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Freeing Europe from the Euro

The Case for a European Free Market in Money

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German Chancellor Angela Merkel has stated repeatedly that there is no alternative to the euro. She is right—up to a point. Today, people inside the euro zone do not have any alternative to the euro for an all-purpose currency, but that is because governments have barred any alternatives.

Chancellor Merkel and many other European leaders want to defend the euro at any price, calling the single currency the foundation for the rise of a "United Europe."[1] The opposite is true. The euro is, in fact, one of the major causes of the problems besetting Europe today. And things could still get worse. Maintaining the currency union in its present form may cause the breakdown of Europe's single market over the long run.

Is there a solution? Yes. The basic principles of the common market could save the European Union, if they were applied to monetary policy. Europe's currency future lies in competition.

Inherent Problems of Government Currency Monopoly. Over the last decade in the developed world, monetary policy implemented by central banks—and influenced by governments—helped to create huge bubbles in property markets. It also enabled governments to pile up incredible debts at low interest rates. This is a problem for most countries, not only the euro zone. The U.S. Federal Reserve has arguably done an even worse job than the European Central Bank (ECB), due to its twin inflationary policies of very low interest rates over the last decade and so-called quantitative easing, which formed the core of its response to the financial crisis. However, the ECB is catching up.

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Yet today the external values of the euro and the U.S. dollar are more stable than one would expect, given the loose money policies of the Fed and the ECB. In both cases, the reason is a lack of alternatives.

In the euro zone countries, the euro is legal tender—that is, the use of other currencies for many transactions is prohibited by law.[2] However, trust in the single currency, among both large investors and the general public, has been steadily diminishing.

A major goal of European politicians is for the euro and European government bonds to regain the markets' trust. But trust cannot be built—or rebuilt—by political diktat. At any given time, consumers and businesses may trust monopolies, but they do so because there are no alternatives available. Monetary monopolies are no different. People use government money because there is no alternative currency available.

When governments limit or ban competition, especially the entry of new competitors into a market, they ban the distribution of certain kinds of knowledge and the evolution of certain institutions and procedures. If businesses and consumers are allowed to use only one kind of money, there is no incentive for anybody to consider the quality of a currency. Which criteria make a currency trustworthy? How much inflation, if any, should one tolerate? Is it necessary to use only one currency or would it be better to use one currency for spending and a different one for saving?

The same applies for money issuers, both current and potential. Competition would beget strong incentives to find novel ways for currencies to build and retain users' trust without having to resort to monopoly or coercion. It also would allow for the dissemination of new kinds of knowledge regarding the nature of money. As the Nobel Prize winning economist Friedrich A. Hayek noted, "[I]t is useful to recall that wherever we make use of competition, this can only be justified by our not knowing the essential circumstances that determine the behaviour of the competitors."[3]

Advantages of Free Competition. Free market policies are based on the assumption of uncertainty and incomplete knowledge. Free market proponents cannot foresee or guarantee the outcome of market processes, but they trust in the ability of many people and companies to creatively adapt to existing conditions and to develop better forms of organizational and institutional arrangements. This evolutionary process—even with all its dead ends and detours—ultimately helps make the world a better, more prosperous, and efficient place.

By contrast, government solutions are based on coercion and the promise of certainty and safety. The latter is an illusion, but a very attractive one which politicians of various stripes try to sell to voters. The challenge faced by free marketers is to counter that snake-oil sales pitch by showing how the discovery process in a system of open competition helps to create a monetary system that is better at fulfilling the wishes of consumers than a centralized monopoly run by government agencies—which have no more knowledge of the future than do private market actors.

Toward a Free Market among Currencies. In his essay, "Denationalization of Money," Hayek proposed the establishment of "the full freedom to use any of the currencies for contracts and accounting" as a first step toward creating a competitive market for currencies.[4] That includes abolition of all "legal tender" regulations, thus allowing any currency to be used for all transactions in a given country. In the beginning, this would apply to all government currencies. For example, all euro zone members would have the right to create their own currencies parallel to the euro. The people in those countries would then have the freedom to decide whether to use national currencies, the euro, or any other currency. Freedom of contract would prevail.

As a next step, governments should allow private financial institutions to issue bank notes that can function as money. Each bank would issue its own distinguishable currency. No bank could issue euros unless granted the power to do so by the ECB. Each bank would bear full responsibility for its own brand of money. To succeed in the new currency market, banks would need to find ways to overcome a huge challenge: to find out how to create and sustain trust in a currency without relying on monopoly and coercion.

Positive Effects of Competition. A competitive market would exert pressure on central banks to retain or regain trust in their currencies by forcing them to compete with other currency issuers. Thus, central banks would have a strong incentive to avoid risky operations, such as buying low-rated government bonds or printing money to stimulate economic growth.

If private banks could issue money, different types of monetary arrangements could be tested in the marketplace. As Hayek noted regarding economic activity in a more general sense, no central planner can know what are the "optimal" methods of money creation and management of the money supply.[5]

Currencies redeemable in gold or other precious metals might have an advantage at the beginning, but it is far from certain that commodity-based currencies would be the only ones on offer in a competitive currency market.

It is even conceivable that money users could trust fiat-money issued by private banks. It would be up to those banks to convince potential customers to use and accept their currency. The issuer banks could guarantee stable purchasing power for a defined basket of goods, minimum exchange rates relative to other currencies, or a combination of these criteria.

Banks would also face strong incentives for transparency. Analysts, the media, and investors would test all issuer claims, providing a safeguard against fraud and claims that cannot be fulfilled.

Conclusion: The Long View. Eventually, different global, and even local, currencies could emerge. The use of different currencies would be common in many places. Would that pose a problem? Not at all. It might be a little bit inconvenient at first, but markets would adapt. Moreover, many countries that suffer from high inflation already have experience with multiple currencies—foreign currencies (usually the U.S. dollar) circulate there alongside local ones. In addition, people could decide to use only one currency if they so chose.

Would opening the market for competitive issuers of money help to solve the current debt crisis? Not in the short run. Government defaults are highly likely over the next years, and it is not clear whether some countries can find a way out of their budget deficits. Policies like quantitative easing that substantially increase the money supply inevitably lead to inflation or, at the very least, to huge asset bubbles—which are essentially inflation concentrated in one economic sector.

However, over the medium and long term, vigorous competition among currencies, without barriers to entry into the market, could go a long way toward avoiding future debt crises. If governments decide to borrow money, they would have to pay interest rates determined by the market. Investors would deal with currencies under monetary conditions much more stable than those of today. Banks that rapidly expand the supply of their currency would have a very hard time convincing consumers to use it.

A free market in currency would contain, if not eliminate, the two main sources of financial crises: unlimited expansion of the money supply and unlimited growth of government debt. Governments would not be able to influence money production anymore. If the euro could survive in a competitive environment, it would be a much stronger, currency than it is today. It would rely not on government monopoly, but on gaining and keeping consumers' trust.

Notes

[1] For example, Merkel declared: "Europe will fail if the euro fails. Europe wins if the euro wins" in her government statement February 27 in the German Bundestag. "Large majority approves Greek bailout package," *Der Spiegel*, February 27, 2012, http://www.spiegel.de/international/europe/large-majority-german-parliament-approves-greek-bailout-package-a-817881.html.

[2] Article 128 (ex Article 106 EC Treaty): "1. The European Central Bank shall have the exclusive right to authorise the issue of banknotes within the Union. The European Central Bank and the national central banks may issue such notes. The banknotes issued by the European Central Bank and the national central banks shall be the only such notes to have the status of legal tender within the Union."

[3] Friedrich Hayek, "Competition as a Discovery Procedure," *Quarterly Journal of Austrian Economics*, Vol.5 (2002), p. 9.

[4] Hayek, *Denationalisation of Money—The Argument Refined*, Institute of Economic Affairs, London, 1976, http://mises.org/books/denationalisation.pdf.

[5] For the most concise version of the argument see: Hayek, "The Use of Knowledge in Society," *American Economic Review*, Vol. 35, No. 4, pp. 519-530, http://www.econlib.org/library/Essays/hykKnw1.html.