

Austrian Economics Newsletter

The Other Side of the Coin: Free Banking in Chile

by Murray N. Rothbard

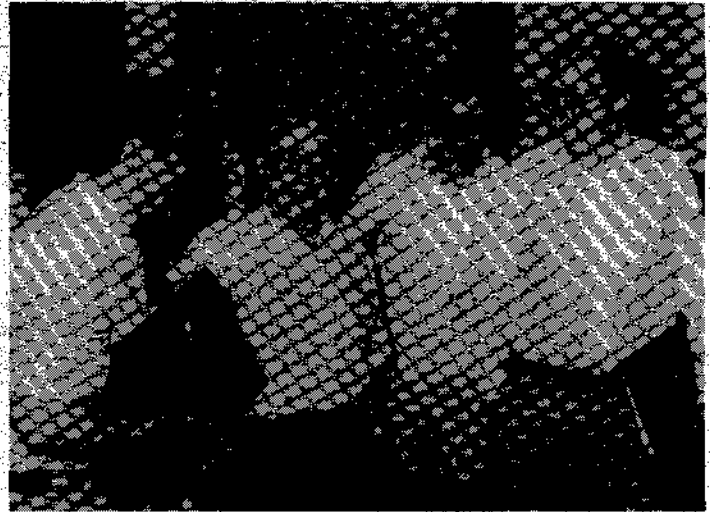
In recent years, disillusionment in central banking has understandably set in among many economists. As a result, some writers have turned to the alternative of free banking, praising both the theoretical model and historical cases in which free banking has allegedly worked effectively. But there may have been an unwise rush to judgment.¹ It is high time that we call attention to the other side of the coin: the apparent disaster of free banking in nineteenth-century Chile.

During the first half of the nineteenth century, Chile was a haven of monetary and financial stability, the envy of Latin America. The reason was not simply that the country had no central bank; more importantly, Chile had no paper money or fractional reserve banking at all! For the Chilean leadership was devoted to the idea of pure, 100 percent commodity money. Thus, in 1824, the Chilean Finance Minister strongly opposed the introduction of even convertible, fractional reserve bank notes. Such notes would be admitted, he warned, "only at the point of the bayonet. The person who dared to propose it would be looked upon as a dreamer, a tyrant, even a heretic."²

Throughout the 1830s and 1840s, Chile rejected proposals for a governmental paper bank, due to fears of mismanagement and inflation. In 1839, the government passed a law banning any bank paper issue without government permission, and required that any permitted issue had to be fully guaranteed by the bank. The result was the virtual absence of paper money in Chile. In 1848, the Minister of Finance, Manuel Camilo Vial, ruefully stated that he would have liked to establish a governmental bank, but found it politically impossible to do so: "I would not have hesitated to propose the establishment of a bank by the government were I not aware of the almost insuperable opposition which many of the most distinguished citizens of the country have to such an idea..."³ Three years later, the then-Minister of Finance prayed: "May we hold ourselves aloof from institutions such as banks of issue!"

Only one breach of this principle occurred before the end of the 1850s. In 1849, the government granted the right of note issue to the Banco de Chile: but large-scale protests by merchants and an adverse Supreme Court decision caused the bank to close its doors the following year.⁴

Into this idyll of hard money and monetary stability, there stepped, unfortunately, one man with an idea. As an



Students and faculty alike find the informal discussion time a valuable aspect of the Mises Institute's summer conferences. Dr. Gordon, Professors Rothbard and Hoppe and a student continue a discussion during a break at last summer's Introductory Course in Austrian Economics at Dartmouth.

undeveloped country, Chile was understandably in awe of European knowledge and civilization, and in 1853 it hired as its first professor of economics in the new University of Santiago the French economist and banking theorist Jean Gustave Courcelle-Seneuil (1813-1892), who was also to serve as an official economic adviser to the Chilean Ministry of Finance.⁵ Courcelle-Seneuil was devoted to free trade and laissez-faire in general, but his major interest was in the abolition of central banking and the establishment of a free banking system. Entering an academic vacuum, Professor Courcelle-Seneuil quickly became extremely influential in Chile, persuading the government to enact a free banking law drafted by himself in 1860. His

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charismatic teaching style produced a host of highly influential disciples, who dominated Chilean economic thought and political economy for decades.

The Law of 1860 created a free bankers' paradise in Chile. Anyone or any group could set up a bank and issue notes. There were no reserve requirements, no minimum capital or loan requirements, no limits on loans to directors, and no inspection by government agencies. Only two minor restrictions were imposed: a maximum note issue of 150% of the bank's capital, and a ban on very small denomination notes under 20 pesos. All else was permitted, within, of course, the standard free-banking framework of requiring banks to redeem their notes in gold on demand.⁶ The Law of 1860 continued to be the basic banking law of Chile until 1925.

As a result of the new system of free banking, however, Chile rapidly embarked on a long-run, generally accelerating course of inflation. The old haven of hard money and financial stability was no more.

It took less than five years for the brave new free banking system to collapse. In 1864, Spain and Peru went to war over the Guano Islands off the coast of South America, and Chile went to the aid of Peru, declaring war on Spain on September 24, 1865. By the outbreak of war, the free banks had inflated to such an extent that they were vulnerable to insolvency in a major crisis. Hence, the war scare of 1865 led to massive withdrawals of bank deposits and the cashing of notes from the fractional reserve banks. At the point of insolvency, the banks were promptly saved by the Chilean government, which now embarked on a path of inconvertible bank paper. First, five days after the declaration of war, it authorized the new Banco Nacional de Chile to issue a mass of inconvertible bank notes, stipulating (a) that the inconvertibility

Edwin W. Kemmerer, the American "money doctor" on one of his trips to South America to help with monetary "reforms" that led to the creation of the Chilean central bank.



would last only for 90 days and (b) that the maximum note issue would be 1.5 million pesos. The fiat notes would not be legal tender, but would be receivable in taxes or other payments to the government. Second, the government induced four of the leading banks to agree to receive the Banco Nacional notes at par, and also to turn over to the government all coin taken in to help eventually redeem the bank notes received by the government. Third, the government agreed to issue 1 million pesos worth of bonds to be kept as a guarantee for any of the inconvertible bank notes received by the government.

As always happens with monetary expansion, this first step was but the tentative beginning of the inflation program. Another law was passed at the end of December, delaying specie convertibility until six months after the war with Spain was over, or, at the latest, by the end of June 1867. In addition, more inconvertible bank notes were made receivable in taxes.

Fiscal needs escalated rapidly as the blockade by the Spanish navy led to a fall in customs revenue, and to difficulty in repaying the public debt, held mainly by England. The next step in the acceleration of inflation came in July 1866. The government borrowed massively from banks to help pay the foreign debt; in return, the government bestowed a host of special privileges on the banks. The law of the previous December was repealed. From now on, there were to be no restrictions on the amount of loans or note issue by the banks; all bank notes would be inconvertible until six months after the war, or June 1867 at the latest. All banks lending money to the government would agree to receive each others' notes at par for twenty-two years, to the extent of 4.5 million pesos. For this massive set of privileges, the banks agreed to pay the government a fee of 2 percent per annum on any inconvertible notes outstanding.

Fortunately, the war was shortly over, and convertibility into specie was soon resumed. But the signal had been given to the banks that the government would bail them out in times of real financial trouble, and so an inflationary boom soon began, fueled by bank credit expansion and ensuing speculation. The bank credit boom after 1866 led to a speculative boom in mining, as well as an increase in wheat and copper prices. Frank Fetter notes that "the banks were doing business on a very small margin of safety."⁷

Booms always give way to busts, and a depression set in by 1874. Farmers and landlords went even more heavily into debt, and total agricultural debt in arrears rose to 11.7% in 1877 and to a staggering 33.6% in 1879. There was a heavy depression in the mining industries. The Chilean government incurred heavy deficits from 1874 on. Having exhausted private nonbank credit sources after several years, the government in June of 1878 finally turned to the already overextended banks, borrowing 2.5 million pesos per year for two years. In turn, the Treasury allowed the lending banks to issue 10.1 million pesos in bank notes, to be receivable in taxes.

This inflationary issue of bank notes led to domestic inflation and to a rapid export of specie. The "free" banks were now on the ropes, then quickly, on July 23, 1878, the

Chilean government authorized all of the banks participating in the recent loan to immediately suspend specie payments "temporarily"—until the end of August 1879. In the meanwhile, these now fiat bank notes would serve as legal tender. In fact, this "temporary" inconvertibility was to last for nearly fifty years. Chile had been plunged into the inflationary world of fiat money, and had done so in the absence of a central bank, in fact in the midst of a supposedly ideal system of free banking.

Central banking and free banking are not the only two possible monetary alternatives. A third route is freedom of banking within a firm matrix of 100 percent specie reserves.

The fateful suspension of specie payment in 1878 was blamed, as usual in such situations, on the "unfavorable balance of payments," no recognition being given to the cause of that balance—the domestic bank credit inflation. The actual reason for the suspension was the imminent bankruptcy of several of the largest banks participating in the government loan. Just before the suspension, on June 30, 1878, demand liabilities of the Chilean commercial banks totalled 46.8 million pesos; specie reserves of the banks totalled only 3.45 million pesos, a reserve ratio of 7.4%. Even during prosperity at the end of 1869, total reserves had constituted only 8% of demand liabilities. The largest lending bank, and the most ardent advocate of suspension, the Banco Nacional, was the most unsound of the banks. Not only was its reserve ratio in 1869 far lower than the average of 5%, it also engaged in large-scale loans to its own directors. Just before suspension, on July 11, it had loaned out no less than one-half of its capital to its own directors.

During the next half-century, Chile made only one feeble attempt to return to gold. In 1895, when the market exchange rate between the peso and English pound was 14 pence to the peso, the Chilean government insisted on returning to gold at 18 pence to the peso. The subsequent appreciation of the peso and monetary and price deflation in Chile led to a run on the banks in 1898, and a permanent return to fiat money.

The fiat system and the legacy of Professor Courcelle-Seneuil finally came to an end in 1925, when the American "money doctor," Edwin W. Kemmerer, in a mission to Chile, succeeded in imposing yet another of his monetary "reforms." The 1925 reform repealed the Law of 1860, imposed a Central Bank, and engineered a return to a gold exchange standard, in which the peso was only nominally tied to gold, and was actually tied to the dollar. A few years later, the Chilean experiment joined the other gold-exchange standard nations in the dustbin of history, and fiat paper money was established permanently.⁸

And what of Courcelle-Seneuil? He had the good fortune to return in triumph to France in 1863, after the victory of his ideas and before their consequences would

become apparent. While in Chile, his *magnum opus*, a two-volume treatise on political economy, was published in France in 1858, and the grateful Chilean government financed a Spanish translation. After his return to France, he continued as a prolific writer on banking, economic and historical topics, and himself translated works on political economy from the English into French. He was appointed a member of the Council of State in 1879 and elected a member of the prestigious Academy of Moral and Political Sciences three years later.

Unfortunately, Courcelle-Seneuil's reputation did not fare nearly so well in the country of his major influence. Courcelle-Seneuil is still, to this day, de-nounced bitterly by Chileans as being personally responsible for the continuing history of inflation as well as for nearly all other economic ills. As Albert Hirschman notes, Courcelle-Seneuil has been "demonized."⁹ Unfortunately, his free-banking inflation also in retrospect discredited other, far superior reforms due to his influence: e.g., a drastic cut in Chilean tariffs in 1860, as well as the privatization of nitrate mines conquered in a war against Peru in the early 1880s. Thus, Professor Courcelle-Seneuil's legacy in banking was successfully used to discredit his other, more beneficial contributions to the Chilean economy.

The Chilean experience highlights an important point: that central banking and free-banking are not the only possible monetary alternatives. A third route is freedom of banking within a firm matrix of 100 percent specie reserves, any fractional reserve issue being considered a violation of the general laws against fraud and theft.

Notes

I am greatly indebted to Professor Joseph Salerno of Pace University for calling my attention to this problem and to the relevant literature.

¹On the most prominent example of this undue haste, see Murray N. Rothbard, "The Myth of Free Banking in Scotland," *Review of Austrian Economics*, 2 (1988), pp. 229-245; and Larry J. Sechrest, "White's Free-Banking Thesis: A Case of Mistaken Identity," *Review of Austrian Economics*, 2 (1988), pp. 247-257.

²Albert O. Hirschman, *Journeys Toward Progress* (New York: Doubleday, 1965), pp. 221.

³Frank W. Fetter, *Monetary Inflation in Chile* (Princeton: Princeton University Press, 1931), p. 7.

⁴During the 1850s, two commercial houses in Santiago began to issue and circulate notes, but at least one of them, the Banco de Valparaiso was prohibited from issuing notes by a special law in 1855. *Ibid.*

⁵Born in the Dordogne, Courcelle-Seneuil had studied law, managed an industrial firm in his home province, had written many articles for the *Journal des Economistes*, and had published a small book in 1840 on *Credit and Banking*. He briefly held a high post in the French Ministry of Finance after the 1848 revolution, and published a successful textbook on banking in 1852. Albert O. Hirschman, "Jean Gustave Courcelle-Seneuil (1813-1892)," *The New Palgrave: Dictionary of Economics*, I (London: Macmillan, 1987), pp. 706-708.

⁶Before independence from Spain, the Chilean currency consisted solely of freely circulated European gold and silver coins. Independent Chile imposed a bimetallic

standard, but the fixed rate of 16.5:1 overvalued gold and undervalued silver, and the result was an effective gold standard. In 1851, the fixed ratio was changed to 16.4:1, but silver was still undervalued, and the gold standard continued.

⁷Fetter, *Monetary Inflation*, p. 25.

⁸On the farflung activities of Edwin O. Kemmerer in imposing the gold-exchange standard and central banking in the Third World, see Robert N. Seidel, "American Reformers Abroad: the Kemmerer Missions in South America, 1923-31," *Journal of Economic History*, 32 (June 1972), pp. 520-545; Emily S. Rosenberg and Norman L. Rosenberg, "From Colonialism to Professionalism: the Public-Private Dynamic in United States Foreign Financial Advising, 1898-1929," *Journal of American History*, 74 (June 1987); and Murray N. Rothbard, "The Origins of the Federal Reserve," (unpublished MS), pp. 50, 60-61.

⁹Hirschman, "Courcelle-Seneuil," p. 707.

Murray Rothbard is the S.J. Hall distinguished professor of economics at the University of Nevada, Las Vegas, and is vice president for academic affairs at the Ludwig von Mises Institute. ■

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The Implications of Freedom in Banking and Note Issue

by George A. Selgin

(This article is the first of two parts based on a lecture given at the Mises Institute's Austrian Economics Colloquium at Auburn University.)

I wish to defend two controversial claims in this article. The first is that the monopolization of banknote issue by monetary authorities all over the world has been the greatest blunder ever committed in monetary and banking policy. The second is that economists' failure to clearly understand the implications of monopolized note issue has been the greatest blunder ever committed in monetary and banking theory. Monopolized note issue is a policy blunder because it has been the main cause of instability of money supply and of consequent monetary disturbances. Had note issue been allowed to develop freely and competitively, we probably would not have come to think of money as something that "will not manage itself." The failure of theorists to understand the implications of monopolized note issue has been a blunder of theory because it has led to their approval of monopoly in the one industry where it could do the greatest harm.

Note Issue and Monetary Stability

What is meant by monetary stability? How do we want the banking system to behave? I take for granted that monetary stability means that the supply of money is neither excessive nor deficient relative to the wants of the public. To accomplish this, a banking system should increase the supply of bank money whenever the public's demand for it—relative to some given level of income—grows, and it should reduce the supply of money whenever the public's demand for it relative to its income falls. At all other times the supply of money should not be changed at all. Finally, the banking system should supply the public with the right mixture of different types of bank money, including currency and deposits of different kinds.

Obviously, real-world banking systems do not work this way. Why is that? The three most important reasons are as follows: 1) unwarranted changes in the supply of "base" or "high-powered" money—the stuff banks hold in reserve; 2) unwarranted changes in the reserve ratio; and, 3) unaccommodated changes in the public's relative demand for currency. The first of these reasons is the main cause of undesirable, secular maladjustment of the money supply, whereas the third is the most important cause of cyclical maladjustment. This, at least, has been true for all banking systems with a centralized currency-issue. But how significant would these causes of disequilibrium be in a system with competitive note issue? The answer is, not very. Compared to centralized banking, free banking offers relatively little scope for disequilibrium money supply.

Consider first the matter of the monetary base. In monetary systems with centralized note issue, the liabilities—both currency and deposits—of the privileged bank of issue inevitably become part of the supply of base



George Selgin presented his paper on "The Implications of Freedom in Banking and Note Issue" to students and faculty at the Austrian Economics Colloquium sponsored by the Mises Institute at Auburn University.

money. That is true even with a commodity standard; with a fiat standard the liabilities of the central bank are the only kind of base money. This comes about because other banks, stripped of their right to issue notes, are anxious to keep on hand notes issued by the central bank to give to their customers who ask for cash.

Even under a gold standard, a contest for notes of the central bank develops among the unprivileged banks, taking the place of what (under free note issue) would be a contest for gold. Banks end up treating the central banks' liabilities as reserves, using them to settle clearings. Thus these liabilities become part of the monetary base—a kind of high-powered money. What's more, they are a most unstable type of high-powered money, because they can be increased or withdrawn at any time at the whim of the central bank. This causes a multiple expansion or contraction of loans and deposits by all other banks. All large inflations in recent history were a result of expansion of this kind of high-powered money; the economics of gold mining make it impossible for the supply of gold ever to expand for very long at an excessive rate.

Had note issue never been monopolized, the monetary base in most countries in the West would have consisted of gold: no bank would have exclusively been able to have its liabilities held by other banks as reserves, or used to settle their clearings with one another, instead of being routinely redeemed. Additions to the stock of monetary gold are, of course, limited by the profitability of gold mining. Notwithstanding conventional wisdom to the contrary, this makes the supply of monetary gold endogenous. Most of the alleged gold "supply shocks" in history actually occurred in response to falling prices, that is, they were provoked by an increase in the relative price of gold. They therefore represented movements along a gold-supply schedule rather than shifts in that schedule. Furthermore, many of these movements were a result of government interference in the monetary system, which

created deflationary pressures that would not have arisen under free banking. All told, then, changes in the monetary base would be a much less significant source of monetary disequilibrium under free banking than they have been under central banking.

All of this assumes free banking has to be based on a commodity, such as gold. Today, another alternative exists: to establish free banking on the basis of a frozen stock of fiat base money, such as Federal Reserve Notes. In this arrangement banks would issue paper claims redeemable in base dollars, to be held by the public; the base dollars themselves, however, could be used exclusively as bank reserves. Obviously this kind of reform would provide no scope at all for monetary disequilibrium stemming from unwanted changes in the size of the monetary base.

Next let's consider how the reserve ratio would behave in a free banking system. It is often assumed that unregulated banks, issuing convertible notes, could expand their issues without limit because they would not be under pressure to hold any definite fraction of base money reserves. Statements in many textbooks even imply that this would occur with checkable deposits were it not for the presence of statutory reserve requirements. Yet in many countries for many years banks were not constrained by statutory reserve requirements, and the supply of deposits did not explode. This was even true when banks were relatively unhindered in their ability to issue notes.

What was it that made the reserve multiplier finite in these banking systems? For competitively issued notes, just as for deposits, any issue in excess of the public's aggregate needs (for some given level of income) leads to a redeposit of the excess, mainly at rival banks. Banks send the notes through the clearinghouse to be redeemed, like so many checks. Net clearing debits have to be settled in base money. Since the exact incidence of net debits cannot be known with certainty, every bank will, in anticipation of such debits arising at any particular clearing session, keep a balance of base money on hand. The size of the balance is determined according to the same principles which determine the size of other private firms' holdings of precautionary and transactions balances of bank deposits.

These determinants of reserve-demand do not imply a constant average reserve ratio; for in a free banking system there is one circumstance when the reserve ratio will change: it is when the public's real demand for free-bank notes and deposit credits expands or contracts over time. For example, as the demand for notes increases, more notes become "lodged" in circulation, and fewer enter the clearing mechanism. As a result of this, gross bank clearings fall along with other measures of nominal spending. Since the transactions and precautionary demand for bank reserves is positively related to the volume of clearings, the new, optimal reserve ratio will be lower than the actual ratio of bank reserves to liabilities. Assuming that the nominal supply of reserves is fixed, banks will adapt to the new situation by expanding their balance sheets through new loans and note issues until the volume of gross clearings returns to its former level. In effect, the banks offset changes in the velocity of money

with equal and opposite changes in its nominal quantity: the money multiplier adjusts passively to the wants of the public. This is very desirable; it is manifestly *not* what happens in regulated and centralized banking systems.

This brings us to the third and final cause of monetary disequilibrium in conventional banking systems: unaccommodated changes in the public's currency ratio, that is, in the public's preferred mixture of currency and deposit balances. It is now well known that, in centralized banking systems with a constant monetary base, an increase in the public's relative demand for currency leads to a net loss of bank reserves, which in turn leads to a much larger, disequilibrating fall in the volume of deposits. Likewise a fall in the demand for currency leads to an equal expansion of bank reserves, which—in the absence of adjustments by the central bank—will cause a disequilibrating, multiple expansion of deposits. Histori-

Had note issue never been monopolized, the monetary base in most countries in the West would have consisted of gold.

cally, such uncompensated changes in the demand for currency have been a very important cause of monetary crises. Here in the United States, an uncompensated fall in currency demand was largely responsible for the post-World War I inflationary boom. On the other hand, unaccommodated growth in currency demands played a major role in the pre-Federal Reserve money panics and also in the "Great Contraction" of 1930 to 1933.

Such disturbances caused by changes in currency demand are what monetarists like Henry Simons, Lloyd Mints, and Milton Friedman have in mind when they refer to the "inherent instability" of fractional reserve banking. Yet this instability is really not inherent in fractional reserve banking at all. It is only inherent in fractional-reserve banking systems that lack freedom of note issue, including, in particular, all central banking systems. This is because the notes of a privileged bank of issue come to lead a kind of "double life" as so-called "high-powered" money. These notes are not really always high powered: when in the hands of the public they resemble other types of "mild mannered" bank money. It is when they enter the tills of commercial banks that they become "super" money. The ebb and flow of these notes to and from bank reserves causes their power to change, thereby also causing the total money stock to increase and to diminish.

Nothing of the sort occurs under complete freedom of note issue. For here whenever a bank's customers come to it demanding currency in exchange for their deposits, the bank can simply draw upon a stock of notes produced, as it were, by its own printing press. On its balance sheet the bank debits the entry for "liabilities-deposits" and then credits the entry for "liabilities-circulation" by the exact same amount. The bank's liquidity—its reserve position—remains unaffected: the notes it has handed out over its counter were not part of its reserves, and they will not

become part of its reserves in the future when they are sent back for redemption. In short, a free banking system is readily capable of accommodating changes in the public's currency ratio simply by adjusting the form of its outstanding liabilities, without provoking any undesirable changes in the total quantity of those liabilities. Such a banking system is not "inherently unstable" in the sense meant by Friedman and Mints. Indeed, Friedman and Mints themselves realize this advantage of free note issue. That fact did not inspire them, however, to argue in favor of free banking. Friedman uncharacteristically dismissed the idea as being politically impossible, although he has recently become more open to it. As for Mints, he was frankly opposed to fractional reserve banking in any form; he did say, however, that those who weren't entirely opposed to fractional reserve banking were being inconsistent and illogical in not arguing for competitive note issue.

Note Issue and Monetary Theory

Regrettably most economists failed to see any of the potential advantages for monetary stability of freedom in note issue. Instead, they completely misunderstood the role played by bank notes, treating them as if they must always be high-powered money, and using this approach to justify and defend the monopolization of note issue in banking systems everywhere. The irony is that it was really the monopoly privilege in note issue itself which caused notes to become high powered. The very thing that was perceived as giving central banks the power to control the money supply was also the principal cause of the money supply being out of control in the first place.

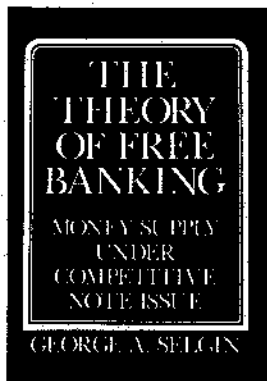
Take, for example, the case of England. The Bank of England enjoyed limited monopoly privileges in note issue from the time of its establishment in 1694. For the next century and a half, England was subjected to numerous monetary crises, including the long-lasting Bank Restriction during which the price of gold appreciated in terms of bank money. Many of these crises were blamed on the overissue of bank notes. But rather than appreciate the unique ability possessed by the Bank of England to engage all other banks in a general expansion, the reformers targeted the already underprivileged *country* banks for the strictest regulation. The ultimate consequence of Peel's Bank Act of 1844 was to strip those banks entirely of their powers of note issue, actually enhancing the power of the Bank of England. It was as if the traffic police revoked the licenses of a pack of speeding bicyclists without noticing that the bicycles were being chased by an out-of-control tank, and then put the tank in charge of directing traffic!

In the United States the most serious defects of the National Banking system can be traced to bond-deposit requirements on note issue and to restrictions against branch banking. But instead of acknowledging this and moving to a deregulated system, the authorities chose to heap another batch of bad regulations on top of the ones that had failed. The new system, because it was more centralized, was actually capable of even greater mischief than what it had replaced; yet when this fact was revealed

after no less than two decades its only effect was to launch still another batch of misguided banking regulations.

In short, economists' failure to understand the implications of freedom of note issue has led them to endorse monopoly in the one place where its effects could be most devastating. In so doing they helped to tarnish the invisible hand by involving it in regular monetary crises that were not a product of its own wrongdoing.

George Selgin is a lecturer at the University of Hong Kong. He will also be a member of the faculty for the Mises Institute's summer conference at Stanford University, July 8-15, 1989. ■



George Selgin's book, Theory of Free Banking: Money Supply under Competitive Note Issue is available from the Ludwig von Mises Institute; \$25.00 hardback.

European Economic Integration and the ECU

by Hans-Hermann Hoppe

According to official, intergovernmental agreements, by 1992 a European central bank—most likely as an offshoot of the present European Monetary Cooperation Fund—will be established, and the ECU, in existence since 1979, will become the all-European currency supplanting the various European national monies. At the same time the economic integration of the ten current member states of the European Community will supposedly be complete.

There are some who, for one reason or another, doubt that this will actually happen, or that it will occur as soon as 1992. However, almost everyone thinks of it as 'a generally good idea'. Yet European integration and the ECU are nothing but bad news, economically as well as morally.

Public opinion, which will ultimately determine whether or not these plans will become reality, and which presently gives them so much favorable treatment, suffers from two fundamental misconceptions, spread and reinforced through deliberately deceptive government propaganda.

Public opinion is correct as regards its intuition that integration into wider markets is economically better than integration into a smaller one, and that a more

widely used money better functions as a medium of exchange than a less widely used one. It is misled, however, in supposing that European integration and the ECU—only because Europe is obviously larger than its national components and the ECU thus would circulate more widely than any national currency—have anything to do with wider markets or better money. The truth is precisely the reverse: European integration implies a uniformly raised overall level of governmental interferences with market operations, i.e. of economic disintegration; and the ECU means the substitution of bad monies circulating in smaller territories by a worse one circulating in all of Europe.

If European integration were really meant to widen markets, there would be no need for intergovernmental negotiations or agreements. This could occur at any time simply by refraining from any restrictions and regulations regarding the inflow and outflow of goods and services across state borders. Even if other governments did not follow a state's example, such a policy would invariably ensure the state's optimal economic integration and the level of wealth production and acquisition (such that any retaliation for another's non-free trade policies would not only harm foreigners, but invariably also inlanders).

Needless to say, unilateral free trade policies combined with attempts to convince others of the mutual advantage of following suit is not the integration course that governments of Western European countries have been taking during the last 30 some years. Revealingly enough, the one European country coming the closest to a policy of unilateral free trade, Switzerland, has never shown any serious interest in joining the European Community (nor does it plan to supplant the Swiss Franc by the ECU). Switzerland—small, multilingual, sparsely endowed by nature—has not only not suffered economically from this non-integration course, but has increasingly outdistanced its integrationist neighbors and could conceivably become the world's most prosperous country.

Instead, what the integrationist European governments have been up to from the very beginning is the multilateral negotiation of cartel agreements between agencies possessing the powers to tax and regulate distinct populations and areas. Naturally, it is against any such government's interest to enter an agreement that would imply a reduction of its own income. If agreements between governments are at all possible, they can only concern the coordination of measures designed to increase taxes and/or regulatory powers for all of the participating governments. In the field of regulatory action, in particular, this implies that agreements must typically involve compromising on the smallest common denominator such that if government A regulates matter X and B the matter Y, their "integration" then consists of A and B uniformly regulating X and Y. Such indeed are the major accomplishments of the European integration: the creation of a steadily growing and lavishly supported Eurobureaucracy in Brussels, Strasburg and Luxemburg in addition to or, most likely, equally increased national bureaucracies; the implementation of agricultural policies more absurd even than those of the United States, with mindboggling waste and pervasive corruption; the

the recurring cycles of inflation and subsequent liquidations necessarily associated with fractional reserve banking.

Naturally, no such thing has ever been the objective of the major European governments. With a system of central banking and a pure paper money standard in place, each government reaches complete internal autonomy for counterfeiting. That is, each is in the position to enrich itself at the expense of others simply by creating money out of thin air and buying real assets with such money. No government will ever deliberately sacrifice this magic wand. If there can be agreements between governments on monetary policy at all, it can again only concern an *increase* in each government's counterfeiting powers. And indeed, the European monetary integration policy, traditionally implemented through a system of 'flexibly fixed' exchange rates between national currencies (much like the present "snake"), has served precisely this purpose of enhancing the state's inflationary powers by agreeing with other monopolists on a policy of joint, coordinated counterfeiting.

However, this system is still unsatisfactory for each individual government because it cannot rule out that one currency may systematically depreciate against another, and hence that the power of one government will fall relative to that of another. The ECU and the plan to substitute it for the various national European currencies is the means for overcoming this obstacle. With the ECU established as the all-European paper currency, such relative depreciation is no longer possible within the entire territory of the European Community, and thus the new joint counterfeiting powers of all the involved governments are extended.

The idea of the ECU is not pushed for economic or other reasons that have anything to do with the com-

tax, regulate and counterfeiting and which accordingly can draw on more prosperous societies and to be the ones financially better off, are also those governments which have the least interest in complying with any cartel agree-

With the ECU established as the all-European paper currency, joint counterfeiting powers of governments are extended one step further.

ment. To be sure, their exploitative powers could surely increase with successful intergovernment cartelization. However, their power being relative to that of the competing governments would rise if they abstained from such a course of action and kept pursuing their policies of low level taxation and regulation and of hard money which made them the more successful governments in the first place. If instead they participate in an intergovernmental cartel, this implies benefiting less successful governments at their own expense.

Why in spite of these disincentives, has the West German government—the most economically advanced country among the major European nations and the one with the hardest currency (except for Switzerland)—played a leading role in the European integration process? The reason for this must be sought outside of Europe. The driving force behind the economic and monetary integration of Europe is the United States. It is the United States government that most wants it and has used its dominant position vis-a-vis the major Western European governments, and in particular West Germany, to make them overcome this disincentive and instead choose the course of cartelization they have actually taken. Without United