A Libertarian Money

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After VERY briefly reviewing the last 350 years of money and central bank monetary policy, the author reviews whether recently developed and developing cryptocurrencies provide more stable money. The answer is no. The author proposes that central banks adopt currency board rules that eliminate monetary policy in place of a market determined money supply. Moreover, he proposes that such currencies' value be anchored to the market value of a small basket of globally traded commodities. By adopting the IMF's SDR as the currency anchor and replacing SDR allocations with issuing them under currency board rules and eventually replacing the SDR valuation basket of currencies with the above-mentioned commodity basket, the SDR is likely to replace the dollar or any other currency for international payments and reserves.

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The long history of money began to take its modern form with the development of national central banks. "The story of central banking goes back at least to the seventeenth century, to the founding of the first institution recognized as a central bank, the Swedish Riksbank. Established in 1668 as a joint stock bank, it was chartered to lend the government funds and to act as a clearing house for commerce. A few decades later (1694), the most famous central bank of the era, the Bank of England, was founded also as a joint stock company to purchase government debt."[1] Over time central banks were given a monopoly over issuing their country's currency and usually for regulating the country's banks, which create most of each country's money.

Generally, the currencies issued by central banks (or commercial banks) were claims on, and thus redeemable for, gold or silver. The gold standard oversaw a long period of trade expansion and economic flourishing. A currency's fixed price for gold regulated the money supply both domestically and between other countries also on the gold standard, keeping its supply consistent with the fixed gold price. Countries, like individual families, cannot buy more that they sell over their live time (whatever the lifetime of a country might be). The gold standard, via the price-specie flow mechanism, preserved such balance of trade between gold standard countries.

Two countries on the gold standard, with fixed prices for gold for their currencies, have an unchangeably fixed exchange rate for their two currencies. But if the domestic purchasing power of each currency changes (inflation or deflation) the real value of the nominal exchange rate will appreciate or depreciate. The real exchange rate adjusts via changes in the domestic prices of one country relative to the other. If a country buys more abroad than it sells abroad, the outflow of its money to pay for its trade deficit will reduce its money supply if gold standard rules are observed (gold flows out and the supply of currency

backed by that gold contracts). The reduction in its money supply will reduce domestic (and thus foreign) prices in that money. This adjustment in domestic prices relative to foreign prices, which make foreign goods relatively more expensive domestically and domestic goods cheaper abroad, will reduce and eventually eliminated the trade deficit.

When the United States established the Federal Reserve System, its central bank, in 1913, it continued to fix the price of the currency it issued in gold. But it only adhered to gold stand rules loosely and in 1971 no longer had enough gold to honor its commitment to foreign central banks to redeem its currency for gold. Thus, on August 15, 1971, President Richard Nixon "closed the gold window." The era of the value of currencies anchored by (fixed to) gold or some other hard anchor was over. The Federal Reserve and other central banks needed to develop other criteria for determining the supply of their currencies.

Following the inflationary experience in the U.S. in the 1960s and 70s, there were more and more demands for clear rules for the Fed's regulation of is money supply, now that it was no longer constrained by a hard anchor (e.g., the price of gold). The objective of monetary policy was broadly accepted around the world to provide a stable value for the currency, though the Federal Reserve was shackled with the dual mandate of price stability and maximum employment. The short-term demand for money was not sufficiently stable for a Friedman rule (fixed growth rate for base, narrow, or broad money – M0, M1, or M2). Inflation forecast targeting (IFT) has evolved to become the state of the art of fiat money supply rules.

In IFT regimes, the central banks' policy instruments (primarily the interest rate at which it lends to banks) are transparently set on the expectation (based on model forecasts and judgement) that in one to two years in the future they will produce (or maintain) the central bank's target for inflation. While this approach has performed relatively well, its management of the money supply has been far from perfect and central banks are experiencing increasing government pressure to relax their price stability mandates. And then there are a few countries whose central banks have caved to fiscal dominance and behaved terribly.

Would some cryptocurrency, ala Hayek, provide a better monetary system? Some people claim that libertarians like cryptocurrencies like bitcoin because they do not rely in any way on government. Perhaps those people meant "anarchists" because libertarians accept the critical importance of government in defining and protecting property rights and personal safety. Cryptocurrency providers have been lobbying the U.S. congress (and others) to set out the rules for their legal operations. Are they money or speculative assets? Bitcoin and most other cryptocurrencies do not satisfy the requirements for a good libertarian money because they do not satisfy the requirements for good money. This article explains why this is so and defines properties of a good libertarian money.

Are Cryptocurrencies the Answer?

Economists note the incredible power of markets and market prices in directing our scarce resources (our labor, capital, and technology) to their best uses. But prices are expressed in terms of money, the common unit of account that facilitates comparing relative values.

The presumption, and actual reality, is that within each market prices are expressed in terms of the same money. It would not facilitate our choices if apples were priced at $6 per bushel and oranges at 3 bitcoin per bag. Presently, virtually nothing is priced in bitcoin. In addition, sellers don't generally accept payment in a currency other than the one in which the good's price is expressed, thus very few sellers will accept bitcoin in payment. Moreover, you can only accept bitcoin in payment if you have a bitcoin account together with the software required (a bitcoin wallet).

None of these are insurmountable barriers to growth in the use of bitcoins or other cryptocurrencies, but they do require strong incentives for putting up with and/or overcoming them. I explained the basics of bitcoin's value in the linked blog in 2014: "Cryptocurrencies-the bitcoin phenomena"[2] One incentive would be to replace the established currency in a market (a country's legal tender) that has very unstable value (think Zimbabwe, Venezuela, Argentina, Brazil at various times in their histories). Another would be the need for anonymity (as is achieved with paper currency) that an illegal drug dealer or a political dissident in a repressive regime might require and find convenient.

Some mistook Fredrick Hayek's "Competition in Currency" as an endorsement of what we now call cryptocurrencies. In the Preface to that book Arthur Seldon explained "The requirement is not to deprive

government of the power to issue money but to deny it the exclusive right to do so and to force the citizenry to use it at the price it specifies. It is thus the government monopoly of money that is objectionable, and history is full of examples of governments that have attempted to enforce their power by extreme measures, including the ultimate sanction of death. The solution is therefore to allow people to use the money they find most convenient, whether the money issued by their own government or by other governments."[3]

When the Zimbabwean dollar became worthless, reaching annual inflation rates of 10,000 percent in 2007 and exploding in 2008 with an estimated peaked rate in September 2008 of about 500 billion percent per annum, the Zimbabwean government legalized the use of foreign currencies and the country immediately dollarized (priced and paid in U.S. dollars flown in from South Africa). This was the remedy Hayek proposed and it ended inflation almost instantly.[4]

Later in 1976 Hayek followed up his *Competition in Currency* proposal with the more radical broadening to private currencies in his AEI pamphlet *Denationalization of Money, An Analysis of the Theory and Practice of Concurrent Currencies*.[5] Most money these days is privately produced by your and my banks (our deposits), but they are fixed in value to and ultimately exchangeable for the U.S. dollars created by our central bank. They are part of the U.S. dollar money supply. Bank deposits are not alternative, private units of account. In this second book Hayek was broadening his call for currency competition to the bitcoins of the world. Hayek was proposing that inflating central bank currencies should face competition from privately produced units of account and monetary assets (medium of exchange and payment).

Otmar Issing, Chief Economist of the ECB and member of its Executive Board from 1998 – 2006, concluded that adopting Hayek's proposal "We would 'discover' that private currency competition - at least nowadays - would not work and would not serve the people affected."[6] I made the same point to Hayek directly in a debate at the 1976 Mont Pelerin Society meetings in St. Andrews, Scotland. Competing private units of account would undermine an essential function of money in market economies (communicating the relative value of things). In high inflation countries, such as Venezuela, many things are priced in U.S. dollars. However, the Venezuelan government has made payments in dollars illegal. In such cases, Bitcoin and other cryptocurrencies are used to some extent to make dollar denominated payments. But as the value of Bitcoin is so unstable, holding on to then is very risky.

In El Salvador, which had successfully dealt with inflation by dollarizing a decade ago, President Nayib Bukele added Bitcoin as legal tender as of September 7, 2021. Though this legally obliges merchants to accept Bitcoin in payment, "few ordinary folk use…. Bitcoin, which has lost 70% of its value since November, is far too volatile to be a good store of value, especially in a country where GDP per person is $4,400." according to a June 16, 2022, article in *The Economist.*[7] No one prices in Bitcoin.

Cryptocurrencies that use a Block Chain or Distributed Ledger Technology suffer from other problems as well. Bitcoin's claim to eliminate the trusted third party (bank accounting systems) required by existing electronic (digital) payments with bank deposits, is particularly attractive to libertarians. But this claim is a gross exaggeration. To prevent the double spending of the same bitcoin, each transaction must be verified by so called miners (third parties you don't need to trust) which takes five to ten minutes and very large amounts of electricity to process as miners race to solve increasingly difficult mathematical puzzles. Also, all transactions are very public on block chains, though accounts may be held under pseudonyms and are thus described as pseudo-anonymous.

Though actual bitcoin transactions have been made easier via the development of software wallets, many assign their bitcoins to exchanges (trusted third parties).[8] The loss of a bitcoin owner's password to his account is fatal and final. Those bitcoins are lost forever. But more deadly to the use of bitcoin as money (unit of account and medium of payment) is the volatility of its value. The price of a bitcoin has ranged from just under $30,000 to over $67,500 over the last year. It fell to $18,958 on June 18, 2022. Thus, payments of bitcoin generally involve temporarily purchasing them with dollars or some other stable currency and then exchanging them back to dollars as quickly as possible after receipt. The costs of these exchanges are often overlooked when claiming that bitcoin transfers are cheaper than traditional means of electronic payments. Of equal importance is that for an asset to function as money, it must be generally or at least broadly accepted for payments. Bitcoin fails this requirement miserably. Most buyers and sellers of bitcoin are indulging in a form of gambling rather seeking a "good" medium of payment.

Bloomberg exposes a false "libertarian" attraction to Cryptocurrencies on blockchains:

> "An app running on, say, Ethereum, can't easily be taken offline, since there's no particular host or entity that can take it down.
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> "This architecture is inherently oppositional to governments and large corporations, and it's for this reason that crypto has so much embedded politics. The whole space traces its roots back decades to hippies and hackers in Northern California, who anticipated that in an online world, pure cash-like peer-to-peer transactions would be impossible. When you pay a friend using Zelle or something, the payment goes through a series of intermediaries. You can get kicked off Venmo for buying a Cuban sandwich. Bitcoin can't kick you off the network for anything.
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> "Take away the uncensorability of crypto, and all you're left with is Ponzi schemes, dog coins, and drawings of monkeys. (Wait! That's basically all that exists right now in the space, so ignore that thought.)"[9]

Unlike bitcoin, which are not redeemable for anything, so called stable coins have a fixed price for some other legal tender currency or even, potential, gold. The quality of the assurance of a stable price, and redemption at that price, vary considerably. Appropriate regulation that required transparency and external audit would be good. But the payment technology that has emerged in recent years such as PayPal, Venmo, or Zelle to transfer U.S. dollars (claims on bank accounts and ultimately on the Federal Reserve) have already introduced efficient, low cost, and fast payments of legal tender currency. The Federal Reserve is also modernizing its interbank settlement system. FedNow, which will operate real time 24/7 began testing in September and is expected to be operational in the summer of 2023. It is hard to see any further advantages introduced by so called stable coins.

The Libertarian Alternative

There are monetary regimes, however, that satisfy libertarian preferences for minimal government involvement and manipulation while satisfying truly valuable needs. The Constitution of the United States provides the authority for such a regime in Article I Section 8 "To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures;" The classical gold standard was such a system. However, its "rules" were diluted when taken over by central banks. Moreover, the practice of actually buying and storing gold distorted its market price and was costly, flaws that are avoided in the system I propose below.

In the U.S. today, as well as every other country in the world, there are thousands of private companies that create and offer their own currency. Most of them are banks. While that would seem to make libertarians happy, thousands of individual bank producers of money would not constitute an efficient monetary system without rules and mechanisms for linking them into what we think of as one currency--in our case the U.S. dollar.

While the dollars deposited in my bank are my bank's liability, I am protected from the bank's failure by deposit insurance. Your bank accepts my deposits in my bank because my bank credits your bank's account with the Federal Reserve (by debiting its account with the Fed). In short, the deposits at thousands of different banks are accepted by every other bank because they are all ultimately claims on the Fed. This is similar to the gold standard in which the money created by thousands of banks were accepted everywhere because they were redeemable for a well-defined amount of gold.

Libertarians want a currency and monetary system that can't be manipulated by the government (central bank). The dollar is now a fiat currency, redeemable for a deposit with the Federal Reserve, and very importantly, acceptable by the government for the payment of taxes. Thus, its supply is determined by the Fed's judgement of what is needed for "price stability and maximum sustainable employment." We libertarians want a currency that we each individually control the supply of. In short, we want a currency

with a hard anchor (which was the case for the gold standard) supplied according to currency board rules (which historically were violated by central banks nominally anchored by gold).

Currency board rules require the currency issuer to sell or repurchase its currency at its fixed price in response to public demand. Any number of private producers of dollars redeemable at an officially fixed price for a well-defined anchor (gold, aluminium, a basket of goods, etc.) would result in a money supply determined by the public that was consistent with and appropriate for its fixed price to the anchor and that was fully interchangeable. The central bank would be passive. It would have no monetary policy (beyond the fixed price for the anchor). This seems like libertarian heaven.

In addition to being anchored to a single commodity whose relative price could vary more than would the price of a basket (portfolio) of commodities, the gold standard was flawed by central banks actually buying and storing gold and thus distorting its market price. An ideal regime would use the anchor for setting the currency's issue and redemption price but the anchor itself would not be purchased and stored by the central bank. Instead, the central bank would issue its currency for assets (such as treasury bills) of equivalent market value to the anchor. The arbitrage mechanism works just as well with this "indirect redeemability"[10]

I led the IMF teams that established the Central Bank of Bosnia and Herzegovina, which follows currency board rules. I have written a book about that experience.[11] I also participated in Bulgaria's central bank's adoption of currency board rules. The currencies of both countries are anchored to the Euro and their currency experiences have been outstanding. Their money supplies are basically regulated by market arbitrage. If the market exchange rate of the Bulgarian lev to the Euro rises above its official rate, it would be cheaper for the banks that issue lev to buy Euros from the Bulgarian National Bank thus reducing the supply of lev in the market and lowering its market price for Euro. See my article on Bulgaria's experience.[12]

A Libertarian International Reserve Currency

What about cross border payments? In brief, cross border transactors have found it economical to price and settle transactions in a vehicle currency, usually the US dollar. The increasingly frequent deployment of sanctions enforced by restricting the use of the dollar has intensified the search for alternatives. See my more detailed discussion in "The Empire and the Dollar"[13] The search for alternatives to the dollar as proposed by Russia's Sergey Glazyev[14] risks fragmenting the global market place.

The International Monetary Fund has already created such an alternative. An internationally established unit (anchor) is much less likely to be abused for national political purposes, but the IMF's Special Drawing Right (SDR) suffers from some serious defects. However, these can be fixed.[15,16]

The SDR can be "fixed" in two stages. The first is to develop the private sector's uses of the SDR unit of account (invoicing oil and other globally traded commodities in SDRs, borrowing and lending denominated in SDRs, SDR bonds and bills, and digital SDR deposits--eSDRs). See my more detailed discussion in "Proposal for an IMF Staff Executive Board Paper on Promoting Market SDRs."[17] As with national currencies, where hundreds of individual producers of the national currency are made interchangeable by being claims on the central bank, the market SDRs of many competitive producers would be interchangeable as the result of being redeemable for the official SDR of the IMF.[18]

The second stage would require a reform of the IMF's official SDR. Rather than allocating them from time to time to all IMF members, they should be issued according to currency board rules. In addition, the valuation of the official SDR should be changed from its current basket of five currencies to a small basket of homogeneous, globally traded commodities. The IMF's existing rules for periodically adjusting the SDR's valuation basket are transparent and appropriate and should continue to be used. In one sense, this would re-establish an improved international gold standard like system. It would be improved on the gold standard by replacing a single commodity anchor with a small portfolio of commodities and its supply would be improved by adopting the market driven rules of a currency board. Such a Real SDR issued by the IMF would bring to international payments the same hard anchor and currency board rules favored by libertarians for domestic currencies.[19]

ENDNOTES

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