wealth was often measured by the number of heads of cattle that he held.

In Defense of Monetary Freedom

To peer much further ahead would take us into the world of science fiction. The future can be left to the evolution of normal market forces provided that the present freedom in monetary movements remains. This can by no means be taken for granted. Retrogression is always possible. The anti-globalization movements and hysteria about boom and bust and corporate misgovernment could easily lead to the partial resumption of exchange control or limits on capital movements by some of the countries that abandoned them toward the end of the 20th century. Rather than squabble about the exact form that monetary freedom might take in future, it would be much better to con-

centrate on the defensive task of protecting the freedom we already have.

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