The Uselessness of Monetary Sovereignty

Pedro Schwartz

> The very politicians and economists who repudiate Keynesian policy at home become fervent Keynesians when they contemplate the horrors of British membership of the single currency.
>
> —Robert Skidelsky

Before addressing the question of whether Britain should keep sterling, we should examine what little we know about the nature of money and about the functions and capacities of the nation state. Though it may be true that changing one's monetary standard has deep implications for national sovereignty, one should first give some thought to the reduced role of money and to the limits of state power in a modern open economy. There could be a need for recasting the arguments both for and against adopting the euro.

Thus, as regards the ability to influence the real economy with monetary instruments, the friends of the euro predict that economic convergence brought about by the single currency will help the European Central Bank govern the European economy with a continent-wide monetary policy; and the friends of sterling hold it that it will be much easier to control economic fluctuations by means of the Bank of England interest rate. Thus also, as regards the consequences of globalization on national states, the defenders of the European Monetary Union hold it that the nation state is obsolete and impotent, while the defenders of national sovereignty, especially in Denmark and Sweden, fear the discipline of the euro for its effect on the welfare state. But views may change in more ways than one after

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seeing the limited effects of all monetary policy on real economies in a globalized world, be it applied by the ECB or the Bank of England. And the same may happen to one's political hopes for Europe or Britain after realizing that the nation state is enfeebled, not so much by its small size, as by the excessive span of its functions.

It is my contention that the notion of sovereignty is stretched and misapplied as regards the economic and political consequences, both favorable and unfavorable, of adopting the new European currency. It is as if both camps started from an unspoken Keynesian assumption that monetary and political authorities can exercise discretionary influence on society if their territories are of the requisite size.

For Keynes, the capitalist system could not function properly without continuous intervention by politicians and civil servants; and what is more, elected and unelected officials could be trusted to work for the public good. The defenders of the euro, pointing at the fact that national currencies are too small for an independent macroeconomic policy and ruing the time when national central bankers enjoyed monopoly powers, extol the advantages of a single European central bank, able to pursue monetary stability while governments can carry out active macroeconomic and welfare policies. Many critics of the euro also want an active monetary and social policy but think it possible only within a sovereign national state.

Now, *what if*

- a successful anti-cyclical policy is not within the reach of a central bank;
- central banks cannot directly and permanently contribute to full employment by expanding the money supply or reducing interest rates in the money market;
- central banks turn out to be unable to change the real interest rate on long-term credit;
- the real rate of exchange cannot be managed discretionally;
- the welfare state should turn out to be unsustainable whatever the size, national or continental, of the area over which it obtains?

Then a whole family of economic and political arguments *for and against* the euro lose relevance.

One may ask those in favor of the euro why they want to impose a new currency if people will increasingly be able to choose whatever money suits them best. Equally one may say to those wishing to retain monetary sovereignty that there is little point in wanting to control monetary policy, or wield the instrument of the bank interest rate, or intervene in foreign exchange markets, as economies become

increasingly globalized. The discussion should turn on whether the various economies are flexible and open enough to ride over monetary disturbances and what political institutions will contribute to making them so.

Assume for a moment that in trying to exercise sovereignty both national and European authorities cause more harm than good. In that case there is room for a different type of monetary and political arrangement, allowing Europeans to reap the benefits of currency competition thus thwarting central banker attempts to manage the economy; and to profit from the capabilities of a minimal state, thus escaping attempts to regulate everything under the sun.

The battle must be fought on another field than euro pro and con. The choices would be those of centralization versus individual choice, and of government discretion versus competition among institutions and jurisdictions. To join or not to join, is not a question of sovereignty.

Does the Currency Matter?

Economists, believe it or not, have always had great difficulty in integrating money in their models or representations of the economy. If, on the one hand, the analytical framework is that of a perfectly competitive economy, tending toward a state of general equilibrium, what is the point of perfectly informed transactors keeping liquid money in their pockets? From that point of view money is but a veil that should be pulled aside to get at the real phenomena. If, on the other hand, the starting assumption is that cash balances are needed because transactors are immersed in a world of uncertainty, is not the belief that authorities can manipulate money to counter fluctuations and make the economy grow a return to the belief in Plato's philosopher kings?

Money Is Two-Edged

Explanations of the need for money go back at least to Aristotle. Everyone is familiar with the three functions of money: measure of value, means of exchange, and store of value. All three are of great importance in helping supersede the primitive barter economy and moving to one in which people can sell without buying (and vice versa) and not have to take what they do not want. The store of value function is especially useful in allowing individuals to deal with uncertainty: receipts may unexpectedly not tally with payments, so that a store of cash comes in handy. Notice that the value stored in coins or notes is simply one way of dealing with the uncertainties of the

future: credit is the supply of a store of value by a saver to a borrower. Hence, this third function summarizes all the financial services of a community that help multiply productivity. Adam Smith saw this very clearly when he defined money as capital, that is to say, as a factor of production (Smith [1776] 1976: Book II, chap. 2).

However, this useful instrument of trade and credit is not the coins, notes, book entries, or electronic digits that we perceive with our senses, but the permanent value symbolized by the monetary instrument. Smith saw this too:

> When, by any particular sum of money, we mean not only to express the amount of metal pieces of which it is composed, but to include in its signification some obscure reference to the goods which it can be had in exchange for them, the wealth or revenue which it in this case denotes, is equal . . . to the money's worth more properly than to the money [Book II, chap. 2: 17].

So that individuals, if they can help it, will not be taken in by the appearance of money, but will use the real value behind its nominal worth. That is to say, people will continuously discount the nominal money they receive by its purchasing power in the market.

The first way in which money matters is the positive one of allowing people to transact, because they accept it as a representation of real wealth; and a greater ease of transaction helps create greater wealth.

For market participants, the mental operation of calculating the real value or purchasing power of nominal money is not a simple one. Gathering the necessary information does not come easy. The result depends on the goods and services each individual intends to trade in. There are shortcuts but the result is always approximate: consumer price indexes, prices at factory gate, the GDP deflator, the rate of exchange with a world currency, are some of the many used. But one must not forget that strictly speaking each person should use his own price index to calculate the value of the nominal money he uses. It takes time before people realize that a central bank is misbehaving by overprinting or underissuing money.

Another reason why it is possible to deceive ordinary people into making them use worthless money is the fact that issuing of nominal or fiat money is always an oligopoly. Setting up a currency network is not like opening a restaurant. Money is a "network" good, in the sense that the more people use it the more useful it becomes. People will be resistant to changing the currency they normally use for another that may not be accepted so readily. Hence, incumbent issuing banks are protected by an entry barrier. This means that the issuer may be

tempted to inflate and debase its currency. When legal tender laws impose the use of a national currency and exchange controls are set up as an exit barrier for captive residents this natural oligopoly is transformed into an even more dangerous monopoly.

Despite all these barriers to entry of competitors and exit of users, ordinary people can still protect themselves by taking account in their contracts of the expected debasement. If the rate of inflation is steady year in year out, transactors will discount it easily. Entrepreneurs, workers, producers will not think that an increase in the prices they obtain for their goods and services is due to their being more keenly appreciated, so they will produce and consume as much as before despite the fact that they are richer in fiat money. Contracts will be adjusted to take account of this constant rate of inflation. Nothing changes and an aggressive monetary policy becomes futile.

To overcome these defensive moves the issuing monopolist will try to surprise the public so that they cannot readily calculate the real value of money. To bring about temporary money illusion, extra money will suddenly be created, thus misleading the public into imagining a sudden burst of real prosperity; and then just as suddenly a correction will be imposed in the name of responsibility. This correction will eventually have the effect of reducing the demand for money and financial services; and also of making the supply of these services more expensive as banks have to charge insurance interest over the real cost of lending. It will also make contracting more complicated and bring about random distributional changes.

The second way in which money matters is a negative one: the currency may be abused by the issuer to charge an inflation tax, which cannot be obtained unless the authorities randomly deceive the users of their currency. This upsets the expectations of all and sundry with the end result of reducing growth.

In sum, real money and credit matter for the good because they are a factor of production; and nominal money can matter for the bad if it is strategically managed.

Money is Neutral in the Long Run

This lurid tale of central banker misbehavior need not be taken as a faithful representation of reality in all circumstances. But even when monetary authorities are well intentioned, the skeptical conclusions of what is called “intertemporal” or “rational expectations” macroeconomics still apply.

Let us imagine that the central bank takes measures aimed at pulling the economy out of a recession, such as lowering the short-term

bank rate or expanding the monetary base. Can we count on them to be effective? If private agents were inert pawns in the hands of authorities they might react like Pavlov dogs to cheaper more abundant money, and invest or consume more than before. However, people are not content with receiving policy measures as once-and-for-all acts of God. They see these measures as a moments in a behavioral continuum in which future circumstances and expected policy measures weigh on present situations. It may be the case that the public interprets a monetary expansion as the sign of a parlous underlying situation of the economy and will not be induced to invest or to spend, either because they think more monetary easing is on the way on the part of the authorities; or because the present reaction of the central bank suggests that the economy is going to get worse and they would be advised to save more. This seems to have happened in Japan during the last 10 years.

As Milton Friedman (1976) noted when criticizing Keynesian economics, the injection of liquidity will certainly cause an expansion of the *nominal* national output (i.e., real output multiplied by the price level) but it is impossible to tell how much of that expansion will go into new real activity and how much into mere price increases. It may be the case in the short run that the injection will revive real production, if at first private agents cannot tell an inflationary rise in prices from increase in the prices they can charge for their output; but in the long run, they will not be taken in by a mere monetary phenomenon, since rational people react to real incentives.

Friedman himself noted another consequence of the classical view that expectations make an active and discretionary policy nugatory. It is real, not monetary incentives that count in the end; and an effective policy (or at least one capable of being evaluated and recommended) must base itself on creating permanent expectations. Hence, one should aim at putting rule-based policy regimes in place.[1] One of the luminaries of rational expectations, Robert Lucas of the University of Chicago, has disparaged the idea that monetary authorities can influence economic performance for the good by taking discretionary measures to influence aggregate behavior (see Lucas 1972 and 1976).

In sum, the long tradition that money is neutral and can only impinge on the real economy for the worse, if central bankers act strategically and discretionally, has been taken up again with renewed force by the intertemporal or expectations school of macroeconomics.

[1]Friedman (1959) proposed that base money creation should be put on a permanent growth path parallel to the real growth rate.

But if in the long run money when well managed is neutral, why worry about adopting or not adopting the euro? As long as the ECB behaves properly and supplies a reliable currency, giving up sterling for the euro would, according to this theory, be quite indifferent.

But There Can Be Money Illusion in the Short Run

If Friedman proposed to fix the increase of base money at a constant rate, come what may, it obviously was because he expected the real economy to become capable of accommodating shocks with quick changes in relative prices. If real interest rates and real factor prices, especially wages, respond immediately to changed conditions, there will be no need to rely on monetary pump-priming to counteract prolonged recessions and their consequent long-term unemployment. This is how things were in 19th century with Britain under the gold standard. Come a financial downturn, the pound sterling would stay pegged to gold, a monetary steadfastness barely relieved by a reduction of the bank rate; wages and the labor force would be quickly and drastically cut; numerous bankruptcies would be declared; and barely a year would pass before the recovery was under way.

Conditions today are very different, though some economies, especially those of the United States and Britain are less rigid than others. As Mancur Olson (1982: chap. 7) remarked, it was an achievement of Maynard Keynes and John Hicks to point at sticky wages, among other sticky prices, as the culprits in the 20th century saga of long periods of unemployment.[2] After remarking that sticky wages as an explanation of unemployment was rather ad hoc in Keynes's model, Olson suggested that in many democracies cartels, unions, and lobbies contributed to making wages and many prices rigid: as far as wages were concerned unionized workers had an interest in keeping competitors unemployed, through minimum wage legislation and other ploys; and large employers of labor also had an interest in keeping the wages of nonunionized workers low by means of a large reserve army of the unemployed.

The Vain Chase after Currency Area Optimality

The belief that money matters a great deal in modern economies comes in two different forms. One is that the liquidity services of a

[2]Keynes rightly pointed out that forcing a wage reduction to cure involuntary unemployment was no solution by itself: the reason for long recessions is not the *level* of wages but the lack of *variability* of relative wages over time.

stable currency are indispensable in a capitalist economy and that therefore inflation, especially unstable inflation, reduces growth. The other is that money can be managed at will so as to counteract the cycle and maintain full employment. I have just argued that, while accepting the need for today's issuers of fiat money to keep the credit system on an even keel, the belief in the powers of discretionary monetary policy to deliver growth and employment is, in the long run, an illusion.

Mundell's Argument for the EMU

One of the forms that this monetary illusion takes is the theory of an optimum currency area. This is the idea that the central bank of a monetary area can manage the currency optimally when the different regions of the area have attained convergence in their business cycles, their industrial structures, and their standards of living. As Ronald I. McKinnon (1963: 717) noted, managing the currency optimally here means that the government with the central bank, by wielding fiscal and monetary tools and a freely flexible exchange rate, can attain "three (sometimes conflicting) objectives: (1) the maintenance of full employment, (2) the maintenance of balanced international payments, (3) the maintenance of a stable internal average price level."

This concept of an OCA was launched by Robert Mundell, the winner of the 1999 Nobel prize for Economics. In an almost unnoticed 1961 communication titled "A Theory of Optimum Currency Areas," he laid the foundation for the imposing edifice of the euro: in no more than nine pages he set out some necessary conditions for the EMU to function "hitchlessly," as Hicks would have said.

In the 1961 paper, Mundell argued explicitly against freely floating exchange rates and implicitly for monetary unions: this has been his consistent position up to the present day, when he has taken the role of foremost champion of the EMU and the euro.[3] He argued that a country could not maintain full employment while correcting its external deficit by means of devaluations of its currency, if the country had, like Canada, a very diverse regional structure. Under those conditions, one either had a different floating currency for each region, or one tried to steer the variegated regions of that economy toward convergence in cycle, structure, and living standards. This latter

[3]"Exchange rate volatility is the most important kind of asymmetric shock because it is truly nation specific. Such volatility or instability results in real economic changes, particularly in the real exchange rate and sometimes in the terms of trade" (Mundell 2002: 201).

solution was clearly preferable, since it permitted the creation of currencies accepted over large areas (and ideally the world over): people want their currency to be liquid, meaning wide acceptance and easy disposal. Finally, Mundell (1961: 661) noted that a non-optimal currency area could approach optimality if its productive factors were mobile as between industries and regions. As he put it, "an essential ingredient of a common currency, or a single currency area, is a high degree of factor mobility."

Here we can see the origin of two ideas current in euroland today—and present in two of the British Chancellor's suspensive five conditions before Britain adopts the euro. One is that all efforts should be made to attain economic convergence among the different countries of the EU. Another is that, since factor mobility, especially labor mobility, is patently lacking in the EU, the imposition of the euro over divergent European regions will, within reason, prove an irresistible force for reform and for greater economic flexibility.

But a *monetary* optimum (for central bankers) need not be an *economic* optimum (for ordinary people). National economies are made up of countless individuals and firms, each with their own structures and each affected differently by the monetary policy of the central bank. Bank credit and stock exchanges may move in sympathy with the local cycle and thus affect large groups in a collective fashion. But each business is otherwise differently affected by changes in monetary policy and the bank rate; indeed each face different interest rates depending on their reliability and expectations. There will never be a monetary policy adapted to the circumstances of each and every economic actor in an area. Apart from trying to avoid unnecessary financial collapses of the kind suffered in 1929–32, central banks are there to maintain the value and liquidity of the currency, not to steer the aggregate economy.

Greater factor mobility in euroland should not be treasured because it makes life easier for central bankers but because it is in itself a contribution to growth. Such factor mobility will be quickened by the very fact that the area is *not* an optimal monetary zone. In itself structural divergence is an incentive for trade, cross-country investment, and productive migration. Structural convergence of member states, if brought about by EU funds and not by competition and learning by doing, puts a brake on growth.

It will of course be easier for a central bank to apply the strict measures needed to protect the value of money if the population of the country is accustomed to its presence and policies. The United States is not an OCA, despite labor mobility among the several states and federal fiscal stabilizers; the different regions go through their

own peculiar slumps and booms that work as incentives for change. After 90 years of the Fed, Americans accept its rulings even if they do not suit all regions and businesses equally.

In my view, the attempt to turn Europe into an OCA is simply a search for making macroeconomic policy workable again and to stop migrants from moving to where there are jobs. If the monetary policy of the ECB were to fit euroland because all member states were equally rigid and synchronous, we would find ourselves with an optimal money and a pessimal economy.

An OCA is an oxymoron, a perpetually receding horizon that should never be longed for. The more flexible and open an economy, the more liquid and accepted its currency, the less the need to join a monetary cartel like the EMU.

When Monetary Policy Matters

In place of price and wage flexibility, present-day economies favor devaluations against other currencies, or money injections by the central bank, or automatic fiscal stabilizers based on the possibility of running budget deficits.

In today's socially rigid economies, creating short-term money illusion seems to be the only way to soften economic fluctuations. The welfare state has made individuals grow intolerant of uncertainty and sudden change. The need for foresight and adaptation has been shifted onto communal shoulders. An inflationary policy on the part of the monetary authorities helps prop up sectors of the economy for a time while fundamentals right themselves again. The more transient result of active monetary policies is stock exchange elation, for share prices must quite soon reflect company results. Private consumption may stay up for some time longer. Low interest rates and cheap mortgage policies are more effective in the housing market. The hope is that companies will be led to restructuring when the furnace is stoked with artificial money and that the economy will be ready to start again on a sounder basis when the inflationary illusion wears off.

Experience has shown us that inflation must not be allowed to run out of hand if it is to tide over the economy effectively. The central bank must be able, in our highly rigid societies, to use the bank rate to "cool" the economy when its own previous monetary easing has heated it. But, however nimble the central bank, monetary sovereignty in today's moral hazard atmosphere is a Hobson's choice: inflation, take it or leave it.

The more rigid an economy, the greater the need felt for monetary sovereignty to alleviate economic downturns. But one should not conclude from this that managing the currency acts like a magic wand. Variable inflation may alleviate pain but reduces the capacity of economies to grow in a sustained manner. The sensible conclusion should rather be that central banks maintain a stable monetary regime and governments remove barriers to internal and international competition.

Democracy and the Nation State

Much of the argument around the adoption of the euro turns on the alleged obsolescence of the nation state. The single currency is inevitable, some say, because the nation state is too weak to control and direct as much as it tries. The single currency is to be feared, say others, because it will deal the death blow to the welfare state. Both are in a way right. But the report of the death of the nation state will have been an exaggeration, if it undergoes a slimming cure.

The globalization of the economy and society, the openness of the world economy, and the new facilities for cheap travel and ready information are undoubtedly reducing the control of the state over its citizens. The answer of centralizers is to create cartels of nation states and of central banks, so that their writ runs over a larger zone from which individuals and firms cannot so easily escape. The answer of the nationalists is to try and maintain monetary sovereignty, so as to avoid having to trim their welfare systems. Perhaps the answer is to slim the nation state down and reinforce its role as the natural constituency for democracy. Jurisdictional competition in and among states could turn out to be a better way of defending individual freedom and maintaining world stability than super-state consolidation and centralization.

From Warfare State to Welfare State[4]

The coining of money used to be one of the essential appurtenances of sovereignty: now many countries around the world are happy to dollarize their economies and 12 historic nations on the continent of Europe have given up their currencies for a new untried money. Not only was seignorage essential to governments as a source of revenue but the inflation itself, though often unnecessarily abused in peacetime, was seen as an essential wartime weapon, given the

[4]Ferguson (2001) coins the phrase "from warfare to welfare" to characterize the growth of the "servile state" (see pp. 98–106).

inertia of money users who keep on transacting in a currency even while it is being depreciated.

This willingness to give up the national currency may be an indication of a wider crisis in the institution of the state, which is often incapable of encompassing defense, the economy, business, health, welfare, culture, entertainment, and other dimensions that used to be in its ken. The growing unpopularity of military power is not the only force that seems to be undermining the modern state. The globalization of human affairs due to reductions in transportation and information costs, increased international trade and cross-border services, and expanding population movements has reduced the ability of nation states in isolation to supply public goods or reduce public bads—meaning diffused consequences of activities by people who do not receive the returns or pay for the costs of their actions. To many it seems obvious that states should be superseded by international institutions or merged into larger federations to internalize, so to speak, those external effects that escape their control. The question is whether one public good that only nation states and smaller jurisdictions seem able to deliver, namely, democratic control and participation by the people, will be lost in the effort to create larger and allegedly more efficient political entities.

Nation states took a long time to become the main characters on the stage of domestic politics and international relations. They were born in Renaissance Europe, on the remnants of feudal Christendom. Organizations that resembled the modern state had existed in other lands but only China had in common with Europe that peculiar institution, a strong structure of civil servants.

The states of Europe had a first aborted takeoff in the 16th century when matrimonial alliances resulted in ephemeral confederations of kingdoms and lordships under one sovereign—the prime example being the Spanish Empire. They were the first vehicles for the absolute power of kings and queens lording over matters civil and ecclesiastical. These confederations suffered a crisis in the first half of the 17th century, in the form of the loss of The Netherlands and Portugal by Spain, the Civil Wars in England, the Fronde in France, and the Thirty Years War in Germany. Then the apt use of science and technology, commerce, and finance allowed a select few states (Britain, France, and Prussia) to grow strong in the 18th century. States underwent a surprising transformation in the 19th century: they slowly became the guarantors of law and order needed for commerce and finance to flourish, and they saw their powers almost reduced to the bare minimum needed as a framework for a peaceful civil society and for the growth and diffusion of wealth. Though nationalism and mass

politics, the portent of things to come, appeared on the world stage by way of the French Revolution, the rout of Napoleon conjured for almost a century the temptation to use state power for world domination.

From 1815 to 1870, the spontaneous order of free economies was allowed to go its way. Then the power of the state multiplied by capitalism was high-jacked by nationalist leaders adept at playing power politics. They harnessed democratic mass politics to strengthen the apparatus of the state. To obtain the loyalty of the masses, Bismarck first struck on the idea of granting social benefits so that disaffected socialist workers should come to rely on the state for their most peremptory needs, a Machiavellian move soon imitated in other states. In the steps of Bismarck, governments lorded over industry and trade and imposed social norms through state education and often state religion. For three quarters of a century nationalism, democracy, welfare, and military might grew together (Lindsey 2002). Now that the dreadful consequences of totalitarian nationalism have become clear to the inhabitants of the civilized world, almost the only relic of state expansion seems to be a bloated welfare system (see Table 1). But this relic is far from harmless and may end with the state acting as an enlightened slave owner on a scientifically cultivated plantation (de Jasay 1985: 274–82).

TABLE 1

FROM WARFARE TO WELFARE

U.K. Government Finance	1898	1998
Gross Public Expenditure (% GDP)	6.5	39
Defense (% GPE)	36	7
Debt service (% GPE)	21	9
Civil government	20	n.d.
Education	10[a]	12
Social Security	—	30
Health	—	17
Revenue[b]		
Excise duties	29	16[c]
Customs duties	19	0.5
Income tax	15	26
Death duties	13	1
National insurance contributions	—	16

[a]In 1898 includes Art and Science.
[b]Items are percentages of total revenue.
[c]In 1998 includes VAT.
SOURCE: Ferguson (2001: 105).

The resistance of taxpayers to pay for an ever increasing public expenditure to maintain the bloated state of today is not only expressed through the ballot box but also by voting with their feet and moving into the black economy or taking their money to fiscal havens. The instinctive reaction of governments with a stake in growing public expenditure is to try and create a cartel of national states under the form of a European Federation, where taxes converge (upward) and the limit on EU revenue is finally lifted.

People who feel defenseless without the protection of a paternalist state jump from observing the spontaneous internationalization of the economy to demanding the construction of superstates to carry out the tasks of impotent nations.

Multistate constructions, such as the EU, are two-sided: By creating larger markets they multiply the possibilities of individuals to escape the embrace of bureaucracy, but by building larger and more inclusive institutions they give civil servants a larger and more defensible territory to work over. Many believe that only superstates and international organizations can fill in the void of national states undermined by individual economic and social activities of individuals spread around the world. One of the ideas that lurk behind the push for a single money, backed by a harmonized fiscal system, and sustained by a single federal government, is the need to restore an all-encompassing government; and since this cannot be national let it be European.

The Venue for Democracy

There is, however, one essential contribution of the modern state that supranational institutions are unable to supply: the national state is the indispensable home for liberal democracy. Westerners have learned that mass democracy cannot work for the well-being of the individual unless it is tempered by the rule of law and the division of power. They also know that civilized institutions cannot endure unless they have the backing of the sovereign people. Hence, the nation state, properly fenced, is the venue for the exercise of democracy and freedom.

The United Nations and other international organizations, among which the EU and its Parliament, are a parody of the modern democratic state. With all its faults, the nation state, when it is not in the grip of tribal fundamentalists, is still the least bad vehicle for the expression of the will of the citizens.

Maybe the solution for the shortcomings of the modern state is not to merge it in grander organizations but to reduce it to the essential

functions that make it indispensable. These are defense, law and order, an independent judiciary, the guarantee of individual rights, the preservation of property and enforcement of contracts: all the functions that are necessary for the exercise of individual and political freedoms. There will be a need for agreements with other friendly states to complete the part of these necessary functions that cannot be performed on a national basis, but international cooperation should not take the form of cartels of old monopolists to stop individuals from voting with their feet. Mere legal rules to bind politicians and voters are unequal to the task of paring down the state. Monetary competition, world free trade, and free capital movements may still do the trick.

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