# Theories On The Money Non-Neutral Nature And De-Monopolization

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*Abstract: - At the beginning of the 90's there was a consensus as to the vital theoretical matters on monetary policy with the result that currently there are few diverging points regarding the fact that a modification in the money offer generates, on a short term, significant consequences on production, while, on a long term, it influences prices.*
*Consequently, the idea that money is neutral on a long term has been accepted, this position being adopted especially by Austrian monetary specialists.*
*Such conclusions were triggered by the divergent points on Phillips curve on the basis of several long debates between Keynesian supporters, monetarists and theoreticians of rational prevention.*
*As it is well known, Phillips curve is an inverse relationship between inflation and unemployment, whose stability on a long term determined the UK Keynesian economists to regard this curve as the equation missing from the Keynesian model, i.e. the one which links price production and occupation modifications.*
*The curve has also been adopted in the USA by Paul Samuelson and Robert Solow, where it seemed to be valid at the beginning of the '60s.*

*Key-Words: - money neutrality, Phillips curve, invariable currency, money de-monopolization, inter-banking clearing.*

## Introduction

Austrian economists consider that the market may promote monetary stability to a better extern in comparison with a central bank. In a free-banking system, adjusting monetary dis-balances is achieved automatically so that economy is not affected. Consequently, these economists do not agree with the idea of money neutrality, considering that modifications of money quantities which circulate in economy cannot affect the prices of all goods and services at the same time and to the same extent. What is modified is the level and structure of prices. This is a fair conclusion, if we think that modifications of relative prices determine the re-allocation of resources in an artificial manner because prices systematically direct productive efforts towards a direction in which they cannot be maintained. The bad allocation of resources determines modifications in production structure and, thus, business cycles are generated.

Finally, recession acts as a correcting force whereby the perverse effects of monetary growth and absorptions are eliminated, both of them being external to the system.

The concept of non-neutrality has different connotations even among Austrian economists, depending on the perspective adopted as to the neutral nature of money; thus, one can speak of two directions.

The former adopts the perspective of Frederich von Wisser and is represented by Fr. Hayek[1], Selgin[2], White[3], Dowd[4] etc.

The second direction originates in the concepts developed by Menger, Bohim-Bawerk and it is furthered by Rothbard[5], Selemo and Hoppe.

In the next lines we are going to analyze the theses adopted over this issue as they were developed by the two renowned economists.

## LITERATURE REVIEW

The matter of money neutral nature and its impact on the monetary policy of the central bank has been central to the Austrian monetary specialists, whose concept was approached differently and it led to the creation of two directions.

## 1. The monetary theory of Fr. Hayek [1]

### 1.1. As to the non-neutral nature of money

Fr. Hayek, a great economist of the Austrian school, is considered as the continuator of Frederich von Wisser, because he preserves in his theories the Wisserian concern for the neutral nature of money. He appreciates that the depreciations and value increase in money value – if not determined by modifications in resources and productivity – do not live up to the expectations of entrepreneurs and generate dis-balance in economy. In other words, any modification in the money demand and offer, which does not rely on the evolution of goods and services demand and supply, leads to dis-balancing economy.

Hayek considers that prices offer an important piece of information to firms. The successful economic activity or the accomplishment of the anticipative actions that generated it largely depends on the correct prediction of prices. Prediction relies on current prices and the prediction of their future evolution. Future prices are, however, always uncertain because the majority of individuals do not know the circumstances that determine them.

A correct estimation of future prices cannot be accomplished unless prices follow a clear tendency at all levels. Such a tendency determines the wrongful allocation of resources and the system deviation from a long term state of balance. Consequently, in order to maintain a stable level for prices, the quantity of money that is necessary in economy is the one that may be put in circulation without generating the increase or decrease of aggregate prices.

### 1.2. Monetary policy impact on the central bank

An exchange value that does not alter due to the modification of the relationship between the money demand and supply, i.e. the so-called invariable currency, requires the permanent intervention of a regulatory authority to determine the monetary value. Still, is it possible for a monetary authority to have relevant information regarding the importance of factors which influence the future value of the monetary unit?

Hayek appreciates that a monetary authority cannot ensure a stable level of prices because it is impossible for it to anticipate the optimum quantity of money that is necessary for reaching this objective. The suggested solution is to create a free-banking system, which should ensure the money offer.

Hayek appreciates that the monetary policy is a major source of market instability and it is rather a cause and not a remedy for depression. According to Hayek, monetary policy is neither desirable and nor possible; thus, he suggests denationalizing money.

It is considered that it is less likely for authorities to act for the public interest even if they had a relevant piece of information and knew what should be done for achieving the political welfare. Once the authorities have the power to favor certain groups or population segments, the majority mechanism will force them to use this power for supporting an enough number of groups in order to obtain the majority share.

Moreover, the monopoly over the monetary issuance generates the irresistible temptation to benefit from “cheap money”.

This practice is generally tolerated and it remains unpunished because its consequences are not understood.

Hayek considers that free competition within the monetary area may generate stability within the monetary system and may settle unsolved problems as long as state gets involved in this sector.

## 2. The monetary theory of Mises [6]

### 2.1. As to the non-neutrality of money

1. Mises, who belongs to the second tradition as regards the perspective over money neutrality, appreciates that prices expressed in money represent the unique instrument for economic calculations; he also appreciates that it is wrong to consider the exchange environment as a neutral factor. In his opinion, Wieser’s and Hayek’s approach is rooted in an error, i.e. the idea that things have an objective and inner value.

The selling and buying of goods are due to the fact that individuals do not appreciate the goods and services which they give up as much as they appreciate the goods and services that they buy or benefit from. Thus, the notion of measurement is not useful. An act of exchange is neither preceded nor accompanied by a process that could be coined as “value measurement”. All market phenomena originate only in the subjective ordination of utilities.

The subjective relationship which individuals establish between money and different goods and services, expressed as the exchange rate between money and goods, is the only way in which goods can be compared quantitatively. These relationships are mental instruments of economic planning.

Money is not an objective hallmark and prices are not measured in money; prices are rather a money expression, they are in fact money. This is the reason why it is impossible to have neutral money or money with an established value.

Mises disagrees that the concept of money neutral nature is useful for monetary policy and he does not agree with the idea that money value variation burdens economic calculation, as he does not agree with the idea that money value variation negatively influence the resource allocation process.

### 2.2. The impact of the Central Bank monetary policy

According to Mises, the state must abstain from exercising any influence over the money value. He considers that the modern monetary ideal is a currency in which the increase or decrease of a metal quantity is independent from any premeditated human intervention. Thus, he denies the role of the central bank in devising monetary policy.

### 2.3. Suggestions for restructuring the monetary system according to the Austrian School

This school, which is mainly represented by the above mentioned economists, considers that the principle of a healthy monetary system is the one which 100% relies on gold reserves; this vision reminds us of the approaches developed by the renowned Romanian economist Anghel Rugină, according to whom after the 90’s it was necessary to introduce a 100% silver-supported currency.

M. Rothbard[7] and other economists consider that the only institutional arrangement which is valid and capable of assuring a stable monetary system, is a free-banking one, with 100% gold reserves. A disciple of Ludwig von Mises, who continued the tradition of Carl Menger during the past third of the $19^{th}$ century, M. Rothbard understood that the spontaneous nature of the market process is incompatible with the existence of several institutions that were set up through the deliberate government intervention, i.e. the central bank and the official currency.

Other economists suggested other monetary systems. Fr. Hayek[1] considers that once the state monopoly over the money offer is eliminated, the market will be dominated by the money which has a constant buying power and which is issued by private producers.

Apart from Hayek's scenario, other monetary institutional arrangements have also been imagined, whereby the money offer is formed on a competition market, while also ensuring a flexible monetary offer; within this trend, there have been identified three types of free-banking by Selgin[2] and White[3]:

(i) A private monetary and banking system is suggested with a unique and distinct currency that forms its basis, consisting of a precious metal or of a certain fixed stock of flat money. This system may issue monetary substitutes or convertible currency, i.e. a system of fractional reserves.

(ii) Hayek suggests creating a flat money system that competes on the market, each coin representing a distinct "mark".

(iii) A competition payment system is imagined, without any kind of money.

According to White, of these three free-banking types, the one that appeared within a fractional system of reserves was possible due to the non-intervention of the state.

In fact, the history of state intervention within the monetary area is a history of inflation, instability and fluctuations. To Romanians, this is the natural result of monopoly, centralization and discretionary policy. The fundamental question as regards monetary policy is whether the state played any role in producing of regulating the production of monetary assets. According to Rothbard[7], the only solution that may be adopted in case of state-generated inflation and instability is to separate the state from the money offer.

## 3. De-monopolization of money

### 3.1. Total de-regulation of the banking system

One of the principles applied to the financial market globalization and shared especially after the 80's by the American Milton Friedman[8] and also by Friedrich Hayek[9] is the principle of free-banking which concerns complete market liberalization, in general, and complete financial liberalization of the financial market, in particular. The application of such a thesis cannot be accomplished outside a total deregulation of the banking system and a non-intermediation of the capital market.

The deregulation of the banking monetary system, in the strict sense of the word, implies that the national monetary authorities give up: the strict regulations governing this domain, as well as the constraints and restrictions imposed to the functioning of the monetary and currency market, and also the free movement of capital. However, this deregulation means, according to several specialists, the de-monopolization of money, a principle which is supported with two arguments. The first category brings arguments for the de-monopolization of the right to issue currency. The second category brings arguments for the banks to enjoy the right to issue money, on the basis of their assets; this money should be convertible into currency, which may be a precious metal or a fixed stock of flat money, which is not necessarily supplied by the state.

As to this privately issued money which is issued by banks on the basis of their assets, one cannot refer to them as a de-monopolization, but rather as a deregulation of the banking system. Within such a context, one should have considered that a free-banking system is supposed to regulate the banking system in general, given the well-defined (central) currency. Naturally, in order to meet this requirement it is necessary to examine the implied and explicit arguments brought against free banking competition.

First of all, one has to distinguish between 100% free-banking and the free-banking which is based on factional reserves. One of the most important arguments brought against free-banking which is based on fractional reserves derives from accepting that in the previous century it generated financial chaos.

Recent research on this matter, made after the 90's by White[3] and Hulsmann[10], do not support such an argument.

The conclusion of these studies is that, in fact, inter-banking clearing is capable of prevent the over-issuance of money (notes and deposits) both by private banks and by the whole system.

The supporters of the free-banking system that is based on fractional reserves argue that any bank - when trying to acquire more liabilities - must impose higher interest rates for deposits, and, thus, they reduce their profit. This expansion reaches a level at which the marginal income resulted from assets is equal to the marginal cost of the drawn liabilities. However, nobody knows where to locate this level. This is the reason why no banker knows what volume of liabilities is profitable and what volume might lead him towards bankruptcy. Hulsmann shows that there is a single way to find out this answer, i.e. by trying and making an error.

Bankers are aware of the fact that in a banking system that is based on fractional reserves bankruptcy may lead to another bankruptcy, like in a chain. They know that the banking community always tries to save a bank that is in a difficult situation. In this context, their main concern is to extend faster than the others so that they may obtain a higher market share.

According to J.H. De Soto[11], in a free-banking system each banker tries to internalize all profits that are derived from the extension of one's own credit and to externalize the costs incurred by the entire system. The system is inherently instable because when the clients of a sufficiently large bank no longer trust the bank's payment capacity, this bank may go bankrupt. In order to avoid individual bankruptcy – a threat which endangers the entire system – banks try to reunite their reserves. The newly set up institution may be a clearing private house or a central bank.

No matter the form that the new institution has, it allows banks to create inflation and, however, the appreciation of reserves cannot avoid the risk that the system is exposed to. The last instance creditor position, which a bank enjoys, is due to the banking sector pressure. Some economists, like Rothbard[5], consider that the central bank was not created for eliminating the inflationist tendencies of banks which function in a free-banking system, but to allow banks to create inflation.

These economists consider that the fractional system, as the central bank, is not the result of the natural evolution of the banking system. Their existence is due to a series of "historical accidents" and to the state intervention that allowed bankers to get involved in banking operations based on financial reserves.

Austrian economists, like M. Rothbard, who support a banking system that is 100% backed by gold, appreciate that such a system is not threatened with instability and does not require the intervention of any last instance creditor. This system, however, lacks the flexibility of the monetary offer. The points of view expressed in relation to such a banking system are based on two arguments:

(i) if the money demand is supposed to be stable, the needs of a new emerging company tend to generate deflationist tendencies which trigger economic recession. This is the reason why monetary authorities should supply the money quantity that is necessary for an emerging economy.

(ii) if the money demand is stable, monetary authorities must intervene to harmonize the monetary offer with the modifications of the demand, so that price stability could be maintained.

The last argument invokes the need to preserve state monopoly over monetary issuance since a free-banking system is considered to be instable. However, the theory of public options warns that there is no role which could be justified for the state even in the situation in which one can speak of a market failure.

The role of the state can be accepted after an analysis and demonstration of the manner in which the government is going to act in order to accomplish its role. Such an analysis must be made taking as a starting point the hypothesis according to which "the government is not a well-meant despot and that it usually tends to abuse its monopoly power". Some economists support Mises' conception as to the neutral nature of money and consider that it is not necessary for the money demand modifications to be adjusted by a monetary authority or by a free-banking system based on fractional reserves.

## 3.2. De-monopolization of currency issuance

Some economists appreciate that the de-monopolization of the currency issuance is rejected because of a set of prejudices which exist in relation to the role played by the state in issuing money; they identify four arguments in favor of having the money issued by a public authority, i.e.: the legal means of payment; the argument of the public good; the argument of money seen as a naturally formed monopoly; the argument of the money cost.

When referring to this argument, Fr. Hayek[9] regards it as a thinking cliché, which illustrates the naïve conviction that the government is necessary for issuing and defending money. This conviction continues the mediaeval idea that the state grants value to money, a value which money lacks; thus, it is necessary for a government to declare what should be considered as "money", as if the state had created money, which otherwise would not exist. In fact, money is not invented by state, but it is the result of the spontaneous social and economic evolution of society. The government has not done anything else by confiscate the money and manipulate it in order to achieve its own goals although initially the declared purpose of confiscation was the standardization of the existing currency and the certification of their quality.

### 3.2.1 The argument of the public good

This argument is often used against the idea of money issuance de-monopolization. Money, however, is not a public good and it does not fulfill the non-rivalry condition, as it does not fulfill the non-exclusion condition.

According to L. White[3], the argument according to which the public good is used for producing money by the government is reduced to the following statement: the government may produce money with certain characteristics which private forms may not produce. However, there is no proof to support the fact that the market failed in producing money. Moreover, public authorities are likely to produce money whose quality is less in comparison with private producers.

This argument also evokes the externalities generated by money. In other words, money has an important effect over other parties than the ones which are directly involved and a stable moderate monetary framework is an essential condition for the efficient functioning of market-based economy. That is why the assurance of such a framework is an essential function of the state. After decades in which the public authorities intervened in the monetary domain, it has been noticed that the state intervention worsened the situation because the failure of the monetary authorities to adopt a non-inflationist monetary policy makes it for the intermediate private factors to be instable, as well.

Similarly, money uniformity is supposed to be a positive externalities, which diminishes informational costs which the public must support when it uses more types of money. This argument is synonym with the statement that too many possibilities to choose make life more difficult. In consequence, the individuals' possibilities to choose must be suppressed so that the state may make the choice instead.

If we consider that this statement is correct, we accept that competition is eliminated; competition is the only process which people may use to discover what products and services and how many types of them serve the consumer in the best way.

### 3.2.2. The argument of the monopoly that is formed in a natural way

With this argument, according to R. Vanbel[12], the competition existing between several currencies generate a single type of money because money is a monopoly which is naturally formed. Under these conditions, the central bank does not need a legal monopoly. However, we do not know whether money is a monopoly which is formed in a natural way and the only way to check this is monetary competition. Legal monopoly over money blocks the possibility to discover the answer to this question.

The argument that money is a monopoly that is naturally formed is also supported by M. Friedman[8], as a reason for rejecting the idea that the market should be allowed to benefit from free monetary and banking arrangements.

Fr. Hayek[9], however, supported the suggestion that money should be de-monopolized by allowing competition with private issuers. On the other hand, a series of other economists are skeptical as to the private issuers' capacity to compete with success given the circumstance in which the starting point is a strongly stable (central) governmental currency. For example, M. Friedman considers that the only plausible alternative to the flat money issued by monetary authorities is a merchandise currency, with private producers that produce money on the basis of deposits, i.e. money convertible into that merchandise. But, this result is quite unlikely as long as a major collapse of national currencies, such as hyperinflation, does not occur.

M. Rothbard[7] himself is skeptical as to the de-monopolization which Hayek proposed. His objections are similar to the ones of M. Friedman. Money is not wished for itself but for the fact that it already functions as money so that everyone must be sure that money will be accepted by anyone as an exchange means. Individuals immediately accept notes on which it stands written "Dollar" or "Euro" and this happens not due to their aesthetical value, but to the fact that individuals are sure to sell these notes in exchange of the goods and services which they wish.

Rothbard appreciates that the only plausible system is the monetary system based on gold.

### 3.2.3. The argument of money cost

This argument takes into considerations the fact that flat money supplied by monetary authorities brings social benefits because it may reduce the cost of producing money. Such cost cuts may be accomplished through market processes because, in the absence of convertibility, private flat money would not be accepted on the market.

Other economists consider that flat money is not a natural evolution of the monetary system. The adoption thereof was imposed by the state and there is no proof to support that this is the best alternative. The idea that flat money represents a social economy is generally accepted because paper is cheaper than precious metal. This appreciation ignores that the individuals may prefer a currency-merchandise instead of flat money so that these individuals would agree with its cost. Furthermore, it is unlikely for citizens to benefit from these cost cuts because it is hard to believe that authorities transfer to them through a less reduced tax the cost cuts resulted from flat money.

## CONCLUSIONS

From the above presented information, it results that the economists of the Austrian School appreciate that there is no justification as regards the state monopoly over money; these economists have also brought arguments against any state-intervention in the monetary system. According to them, a healthy monetary system needs to undergo fundamental institutional modifications at structural level so that the state could assure that money is no longer under the state influence and so that state authorities should no longer interfere with monetary problems.

The Austrian School theory is not upheld by the Anglo-American School (Great Britain, USA). For example, when referring to money cost, the great American monetarist, holder of the Nobel Prize, M. Friedman[8], has rejected the idea of private money. However, he recognizes that flat money have triggered the appearance of the types of costs, of which the main one has reduced the predictability of the price level on a long-term. The cost takes the form of the resources invested on the financial markets in order to offer institutions, firms and public bodies supplementary facilities for ensuring themselves against risk.

The development of globalization, with its deregulation and non-intermediation, has led to the appearance of a large number of theories, such as the ones adopted in the monetary area. However, due to the present financial crisis it has become certain that deregulation does stable the market; on the contrary, it generates a stronger deregulation and a better institutionalization for the monetary-banking sector.

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