Must Governments Control Money?

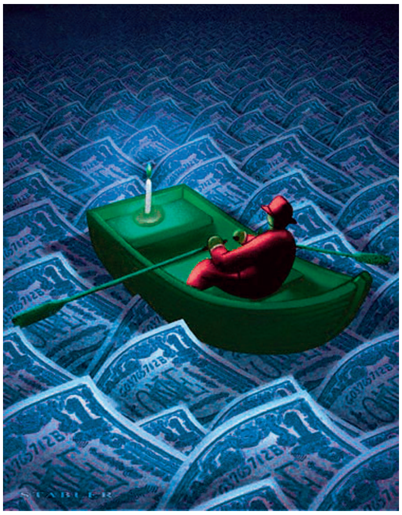
Money is controlled by governments the world over. **Parth J Shah** argues that this need not be so

The woes facing the economies relate in one way or the other to the management, or rather the mismanagement of money on a colossal scale. Whereas the strengths of currencies of different countries vary widely, they all have one thing in common; they are all created and managed by governments. In other words, we only have 'fiat money' all over the world. It may be difficult to believe, but this is not how it has always been and there is no good reason why it should remain so. On the contrary, there are strong arguments to support the notion that government control over money is at the root of economic and financial market ills. However, to understand why this is so, a recap of how we got here is useful. Particularly, to understand how did we move from direct exchange (barter without any medium of exchange), to indirect exchange (through a medium of exchange)?

A brief history of money

Indian currency notes are printed by the Reserve Bank of India, but the RBI is less than a hundred years old. Before that we had coins of gold, silver, bronze and other types of metals. Even before that we had tobacco leaves, cattle skins, and shells as money. Who decided what would be money at a given time?

We understand that money performs the function of medium of exchange and thereby helps avoid the problem of the double coincidence of wants. In a barter economy—where there is no money—if one wants coffee in exchange for one's wheat then he must find exactly that person who has coffee and wants wheat. This necessity of double coincidence limits the extent of trade in a barter economy. On the other hand, in an economy with money it is easy to trade, which makes it possible for individuals, businesses and even nations to specialise. And specialisation, as Adam Smith demonstrated in his Wealth of Nations, is the very foundation of the modern industrial economy.



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Money also performs two other important functions – it is a store of value and is also a unit of account. Savings are held in the form of money (though increasingly other options are available), because it is a store of value. The unit of account function of money makes it possible for businesses to denominate their costs, revenues and therefore profits in a common unit. Imagine trying to calculate profits of a barber shop in a barter economy! A barter economy naturally would have no fund managers or accountants.

Karl Marx well understood that money is the root of capitalism. The original communist doctrine required abolition of money to usher in the proletarian society. At the beginning of the Bolshevik revolution, Lenin did abolish money, but soon realised that an industrial economy cannot exist without it.

Who deserves credit for inventing such a powerful instrument that has made modern society possible? Historically, the most common explanation for the origin of money is the state invention of money. The king, through his divine powers, understood the advantages of a money economy, and decreed his people to start using money. Even today many subscribe to this theory of the origin of money. But how did the king figure out whether to ask his people to use silver coins, cattle skin, or shells as money?

As the divine powers of the king himself came under attack, some offered a social contract theory – that people came together, as in a pure democracy, and decided to use money.

But, nowhere in human history is there any record, of such a gathering, or a decision.

Spontaneous order and invisible hand

Carl Menger, an Austrian economist, offered the theory of spontaneous order. Imagine an alien visiting a bazaar of centuries ago. She observes a person with rice trading with someone for tea. "Why does he do that?", she asks. She follows the person home and sees that he boils the leaves in water and drinks it. Then she goes to the home of the other person and sees that he also boils rice in water and eats it. Barter exchange, or direct exchange, is easy to understand: I want to exchange a good that I value less with a good that I value more, or the one I want to consume, or has direct use value.

Later, she visits a market where the person exchanges his rice for a silver coin. She follows the person home to see what he does with the coin. To her surprise, the coin just sits in the pocket of his jacket. It seems he does not even remember that he has the coin. She wonders why anyone would give up a consumable commodity for something of no direct use? The rationale for indirect exchange - rice against silver coin - is difficult to fathom. The indirect exchange is the origin of money.

Carl Menger suggested that the indirect exchange came about from the failure of some to sell what they had, for what they wanted in a barter market. May be one such frustrated trader noticed that the people who brought coffee beans to the market were almost always able to trade with others and get what they wanted. He decides to try this out. For his wheat he really wants millet, but he sells his wheat against coffee, which was not as difficult as finding someone with millet. Once he had coffee, he is able to exchange that for millet! The frustration in trading wheat for millet leads the economising agent to trade it first for coffee and then for millet - this is the origin of indirect exchange!

In any society at any given time, there are some commodities that are more saleable or marketable than others. Perceptive individuals, frustrated in their barter exchange, figure this out and begin to engage in indirect exchange. As others follow their lead, a commodity emerges, spontaneously, as a medium of exchange. This theory meshes with our knowledge that different commodities have been used in different societies at different points in time. As these societies evolved, they spontaneously converged in using metallic money, given the obvious advantages of metal over, say, cattle skin.

> **Certain commodities came to be money quite naturally, as the result of economic relationships that were independent of the power of the state**

A POW camp during the second World War provides a modern proof of Menger's theory. Each prisoner in the camp was given daily a fixed amount of food, water, and cigarettes. Obviously, each prisoner did not want to consume these commodities in the same amount everyday. They began to trade these items. The cigarette was the commodity always in demand, the most saleable item in the camp. As the spontaneous order theory would have predicted, the cigarette emerged as money in this POW camp economy. It emerged as money, as an indirect consequence of individuals maximising their economic interests.

Menger explains, "As each economising individual becomes increasingly more aware of his economic interest, he is led by this interest, without any agreement, without legislative compulsion, and even without regard to the public interest, to give his commodities in exchange for other, more saleable commodities, even if he does not need them for any immediate consumption purpose. With economic progress, therefore, we can everywhere observe the phenomenon of a certain number of goods, especially those that are most easily saleable at a given time and place, becoming, under the powerful influence of custom, acceptable to everyone in trade, and thus capable of being given in exchange for any other commodity. These goods were called 'geld' by our ancestors, a term derived from 'gelten' which means to compensate, or pay. Hence the term 'geld' in our language designates the means of payment as such." This is from Menger's seminal book, the Principles of Economics, in 1871.

Following Adam Smith, this theory is also known as the invisible-hand theory. As Smith argued, in an economy with private property and open competition, the pursuit of self-interest, as if led by an invisible hand, results in the achievement of social welfare. The frustrated trader, to solve his own problem of getting millet, engages in an indirect exchange and begins to move the society towards the most productive instrument ever invented by man - money.

As Menger sums up: "Money is not an invention of the state. It is not the product of a legislative act. Even the sanction of political authority is not necessary for its existence. Certain commodities came to be money quite naturally, as the result of economic relationships that were independent of the power of the state."

The spontaneous order theory explains not only the origin of money. It also explains the origin of some of the other most important institutions of our civilisation. F A Hayek, economics Nobel Laureate and a follower of Menger, captures this understanding most elegantly: Social institutions like money, law, language, and morals are results of human action, but not of human design. They are unintended consequences of self-interested actions.

The economy is itself a spontaneous order; the result of human action, but not of human design. No one person or a group controls or manages the economy, not even the Planning Commission. Millions of people pursue their self-interest, and as long as they do so within the framework of private property and competition as Smith argued, it leads to public welfare.

Menger's theory can explain how some commodities became money. But today we use paper currency, unattached to any commodity. Our rupees are not convertible into anything, except notes of other denominations and coins. This fiat money - money by decree or law - is surely a state invention. In earlier periods, banks did issue paper currency, as in the free banking period in Scotland, where several private banks had issued their own notes. But these notes were convertible into a commodity, generally gold. Under the free banking system, Scotland had fewer and far less intense business fluctuations compared to England which had the Bank of England as the monopoly issuer of its currency. This, however, will have to be a separate story.

Fiat money and economic ills

The era of fiat money is less than 150 years old, a rather small period in human history. It remains to be seen how effectively central banks will manage it. With the new technologies, credit and debit cards, e-gold, e-money, and even computerised barter networks, the future is destined to be radically different.

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The perpetual mismanagement of money by central banks resulting in episodes of inflation, deflation, and business cycles led Hayek to demand 'Denationalisation of Money' in his influential book by the same name. How can we have an economy that is stable and free of business fluctuations, when one half of every transaction, money, is in the hands of the state? As long as money is controlled by central banks, business cycles are inevitable. In a free market economy, money, as the medium of exchange, must also be governed by market principles. In other words, there should be competing currencies, many of which, in the current and evolving context, would be digital in nature. This could be the cure of four economic ills – inflation, instability, undisciplined government expenditure, and economic nationalism. This is, of course, very difficult to achieve because no government will be willing to give up the enormous power that the control over currency gives them. However, in a free market, one cannot be prevented from hoping! ■

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