

## Professor Hayek's "Bitter Joke"

A flight from currency is an ultimate consequence of inflating fostered by government policies. It occurs when the general public refuses to accept or hold fiat currency and conducts transactions by barter or in some tangible medium of exchange. At such times any tangible commodity might assume the role of a medium of exchange — not only the usual monetary commodities (gold, silver, and copper) but also cigarettes, whiskey, or anything else that is handy for effecting trades.

When a currency becomes worthless, many fundamental financial and economic relationships are destroyed. This has been reflected in a severe contraction of economic activity and an increase in social unrest and lawlessness. Frequently such chaos has enabled a "man on horseback" to "take charge." Napoleon and Hitler both rose to power shortly after currency had become worthless in their countries.

Friedrich A. Hayek, emeritus professor of the Universities of Freiburg and Chicago and recipient of the 1974 Nobel Prize in economics, long has expressed concern over the effects of continued debasement of currencies. Recently he has proposed the creation of "free enterprise money" in a pamphlet\* and in other publications.

Professor Hayek, we assume, well understands the consequences of a flight from currency. As we noted above, such a flight can only follow *official* inflating. Inflating by private issues apparently can never render a currency worthless as long as officially issued purchasing media consists of specie or soundly backed redeemable money. Professor Hayek apparently hopes that private issuers will assume the role of providing sound money (the role that has been abdicated by all the governments of the world) so that a portion of the financial and economic relationships of our modern industrial economies might survive after official currencies had become worthless and, thereby, mitigate the worst consequences of a flight from currency.

Many aspects of this interesting proposal are not generally understood, and we wonder if Professor Hayek, himself, appreciates all of them. He focuses on several questions that seem unessential to the restoration of sound commercial banking. Moreover, some of the details of his exposition seem vague or contradictory.

Professor Hayek apparently believes that governments enjoy a monopoly of issuing money. In fact, people decide what money is, not governments. Governments can only decide what they will accept in payment of taxes and what they will pay to their employees and vendors. That governments have declared that contracts specifying payment in gold could be discharged with official paper

(legal tender) has facilitated continued debasement of official currencies, but this substitution has not given governments a monopoly of issuing money. In the United States, most purchasing media, including inflationary purchasing media, remain privately issued (demand deposits at commercial banks). Thus, although the repeal of legal tender laws would be highly desirable in restraining official inflating, we do not see how it is relevant to the novel aspect of Professor Hayek's proposal, namely, that banks accept deposits and make loans denominated in some unit other than a national currency.

### *What Would the New Unit Be?*

To provide some stability of purchasing power, the new units of account suggested by Hayek would be redeemable in official currencies at a variable exchange rate determined by some measure of purchasing power. Thus, a depositor could claim specified national currencies (dollars, pounds, francs, etc.) in an amount equal in purchasing power (measured in the manner specified by the issuer) to that of the official currencies he originally delivered to the banker. Borrowers of the new unit would have to repay loans in official currencies in amounts providing purchasing power equal to that borrowed. The specifications of the new units could be virtually anything a banker would think the public would accept, and the units of each issuer would compete in the marketplace for acceptance by the general public. In general, such units initially would reflect the price quotations (in national currencies) of various commodities as specified by each issuer.

However, the new units need not be redeemable by the issuer in the commodities used for the specification of the unit. Units that simply represented warehouse receipts of a commodity (or commodities) claimable by unit holders would not involve banking; therefore, they could not serve Professor Hayek's apparent intention of promoting the creation of a money-credit system that could supersede the collapse of national currencies. With Professor Hayek's plan, the issuer of a new unit initially would be only an intermediary, for his obligation to deliver equivalent purchasing power to *depositors* ultimately would be borne by the borrowers of the new unit, provided the issuer maintained a balance between his assets (loans) and liabilities (deposits) denominated in the new unit.

As long as the commodities used in the specification of a new unit were quoted in national currencies, the determination of the exchange ratio between the new unit and national currencies would remain a passive activity for the issuer, that is, the issuer would have no control over the ratio once its method of calculation were specified. The active management of such an enterprise

\*"The Denationalization of Money," Institute of Economic Affairs, 1974. An expanded version is to be published shortly.

thus would take the form of adjusting interest rates and charges to borrowers and depositors in the new unit to achieve a balance between assets and liabilities denominated in the new unit. The adjustments might take the extreme form of charging fees to depositors and offering payments to borrowers, in the event a flight from a currency were to encourage many depositors to seek the safety of a reliable unit and to discourage many persons from borrowing in such a unit.

Such a banking arrangement would be similar to the present day "offshore" or "Eurodollar" operations of banks. Such banks accept deposits and hold assets denominated in a number of currencies, and they attempt to balance assets and liabilities denominated in each, unless they choose to speculate in foreign exchange. If such an institution added a new unit of its own specification to its "stock in trade," few, if any, innovations in its practices would be involved. Thus, obstacles to a bank's offering a new unit of account to its borrowers and depositors appear to be minor banking or securities regulations, not fundamental laws or economic principles.

#### *What Unit Would Prevail?*

Professor Hayek states, "...once the public shows preference for a particular standard (or perhaps several standards), nothing can prevent other banks from basing their own currency (although under another name) on that same standard. I anticipate that ultimately a single or a few standards would prevail, certainly in large regions and perhaps world wide."<sup>†</sup>

He further states that he would prefer "...an appropriately weighted average of the monetary prices ... of raw materials and internationally traded food-stuffs."<sup>\*\*</sup> For such a standard to be feasible, the number of commodities necessarily would be small, because genuine transactions prices are available daily or sooner for only a relatively small number of commodities and a comprehensive average, or index, would not be available rapidly enough to effect immediate exchanges of the new units for national currencies. Moreover, any form of ensured convertibility of the new unit for the underlying tangible commodities would seem to be highly impracticable, if not totally impossible. To illustrate, what depositor would wish to leave the teller's window carrying, say, 1 pound of steel, 2 pounds of cotton, 1 quart of oil, an egg, etc? What bank could hold such items in inventory?

Nevertheless, banks probably could operate using units of account based on "market baskets" as long as the commodities included in the basket continued to be traded in national currencies. As now is the situation with "Eurodollar" operations, deposits in the new unit probably would be in the nature of time deposits, that is, the amount of such deposits outstanding would not affect the general level of prices. However, if the new units were to come into general circulation and the commodities in question were to be quoted in a private unit of account regardless of whether national currencies remained in circulation or disappeared as the result of a flight from currency the banker's management problems would become acute. Were the units to become the medium of exchange, the value of the new unit could fluctuate in terms of the commodities involved, rendering the issuers' specification unstable. Moreover, the object of keeping the (irredeemable) unit of account stable in purchasing

power (which presumably could only be done by appropriate expansion or contraction of the amount in circulation) could conflict with the banker's need to balance his assets (loans) and liabilities (deposits) denominated in the new unit.

#### *Specification in Gold Would Evolve*

A gold unit of account would overcome these difficulties. If prices began to be quoted in units of gold, price fluctuations would not affect the terms upon which the unit was issued, or promised to be redeemed. Bankers could base their lending decisions on the long-term gold-exchange value of their customers' security; this would be the banker's lending guide. The bank's opportunity to buy or offer gold in the market would provide the opportunity to influence prices in general and thereby eliminate the banker's conflict between altering the amount of the unit in circulation (to stabilize prices) and balancing assets and liabilities if his unit were a basket of commodities. Prices would remain stable as long as the amount of circulating liabilities of the issuers were maintained in a nearly constant relationship to the amount of commodities offered in the markets, including the gold held by the issuers. In short, issuers of a redeemable gold unit would have a practicable way to influence the general price level and thus keep their promise to maintain the purchasing power of the unit.

#### *Conclusion*

Professor Hayek's proposal merits serious consideration. Any experiment that could offer protection against rapidly deteriorating currencies is to be welcomed, particularly one that would enable some form of money-credit system to survive a flight from most currencies. However, we believe that Professor Hayek's focus on the legal tender laws as the source of difficulty without mention of the abandonment of sound commercial banking is regrettable. Also regrettable is resurrection of the unworkable notion of a currency based on commodity prices (an idea largely abandoned by the 1930's).

Years ago, Professor Hayek's perception seemed much clearer, when he wrote:

"... Compared, however, with the various schemes for monetary management on a national scale, the gold standard had three very important advantages: it created in effect an international currency without submitting national monetary policy to the decisions of an international authority; it made monetary policy in a great measure automatic and thereby predictable; and the changes in the supply of basic money which its mechanism secured were on the whole in the right direction.

"The importance of these advantages should not be lightly underestimated. The difficulties of a deliberate co-ordination of national policies are enormous, because our present knowledge gives us unambiguous guidance in only a few situations, and decisions in which nearly always some interests must be sacrificed to others will have to rest on subjective judgements. Unco-ordinated national policies, however, directed solely by the immediate interests of the individual countries, may in their aggregate effect on every country well be worse than the most imperfect international standard. Similarly, though the automatic operation of the gold standard is far from perfect, the mere fact that under the gold standard policy is guided by known rules, and that, in consequence, the action of the authorities can be

<sup>†</sup>The Wall Street Journal, August 19, 1971, p. 12.

<sup>\*\*</sup>ibid.

foreseen, may well make the imperfect gold standard less disturbing than a more rational but less comprehensible policy. The general principle that the production of gold is stimulated when its value begins to rise and discouraged when its value falls is right at least in the direction, if not in the way, in which it operates in practice.”††

Professor Hayek has said that his recent proposal began “as a bitter joke.” After years of defending “the gold standard and later fixed exchange rates,” perhaps he now believes that the gold standard (which, after all, was the outcome of centuries, if not millenia, of experimentation and of experience with official debasement of currencies) must now undergo a complete re-evolution. His recent proposal could be a means of promoting that re-evolution.

### STATISTICAL INDICATORS

Among the primary leading indicators of business-cycle changes, the net change in consumer installment debt outstanding increased slightly during July after having decreased during each of the preceding 3 months. The 3-month moving average of this series decreased for the second consecutive month, and there is increasing doubt that it still is expanding cyclically. Nevertheless, we continue to appraise this debt series as probably expanding. The percentage of primary leaders appraised as expanding cyclically remains 88.

The nonagricultural employment ratio increased slightly during August after having decreased during July, and the 2-month moving average of this series has decreased slightly for 1 month. Historically such decreases have not been cyclically significant; therefore, we continue to appraise the nonagricultural employment ratio as expanding cyclically. All of the primary roughly coincident series are so appraised.

Among the primary lagging indicators, the ratio of consumer installment debt to personal income increased during July, and both the inverted average duration of unemployment and the composite of short-term interest rates increased during August. These three series, as well as the other primary lagging series, are at new cyclical highs and clearly are expanding cyclically.

*Because seven of the eight primary leading indicators for which a cyclical trend is evident are appraised as expanding cyclically, we expect that general business activity will continue to expand during the next few months at least.*

### PRICES

#### CONSUMER PRICES

Note: Data other than the percent changes from a year earlier are seasonally adjusted unless indicated otherwise.

According to the Department of Labor, the Consumer Price Index (CPI) increased 1.7 percent, or at a compound annual rate of 6.9 percent, before seasonal adjustment during the 3 months ended in July. The unadjusted level of the index for July, 182.6 (1967=100), was 6.7 percent more than that a year earlier. After adjustments for seasonal variation, the compound annual rate of increase during the 3 months ended in April was 6.4 percent. This rate was the smallest during any 3-month span since that ended in January 1977.

The compound annual rate of increase in the CPI during 1977 through July has been 8.4 percent, which is much larger than the rate of increase widely anticipated early in the year. If the increase in the CPI during all of

1977 is to be in the range of 5.5 to 6.5 percent that most forecasters had predicted and that many assert is the underlying rate of “inflation,” the compound annual rate of increase during the August through December period must be less than 3 percent.

The accompanying table shows the annual rates of change of the CPI and of various subcomponent indexes during the 3-month spans ended in October 1976, and January, April, and July 1977. The rates of change of the subcomponent indexes of the CPI reveal that the recent abatement of the rate of increase of the CPI was entirely attributable to commodity prices. The compound annual rate of increase in the cost of services to consumers during the 3 months ended in July was 9.3 percent, which equaled the rate during the preceding 3-month period. Among service items, the largest recent increase was for the costs of household services other than rent, which includes mortgage interest and utilities. This subcomponent increased at a compound annual rate of 11.9 percent during the 3 months ended in July. Recent increases in the costs of medical care and transportation services were large also. However, the costs for other service items have increased only about as much as the all items index during recent months.

The rate of increase in grocery (food at home) prices moderated markedly during the 3 months ended in July. Such prices increased at a compound annual rate of 5.6 percent during the 3 months ended in July, after increasing at a rate of 18.9 percent during the preceding 3-month period. This subcomponent index actually decreased slightly during July; it was the first decrease in this index since November 1976. In contrast, the cost of restaurant meals (food away from home) has continued to increase rapidly. During the 6 months ended in July, the price index for food away from home increased at a compound annual rate of 10.8 percent.

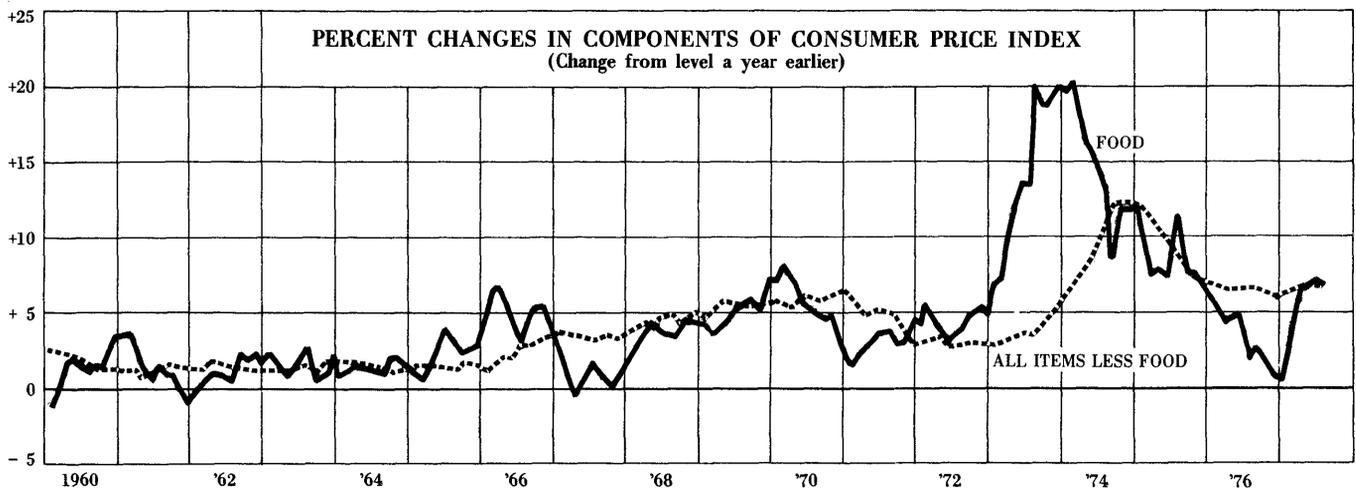
The index of prices received by farmers has decreased markedly during recent months, and the prices of most items of agricultural origin included in the wholesale price index also have decreased. These decreases have prompted many analysts to become optimistic regarding the near-future trend of consumer prices. However, the costs of processing, including distribution, comprise the major portion of the costs of foods purchased by consumers, and the impact of decreased prices for farm products may be relatively small. Moreover, recent plans for intervention by the Federal Government to “support” prices of

ANNUAL RATES OF CHANGE  
IN CONSUMER PRICE INDEXES

| Index                                 | Over Span of 3 Months Ended in: |              |              |              |
|---------------------------------------|---------------------------------|--------------|--------------|--------------|
|                                       | Oct.<br>1976                    | Jan.<br>1977 | Apr.<br>1977 | July<br>1977 |
| All items                             | +4.8                            | +6.1         | +9.9         | +6.4         |
| <i>Expenditure Groups</i>             |                                 |              |              |              |
| Food                                  | +1.8                            | +2.9         | +17.4        | +6.4         |
| Housing                               | +6.0                            | +6.8         | +8.1         | +8.4         |
| Apparel & upkeep                      | +4.4                            | +6.3         | +2.4         | +5.9         |
| Transportation                        | +10.5                           | +8.5         | +10.0        | -0.9         |
| Health & recreation                   | +6.0                            | +7.2         | +5.8         | +6.5         |
| <i>Commodity &amp; Service Groups</i> |                                 |              |              |              |
| All commodities                       | +3.9                            | +5.6         | +10.3        | +4.5         |
| Food                                  | +1.8                            | +2.9         | +17.4        | +6.4         |
| Other commodities                     | +5.5                            | +6.7         | +6.1         | +3.2         |
| Services                              | +6.6                            | +7.1         | +9.3         | +9.3         |
| <i>Memo:</i>                          |                                 |              |              |              |
| Wholesale Price Index                 | +4.0                            | +7.1         | +13.1        | -1.6         |

Note: All rates are compounded and based on seasonally adjusted data except those for housing and for health and recreation, which are based on unadjusted data.

††“A Commodity Reserve Currency,” *Economic Journal*, 1943, p. 176. Quoted in *A Tiger By the Tail*, Hayek and Shenoy, IEA, 1972.



agricultural products at their present levels suggests that any price benefit to consumers probably will be short-lived. Nevertheless, the current agricultural situation indicates that sustained increases in food prices at rates substantially in excess of other items (such as occurred during 1973) are highly improbable in the near future.

Among expenditure classes, the abatement in the rate of increase of the CPI reflected moderating price rises only in the areas of food (as noted above) and transportation. The other subcomponent indexes (for housing, for apparel and upkeep, and for health and recreation) increased more rapidly during the 3 months ended in July than during the preceding 3-month period. The decrease in the transportation subcomponent price index reflected a substantial contra-seasonal decrease in used car prices and a smaller-than-usual increase in gasoline prices during May, June, and July. In fact, the recent abatement of the rate of increase of nonfood consumer commodity prices was entirely attributable to the recent price trends of used cars and gasoline. During the 3 months ended in July, the prices of all other nonfood commodities included in the CPI increased at a compound annual rate of 6.1 percent; during the preceding 3-month period such prices increased at a rate of 4.2 percent.

Although the recent small increases in the CPI may continue for a few months, they probably will not be sustained long, inasmuch as they appear to reflect temporary market conditions for only a few commodities, namely, food, gasoline, and used cars. The rate of increase in the prices of most commodities and services purchased by consumers has remained large during recent months.

#### COMMODITIES PRICES

| Index                        | 1976     |          | 1977     |
|------------------------------|----------|----------|----------|
|                              | Sept. 6  | Aug. 29  | Sept. 5  |
| Spot-market, 22 commodities* | 539      | 524      | 524      |
| Commodity-futures            | 730      | 673      | 679      |
| Steel-scrap                  | \$73.17  | \$60.83  | \$59.83  |
| Gold                         | Sept. 16 | Sept. 8  | Sept. 15 |
|                              | \$114.00 | \$147.50 | \$147.90 |

\*For the preceding Tuesday.

Note: The indexes are, respectively, those of the U.S. Bureau of Labor Statistics, Dow-Jones, and *Iron Age*. The spot-market and futures indexes are converted so that their August 1939 daily averages equal 100. The steel-scrap index is a composite price for No. 1 heavy melting scrap. The gold price is the final fixing in London.

#### SUPPLY INDUSTRIAL PRODUCTION

Production of steel, automobiles, and electric power (1) in the 1- and 4-week periods ended on the indicated dates in the current year and (2) in the corresponding periods of earlier years was as follows:

|                           | 1972  | 1973  | 1974  | 1975  | 1976  | 1977  |
|---------------------------|-------|-------|-------|-------|-------|-------|
| <i>Steel</i>              |       |       |       |       |       |       |
| Ingots (million tons)     |       |       |       |       |       |       |
| 1 week: September 10      | 2.50  | 2.78  | 2.67  | 2.17  | 2.48  | 2.29  |
| 4 weeks: September 10     | 9.91  | 11.09 | 10.66 | 8.25  | 9.98  | 9.39  |
| <i>Automobiles</i>        |       |       |       |       |       |       |
| Vehicles (thousands)      |       |       |       |       |       |       |
| 1 week: September 10      | 146   | 150   | 131   | 162   | 148   | 143p  |
| 4 weeks: September 10     | 599   | 512   | 476   | 558   | 580   | 530p  |
| <i>Electric Power</i>     |       |       |       |       |       |       |
| Kilowatt-hours (billions) |       |       |       |       |       |       |
| 1 week: September 10      | 33.0  | 38.5  | 34.8  | 37.1  | 38.4  | 41.3  |
| 4 weeks: September 10     | 143.4 | 158.1 | 154.1 | 153.1 | 163.6 | 170.7 |

Percent change from 4 weeks a year earlier: +4.4 p Preliminary.

#### DEMAND RETAIL SALES

Estimates of retail sales during the most recent week and 4 weeks compare with such sales during the corresponding periods a year earlier as follows:

| Period                       | Percent change |
|------------------------------|----------------|
| Week ended September 3       | +12            |
| Four weeks ended September 3 | +13            |

#### BRIEFLY NOTED

In view of the credence given by the popular news media to warnings about the dangers of nuclear energy to fuel electricity generating stations, it is interesting to note that property and liability insurance companies have increased their insurance commitment to the nuclear energy industry by nearly one-third, or a \$90 million increase in the total amount of insurance available for each nuclear risk. A spokesman for one of the insurance pools said recently that the new total commitment of \$390 million per risk was one of the highest among the complex technological risk areas and that the reason the nuclear industry could attract so large a commitment was its good safety record. In more than 19 years of nuclear insurance, only \$400,000 has been paid in claims resulting from radiation incidents, and none of these claims were related to the operation of a nuclear plant.

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