FULL PRIVATIZATION OF CURRENCY IN A NEARLY CONVENTIONAL MONEY AND BANKING SYSTEM

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Introduction

Full privatization of currency is a reform that deserves serious consideration. Unfortunately, it is often taken to mean replacing a single government fiat money with multiple private moneys, each denominated in a different unit of account (Klein 1974, Hayek 1978). Currency privatization appropriately refers to the private issue of hand-to-hand currency: bank notes and token coins. Those notes and coins can all be denominated in a common unit of account.

The existing literature on private currency assumes free banking. Sometimes the emphasis is on historical banking systems that combined private currency with free entry and requirements for bond collateral (Rockoff 1974, Rolnick and Weber 1983, King 1983). At other times the emphasis is on historical banking systems that combined private currency with no restrictions on branching or reserve holdings (White 1984, Selgin 1988a, Dowd 1989, Glasner 1989, White 1989). But one common characteristic of the literature is the absence of a central bank and monetary policy.

Currency privatization deserves consideration on its own merits and requires an analysis of institutions that combine the full privatization of currency with an otherwise conventional money and banking system. Most important, a central bank must be able to implement monetary policy.

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Full privatization goes beyond permitting banks to issue currency. It requires that the government be removed from the business of issuing hand-to-hand currency. To provide an analogy, full privatization of the postal service goes beyond permitting private firms to compete for the delivery of first-class mail. The government postal service must be sold or closed down. Government would no longer be in the business of delivering mail.

Privatizing Currency

The full privatization of currency can be introduced without abolishing monetary policy. First, the issue of private notes and coins must be permitted. The simplest approach would be to allow banks to issue notes and coins on the same terms as checkable deposits. Any reserve requirements would have to be made equal for checkable deposits, notes, and coins.

Like checkable deposits, private notes and coins could be denominated in dollars. But they would be differentiated by the name of the issuing bank. Moreover, like checks, notes and coins would clear through the Federal Reserve system (the Fed). As is now the case, each bank would deposit items drawn on other banks in the Fed, which would credit the depositing bank’s reserve account and debit the reserve accounts of the banks on which the items were drawn. The Fed would then return the items to the banks on which they were drawn.

Full privatization of currency requires further steps to remove the government from the business of issuing currency. The Fed must withdraw all of its notes and Treasury currency from circulation. And it must cease redeeming reserve accounts with Federal Reserve notes or Treasury currency. Further, any of the “old” currency that remains outstanding must lose its status as legal tender.

The only remaining currency would be privately issued notes and coins. Members of the public could no longer withdraw base money

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1 That is not to suggest that banks should be prohibited from issuing notes and coins (or deposits) denominated in foreign currencies, Hayek’s more fanciful units, or even precious metals.

2 To remove government currency from circulation, the Fed might accept the items for deposit in reserve accounts at a slight premium for a short time, then at a progressively larger discount, and then not at all.

3 George Selgin (1988a, pp. 168–71) has correctly argued that government hand-to-hand currency might serve as base money in a fully privatized system. The existing stock of government currency is privately owned. And if the government were prohibited from any new issues of currency, base money would be valued much like other limited-edition engravings. Of course, like the rest of the literature on private currency, the result is inconsistent with the Fed’s implementing a monetary policy.
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(high-powered money) from their banks, because it would no longer exist in the form of hand-to-hand currency. Base money would exist only in the form of deposits in reserve accounts at the Fed, so it would be identical to bank reserves. While a single bank could obtain reserves by depositing items drawn on other banks at the Fed, that would simply transfer base money from the reserve accounts of the banks on which the items were drawn.

Even without government hand-to-hand currency, the money and banking system would be nearly conventional. The Fed could control base money and bank reserves by using discount policy or open-market operations.

Differences between Government Currency and Private Currency

Most laymen, and some economists, find private currency almost incomprehensible. But in evaluating currency privatization, it is essential to avoid confusing currency with money. Hand-to-hand currency is only one form of money. Checkable deposits are more important, both in volume of payments made and amounts held.

Perhaps some confusion arises because private currency is physically similar to government currency. But there is an essential economic difference. Government currency is important because it is base money. Checkable deposits and checks are claims to government currency.

Private currency is much less important because it is not base money. Checkable deposits and checks are not claims to private notes or coins. Instead, private checkable deposits, checks, notes, and coins are all claims to base money.

Determination of the Quantity of Money

Many laymen, and some economists, believe that private currency is inherently inflationary. The notion has superficial plausibility. Banks are assumed to use zero-interest currency to finance interest-bearing assets, so issuing more currency always adds to profits.

But a simple textbook derivation of the money multiplier shows that, if the reserve requirements for checkable deposits and private currency are equal and binding, the money multiplier is equal to the reciprocal of the required reserve ratio. The quantity of money is determinate and proportional to the quantity of base money. The currency-to-deposit ratio has no effect on the quantity of money and, instead, determines the division of the total quantity of money between private currency and checkable deposits. Further, the
simplification of the money multiplier should make it easier for the Fed to use base money as an instrument to control the quantity of money.

Much of the free-banking literature is aimed at showing how an obligation to redeem notes, coins, and deposits with base money constrains the issues of banks without reserve requirements (White 1984, pp. 3–7). A bank has an incentive to hold the amount of reserves that it expects will be sufficient to meet its obligations.

Since the full privatization of currency requires that government currency be fully replaced by private notes and coins, banks would have no need to hold reserves to cover withdrawals of hand-to-hand currency. Still, they would have an incentive to maintain positive balances in their reserve accounts at the Fed to cover unanticipated, unfavorable, net clearing balances (Selgin 1988a, p. 72). The most profitable reserve ratio would depend on a tradeoff between the opportunity cost of holding reserves and the expected cost of running out of reserves.

The expected cost of running out of reserves depends on the probability that an adverse net clearing balance will deplete a bank’s reserves and the cost of correcting the problem. Given the amount of reserves a bank holds, the probability that its reserves will fall to zero depends on the variance of net clearing balances, which depends on the gross expenditures of its depositors (Selgin 1989a, p. 82). The cost of obtaining the needed reserves is determined by the transactions costs of selling assets or obtaining loans.

Since the amount of reserves that banks choose to hold can change, abolishing reserve requirements would make it more difficult for the Fed to use base money as an instrument for targeting the money supply. But George Selgin (1989a, p. 84) has shown how the positive relationship between gross expenditures by depositors and the demand for bank reserves implies that a frozen stock of base money will stabilize aggregate expenditures. That implies that the Fed could use base money as an instrument for targeting nominal income.4

Supposed Inconveniences of Private Currency

Many laymen and economists assume that private currency would make payments inconvenient. Fortunately, there is no reason to expect privatized currencies to vary as much as the currencies issued

4Changes in the opportunity cost of holding reserves and the transactions (and liquidity) costs of obtaining reserves would also influence nominal income, complicating the Fed’s efforts to target nominal income.
by different governments. All of the private currencies would be denominated in dollars, and there would be little demand for inconvenient, nonstandard currencies. Further, the Fed (or a private clearinghouse) could regulate the different denominations offered, the positioning of information on the items, and the color of different denominations by refusing to accept nonstandard items for deposit in reserve accounts.

Variable discounts or premiums on different private currencies would greatly complicate transactions. But those are possible only in the absence of an effective clearing institution. Lawrence White (1984, pp. 18–21) has argued that banks have an incentive to increase the demand for their deposits, notes, and coins by agreeing to accept each others' items for deposit at par and then calculate and settle up net clearing balances. Assuming the Fed (or a private clearinghouse) clears notes and coins like checks, the likely result is that each private currency would be accepted at par or not at all.

Sometimes it is assumed that private currency would cause serious problems because of counterfeiting. Criminals might try to pass notes and coins drawn on nonexistent banks. A similar problem would occur if criminals were to purchase notes or coins drawn on failed banks at a discount and attempt to introduce them into circulation. To prevent such an enterprise, penalties analogous to those for counterfeiting government currency might be imposed for passing notes and coins drawn on failed or nonexistent banks.

While law enforcement is unlikely to stop all counterfeiting, it would probably be more effective than attempts to prevent counterfeiting of government currency. The clearing of notes and coins would involve more frequent expert examination of notes and coins at bank counters or the clearinghouse (Selgin 1988a, p. 149). If criminal investigations could begin more rapidly, counterfeiting would be discouraged.

Interest on Privatized Currency

Private currency is sometimes criticized because it deprives the government of a desirable source of revenue. When the demand for currency is growing, the government can finance its expenditures with newly issued currency instead of with taxes, which distort economic decisions and reduce welfare. And even when the demand for currency is not growing, nationalized currency allows the government to borrow at a zero nominal interest rate. By borrowing at less than market interest rates, the government earns rents that can be substituted for taxes.
Banks would compete away and eliminate any rents that might be obtained from issuing private currency. Since paying explicit interest on currency is inconvenient (Fama 1983, pp. 12–13; White 1989, p. 248), banks could compete by providing services desired by those holding their currency.

Lawrence H. White (1984, pp. 7–8) has discussed many services that banks might provide. He suggests extending operating hours; increasing the number of tellers; adding bank branches; increasing advertising of the availability of added services; building impressive buildings; engaging in “image” advertising; and improving design, watermarking, and engraving of currency.

J. Huston McCulloch (1986, p. 75) has explained that banks could make payments to currency holders by means of a currency lottery. The currency would serve as the lottery tickets. To prevent currency withdrawals immediately before drawings, Tyler Cowen has suggested random drawing times (White 1989, p. 374). While not equivalent to explicit interest, the expected return would make a bank’s currency more attractive to hold.

Banks could also eliminate rents by paying higher interest on their checkable deposits. Such competition would occur if banks’ market shares in the currency business were positively related to their market shares in the deposit business.

The relationship is plausible. Currency enters circulation as household cash checks or withdraw currency from their checkable deposits for use in small, face-to-face retail transactions. Retailers also withdraw currency from their checkable deposits to make change and cash checks.

Checks and checkable deposits dominate financial transactions and income payments, as well as payments in manufacturing and distribution. Hence, retailers’ payments are made by check, and most of the currency they receive in payment is deposited at their banks.

As suggested by Knut Wicksell (1935, p. 88), private notes and coins are best understood as a special sort of check, certified by the issuing bank and made out in a convenient round amount. The rents a bank could earn from issuing currency are similar to interest earned from “float” and are closely related to the bank’s market share in the deposit business.

Of course, different depositors withdraw different amounts of currency. That would give banks an incentive to discriminate by classes of depositors. Manufacturers could receive relatively low interest rates on their checkable deposits because they put little currency into circulation. Households could receive somewhat higher interest rates. Retailers could receive relatively high interest rates because
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of their withdrawals of currency for change. Liquor or grocery stores in poorer neighborhoods could receive even higher interest rates because they put currency into circulation as their customers cash their pay checks. Similarly, deposit banks could earn relatively high interest rates on their correspondent balances if they put substantial amounts of their correspondent’s currency into circulation.

Robert E. Hall has suggested a procedure that would allow a bank to pay each depositor all the rents the bank earns on the currency the depositor puts into circulation. The bank would credit the interest to the depositor’s checkable deposit (Hall 1986, p. 226). The procedure would require that banks record the serial numbers of notes or coins when they are withdrawn. If the depositor held the currency, he would continue to earn interest. If he spent the currency, he would continue to earn interest until the items were cleared and returned to the bank.

McCulloch (1986, p. 75) has criticized that approach, because those receiving currency in payment receive no interest. But to be successful, his criticism requires the implausible assumption that private currency would normally remain in circulation for extended periods of time because people receive currency in payment and then use it to make purchases.

But private currency is likely to be withdrawn from a bank, spent, deposited in a bank, and then cleared through the Fed. Given the short period for which private currency would be held, retailers would be unlikely to discriminate between currencies according to the services or lottery payments provided by different banks (Sumner 1990, p. 13). And surely, retailers would find it too costly to allow customers to choose the “brand” of notes or coins to be received as change.

Of course, maintaining the necessary records would be costly (McCulloch 1986, p. 74). That explains why the approach was not used in the past. In the future, improved recording devices and data storage would probably force banks to dissipate any rents from issuing zero-interest currency by directly paying the interest into their depositors’ checkable deposits.

So one of the benefits of privatizing currency is that the public would receive additional benefits from the banking system. Only a competitive market process can determine if people prefer higher quality currency, more services, currency lotteries, more interest

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5Hall suggests crediting interest to VISA accounts, which seems pointless. Still, borrowers (including those drawing on VISA accounts) might be charged a lower interest rate for currency advances until borrowed notes and coins were returned to the bank.
on their checkable deposits, or some combination. Nationalizing currency to obtain government revenue is desirable only if confiscating the benefits the public receives from the private issue of currency causes less distortion than taxing other goods or services.

Special Problems with Full Privatization of Currency

Full privatization of currency involves complications and disadvantages that are not associated with the private issue of currency. One complication involves the contractual relationship between banks and their depositors. In traditional systems, a government hand-to-hand currency or one of the precious metals serves as base money. Checks and checkable deposits (and private notes and coins) can be understood as claims to base money because depositors can demand that their banks provide it in redemption. Alternatively, items could be made indirectly convertible by allowing depositors to demand from their banks whatever variable amount of gold or securities is equal in market value to a broad bundle of goods and services (Greenfield and Yeager 1989).

The full privatization of currency described in this paper makes checks, notes, and coins claims against deposits in reserve accounts at the Fed. But depositors (and note and coin holders) cannot directly hold deposits in reserve accounts, so those claims can be exercised only through the intermediation of another bank. Superficially, it seems that existing depositors are at least partly expropriated when government hand-to-hand currency is abolished.

While the reform does involve a change in the relationship between banks and their depositors (and note and coin holders), the banks can hardly be held responsible for a breach of contract if the government imposes a reform that demonetizes what they had promised to provide in redemption. As for the government, it is difficult to portray ending the redemption of reserve accounts with Federal Reserve notes as a breach of contract with the banks. The government defaulted when the Fed ceased redeeming reserve accounts (and Federal Reserve notes) with gold.

Further, the obligation of banks to cover adverse clearings with funds from their reserve accounts should not be dismissed. Kevin D. Hoover (1988, p. 158) has argued that a monetary system must have some ultimate good of conversion if contracts are to be more than claims to claims. Reserve accounts at the Fed can serve that purpose. Assuming contracts make no specific provision, creditors might be required to accept checks, notes, and coins drawn on any bank, but
the debt would only be discharged once the items were successfully cleared through the Fed.

Also, the obligation to cover adverse clearings with funds from reserve accounts keeps the purchasing power of the checks, deposits, notes, and coins issued by any one bank tied to the purchasing power of both the items drawn on other banks and the deposits in reserve accounts at the Fed. Of course, the purchasing power of all that money depends on the Fed’s monetary policy. So any change in contracts or property rights implied by the full privatization of currency is best understood as an insignificant change in the details of what remains a system of government fiat money. A more relevant concern is the possible disadvantages of abolishing government hand-to-hand currency.

One disadvantage would be the need to examine notes and coins tendered to determine if they are drawn on a sound bank. Permitting the private issue of currency is not subject to that difficulty, because sellers or creditors can always insist on payment with government currency. They will accept only private currency when they find it worth the trouble (White 1989, p. 254). Full privatization of currency forecloses that option.

But currency is used mostly for small, face-to-face retail transactions and illegal transactions. Few want to make illegal transactions more convenient. So at worst, full privatization of currency might make certain retail transactions less convenient.

If retailers felt compelled to accept currency drawn on 10 thousand unit banks, examining all the different notes and coins would be a serious problem. But retailers could accept only currency drawn on a limited number of banks. Even if currency were fully privatized in the near future, there would probably exist a limited number of nationally branched banks. Currency drawn on all of those major banks could be accepted under normal circumstances. Only occasionally would it be necessary to watch for items drawn on a bank that had failed or was in imminent danger of failing.

A second disadvantage would be that members of the public would sacrifice whatever welfare they could obtain by holding government-issued currency in their portfolios. But the primary benefit of government-issued currency is the absence of default and interest-rate risk. Members of the public could do nearly as well (and probably better) by holding shares in mutual funds made up of interest-bearing government

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6Concerns about the status of property rights and contracts have been emphasized by George Selgin in conversation and correspondence.
bonds that are nearing their maturity dates. Such bonds are equally free from default risk and nearly as free from interest-rate risk.

Runs on the Banking System

While full privatization of currency implies some special disadvantages, it also provides some important advantages. A run on the banking system cannot possibly cause a reserve drain, decrease in the money supply, and macroeconomic contraction.

Admittedly, there is reason to doubt that runs on the banking system cause macroeconomic contractions. Some research suggests that widespread bank failures have instead been caused by macroeconomic contractions (Rolnick and Weber 1986, Selgin 1989b). Widespread branching and adequate capital ratios have been able to prevent bank failures despite macroeconomic contractions (Kaufman 1988, p. 568; Ely 1988, pp. 54–55).

There are still plausible arguments that banks are subject to runs and that runs can cause severe harm. Financial intermediation can be subject to self-fulfilling expectations. Banks free investors from the need to obtain and interpret specialized information about the credit risks of borrowers. But that implies that depositors, investors, and other banks are relatively ignorant of a bank’s loan portfolio. They can falsely believe that a bank is likely to become insolvent (Goodhart 1988, pp. 96–102).

Banks also create liquidity. They borrow from depositors at a shorter term to maturity than they lend to borrowers (Diamond and Dybvig 1983). So a run on a bank can develop if many depositors believe that a bank is likely to become insolvent. They will refuse to lend new funds and will immediately withdraw funds from their checkable deposits. The bank must liquidate assets.

A run on the banking system can develop if many depositors believe that each bank is likely to become insolvent. They may recognize that some banks will remain solvent, but if they cannot identify those banks, they withdraw base money and cause a reserve drain. As banks scramble for reserves, they all must liquidate assets. Since it is impossible for all banks to find buyers given current market prices, the market value of the banks’ asset portfolios must decrease.

Further, the reserve drain causes a multiple contraction in the money supply. The resulting contraction of expenditures leads to decreased real activity and prices. Both imply that firms and households have greater difficulty meeting loan payments. The bankruptcies that ensue adversely affect the value of banks’ asset portfolios (Friedman and Schwartz 1963, pp. 167–68).
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So beliefs of depositors about the solvency of the banking system can cause bank runs and a macroeconomic contraction, which can cause many banks to become insolvent. Worse, since false beliefs can cause banks to fail, a single depositor must be as concerned with the beliefs of other depositors as with the facts. If a depositor believes that many other depositors believe that each bank is likely to become insolvent, he will withdraw his funds from the banking system.

The intersubjective indeterminacy of that situation makes self-fulfilling expectations more likely. And even if history suggests that the probability of such a problem is low, the harm resulting from a macroeconomic contraction is potentially great. After the banking crisis of the 1930s, the creation of institutions aimed at preventing that harm was probably inevitable.

Deposit Insurance

Fear of the consequences of runs on the banking system has generated broad support for universal government deposit insurance. It appears to be an ideal solution. Since depositors suffer no risk of loss, they have no incentive to withdraw funds from banks they believe might fail. Therefore, bank runs do not develop, so neither a solvent bank nor a solvent banking system can fail because of false beliefs. Further, the government's power to tax implies that it can credibly guarantee all deposits without building up a reserve (Diamond and Dybvig 1983, p. 416).

But it is generally recognized that deposit insurance creates a serious moral hazard problem (Kareken and Wallace 1978) that is unfortunately exacerbated by competition. When freed from risk of loss, depositors are concerned only with return. From their point of view, lack of geographic or product diversification and low capital ratios are unimportant. Competition forces banks to take excessive risks to pay high returns.

So government deposit insurance makes bank regulation essential. Since regulators must be relatively ignorant of the characteristics of banks' loan portfolios, perfect regulation is impossible. Worse, the savings-and-loan crisis of the 1980s shows how regulation can be aimed at providing concentrated benefits to special interests rather than promoting the diffuse interest of taxpayers in reducing bank risk.

Lender of Last Resort

If the Fed serves as the lender of last resort, runs on the banking system can be made harmless. If a run occurs, the Fed can lend
newly created base money to the bank involved. Since loans from the Fed prevent the failure of solvent banks, depositors do not need to consider the beliefs of other depositors. Further, loans from the Fed signal all depositors that a bank will not fail. The result should be the end, and rapid reversal, of any run.

If the Fed limits loans to solvent banks, depositors have an incentive to avoid risky banks. They will choose banks that hold diversified asset portfolios and adequate capital. Unlike universal deposit insurance, a lender of last resort is consistent with substantial bank deregulation.

But the Fed can easily abuse its ability to serve as lender of last resort. An excessively conservative policy can be disastrous. If the Fed fails to immediately lend to solvent banks, runs and the resulting macroeconomic contraction can cause many banks to become insolvent. So strict collateral requirements or rules against lending to insolvent banks can prevent the Fed from ending a crisis caused by its own tardiness. Excessive conservatism on the part of the Fed was responsible for the banking crisis of the 1930s (Ely 1988, p. 59).

Unfortunately, an excessively liberal policy can also be disastrous. If the Fed consistently lends to insolvent banks, depositors can leave their funds in risky and even insolvent banks. That implies that runs might never actually develop. Of course, a liberal lender of last resort causes the same moral hazard problem that is caused by universal government deposit insurance (Goodhart 1988, p. 7–8).7

Further, the savings-and-loan crisis of the 1980s shows how political pressure can be brought to bear to prevent the concentrated harm caused by the failure of an insolvent bank rather than the more diffuse harm caused by a risky banking system. Perhaps the Fed insists on regulation of the banking system because it recognizes that political pressure makes it difficult to allow insolvent banks to suffer runs and fail.

Full Privatization of Currency as a Substitute

Universal government deposit insurance or a liberal lender of last resort will continue to cause a moral hazard problem that requires the associated regulations until some substitute method of preventing a

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7The Fed can be required to use only open-market purchases to offset a reserve drain. That avoids the moral hazard problem since no loans are made to banks, but a repetition of the Fed’s failure in the 1930s is always possible.
repetition of the banking crisis of the 1930s is found. Fortunately, full privatization of currency is a possible substitute. George Selgin argues that some of the currency withdrawals associated with a macroeconomic contraction are caused by reduced acceptability of checks (Selgin 1988b, p. 110; 1989b, p. 446). If banks are permitted to issue currency, they can meet that sort of run by adjusting the composition of their liabilities without causing a decrease in the money supply (Selgin 1988b, p. 626; Horwitz 1990, p. 647).

Of course, if many depositors believe that banks may become insolvent, the result can be a run for base money. In a fully privatized banking system, a run for base money is impossible. Fears about the solvency of banks provide no reason to exchange checkable deposits for private currency. And if depositors spend checks, notes, and coins on other assets, those selling the assets must accept checkable deposits, notes, or coins. There can be no reserve drain, decrease in the money supply, and macroeconomic contraction.

Lloyd Mints described the benefit of privatized currency in a peculiar way. He pointed out that traditional money and banking systems effectively require 100 percent reserves for currency and only fractional reserves for checkable deposits. He argued that the system was inherently unstable. While Mints (1950, p. 6) advocated 100 percent reserves for checkable deposits, he recognized that his logic applies equally to a system that allows currency to be issued against fractional reserves.

**Runs on a Single Bank**

Private currency does not prevent a run on a single bank. If depositors believed a bank might become insolvent, they could deposit their currency or checks in new accounts at other banks. After the deposited items cleared, the depositors could write checks or withdraw currency from their new accounts. The bank suffering the run would suffer adverse clearings and lose reserves to other banks. If it could not obtain sufficient items drawn

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8 An alternative approach is a temporary restriction on or suspension of cash redemptions (Timberlake 1984, pp. 11–12). An option clause could be used to contractually determine appropriate interest penalties (Dowd 1989, pp. 27–31; Selgin 1989b, pp. 454–55). A possible problem is that an insolvent bank might take large risks during a suspension.

9 If insolvency becomes obvious before the items clear, the depositors shifting funds to new banks as well as those who left funds in the failed bank will suffer losses. Those who believe they will consistently be first in line for base money would prefer a conventional system. But those who fear they will be unable to remove base money before a bank closes would benefit from full privatization.
on other banks by liquidating assets or borrowing, it would soon run out of reserves and be unable to cover its adverse net clearing balance. A single bank could fail.

Since banks could fail, depositors would have an incentive to choose banks that had properly diversified asset portfolios and adequate capital. Full privatization of currency avoids the moral hazard problem implied by universal deposit insurance or a liberal lender of last resort.

Private Deposit Insurance or Lender of Last Resort

Unfortunately, full privatization of currency is consistent with a single bank's failing because of the false beliefs of depositors. But if runs on the banking system can cause no reserve drain and macroeconomic contraction, deposit insurance or the lender of last resort could be privatized.

Private deposit insurance might not survive a reserve drain and macroeconomic contraction, but it could provide limited protection against insolvency while controlling the moral hazard problem. Perhaps the most important service it could provide would be to monitor and control bank risks for relatively ignorant depositors, mostly by insisting on appropriate diversification and adequate capital.

Similarly, a private lender of last resort might not be able to borrow sufficient funds if a run on the banking system caused a reserve drain and macroeconomic contraction. But a specialized firm or firms could analyze the loan portfolio of a single bank suffering a run. Assuming they were willing to risk their own capital, such firms could borrow funds and lend to a solvent bank.

Conclusion

Full privatization of currency requires that government currency be fully replaced by privately issued bank notes and token coins. Unlike government currency, private currency is not base money. Rather than circulate, it clears through the Fed like checks.

Binding reserve requirements are sufficient to determine the quantity of money. Because the money multiplier is greatly simplified, the Fed can easily use base money as an instrument to implement a money supply rule. In the absence of reserve requirements, banks would hold reserves to cover adverse net clearing balances. Because of the positive relationship between the demand for bank reserves and payments by depositors, the Fed might be able to use base money as an instrument for targeting nominal income.
The most important benefit of the full privatization of currency is that runs on the banking system cannot possibly cause a reserve drain, decrease in the money supply, and macroeconomic contraction. Since runs on individual banks remain possible, the full privatization of currency avoids the moral hazard problem implied by universal deposit insurance or a liberal lender of last resort. So, full privatization of currency would allow for bank deregulation and avoid a repetition of the banking crisis of the 1930s or the savings-and-loan crisis of the 1980s.

References


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