

Money: The Ultimate Privatization

Richard W. Rahn

A glimpse into the near future reveals that the concept of money as we now know it will be radically altered. Future “money” will be produced increasingly not by governments but by private companies, helping to fuel privatization in other sectors of national economies. The privatization of money is occurring not so much as the result of explicit governmental privatization efforts, but because technological advances are forcing it.

Technological advances in electronic banking and commerce threaten to all but replace the existing system of paper currency. They ultimately will revolutionize the manner in which monetary exchange transactions are conducted by individuals and financial institutions. And, consequently, they will enhance privatization at the expense of governmental financial and tax systems.

Tangible money is useful only as a means to facilitate trade and investment. New technologies will enable people to acquire goods without handling cash, a troublesome, non-earning asset. In the future, trade will be executed by instantaneous and simultaneous debiting and crediting to and from liquid wealth accounts, held by both banking and nonbanking institutions. Electronic digital payments technology will enable property rights claims on real assets, such as stock and bond funds, or gold, to be utilized as the medium of exchange for virtually all transactions. In sum, when businesses

or individuals wish to purchase a good or service, they will provide—directly or indirectly— an electronic instruction to their bank or other financial intermediary. The instruction will state that an amount equal to the nominal value of the purchase should be transferred immediately to the account of the seller of the good or service.

Accordingly, there will be no loss of interest earned, nor will there be any need for a traditional wholesale interbank clearing system. The buyer and seller will have transferred wealth instantaneously, without risk of nonpayment. By avoiding the use of government-produced fiat money, with all of its uncertainty and instability, some of the problems of inflation and payments insecurity will disappear.

Conventional money will disappear because it is costly and cumbersome. Paper currency and coins can easily be lost or stolen and are bulky to transport and time-consuming to use in business transactions. Such currency requires merchants to keep a monetary “inventory” in order to make change. When used to buy merchandise from vending machines, for instance, costly coin and bill handling mechanisms must be installed. These mechanisms are subject to frequent mechanical breakdown and theft from both employees and others. All of this inventory of currency and coins is at risk and does not earn its owners any material return.

Paper currency also is subject to

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counterfeiting. With advanced copying technology, counterfeiting becomes easier. Despite anticounterfeiting measures, technology-proficient counterfeiters continue to find ways to develop "passable" currency.

Bank checking accounts are also cumbersome and time-consuming to use. On average, it costs the US banking system approximately \$1.50 to process each check. According to the American Bankers Association, an estimated total of 65 billion checks were processed in 1996, for a total cost of \$97.5 billion, more than the total profits of the entire US banking system.¹

Electronic payments, whether made with smart cards, debit cards, credit cards, or directly from computer to computer, eliminate most of these problems and greatly reduce costs. An electronic payment, by being virtually instantaneous, also eliminates the distinction between credit and debit transfers.

We are now entering an era when people will not have to endure episodes of sustained inflation, which is generally caused by governments desire to spend the people's money for their own purposes. People can have a choice of monies, both government- and privately-issued, which will enable them to escape from monetary instability. If a government's central bank, such as the US Federal Reserve Bank, engages in inflationary monetary policy, users of its money will switch to a different currency or will hold other assets.

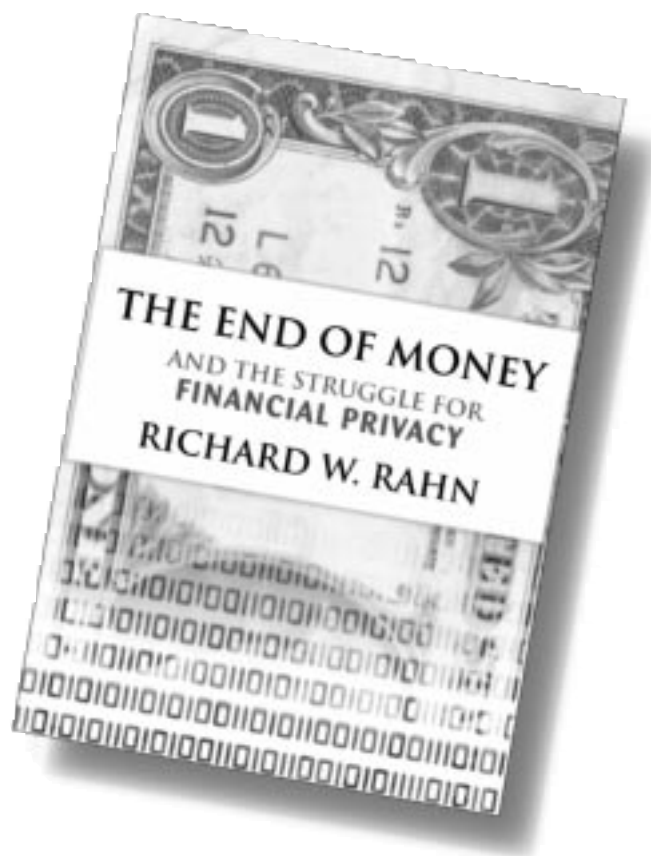
People will still use government money to pay taxes and for the receipt of payments from government. But, for private transactions, they will increasingly move away from government money. Governments that produce money with a stable value (little or no inflation) will find that their money may be used as a unit of account and medium of settlement, although it may not be used as a store of value or a medium of exchange.

There are a series of technological

and regulatory changes under way that will eventually make privately issued digital (electronic) money the norm. These changes will alleviate the many problems experienced with conventional central bank-issued money, particularly with paper currency and coins.

Growing use of cards

Over the past several decades, credit cards have become popular in the developed, high-income countries. More recently, debit cards that deduct funds

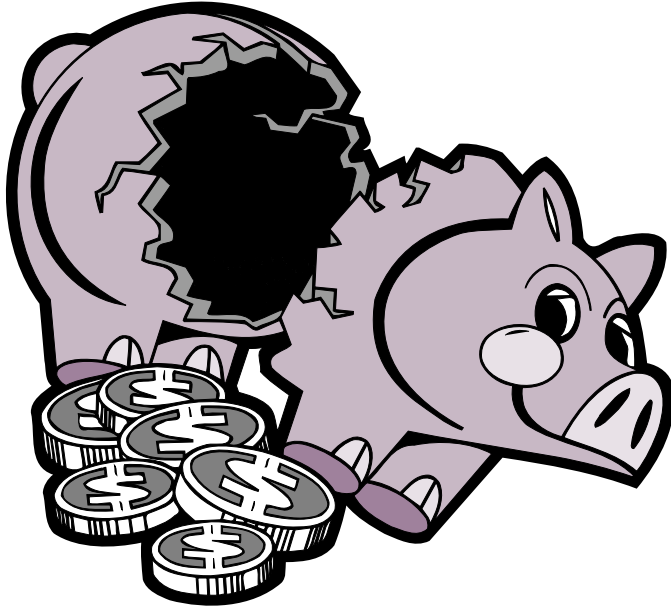


from one's checking account have become popular. Credit and debit cards have a magnetic stripe on the back, which is machine readable, but the magnetic stripe is rather limited in the amount of data it contains. But, because of the necessary telephone hookup and the lack of anonymity, and the impracticality for payment of small purchases, credit and debit cards will never become universal payment mechanisms.

There is a technology that can overcome the limitations of credit and debit

¹ These estimates are courtesy of the research department of the American Bankers Association in Washington.

cards—the “smart card.” The smart card resembles a credit or debit card, but it contains a computer microchip, which processes a considerable amount of information. Monetary value can be downloaded into the card and stored, and then deducted in increments as purchases are made.



The machine that adds and subtracts information into the card chip is known as a smart card reader/writer. These are small and inexpensive and can be easily installed in ATM machines, PCs and telephones. When you use a smart card as a “cash purse,” you will download the money from your bank account into the card similar to the way you withdraw cash from an ATM machine. Each time you make a purchase from the card, the amount of the purchase is deducted from the value of the card and deposited in the merchant’s computer through a reader/writer.

Payments also can be made directly from a computer. In the same way that money is downloaded from a bank account into a smart card, it can be downloaded directly to the hard drive of a PC. The “money” on the hard drive can be sent to someone else’s PC and then to that person’s bank account. All of these transactions can be secured by

utilizing virtually unbreakable public key encryption.

As a result of these new technologies—all already operational—it is possible to send “money” from one point to another point on the globe extraordinarily fast and anonymously. These fund transfers can be sent in an encrypted format that, for all practical purposes, is unbreakable and totally secure from any criminal or government.

Detecting crime

We are entering an age when governments will not be able to trace the money transactions of those who wish anonymity. Previously, this had been true for cash transactions only. Because cash is difficult to hide, it is easily detected. New technologies will force governments to change their tax systems and the techniques they use to detect criminal activity. The question is whether they will engage in constructive change by reducing taxes on capital and their attempts at financial intrusion, or resort to destructive change by criminalizing activities of a significant portion of their populations.

The government monopoly on money is a recent occurrence. In the US, this monopoly dates to 1913 with the creation of the Federal Reserve system. Until that year, private banks also issued currency, which were private, dollar-denominated bank notes. Before creation of the Federal Reserve, the government defined the dollar in terms of the amount of gold and/or silver needed to acquire one dollar.

Governments favor the monopoly on money issuance because, to the extent that they are able to produce currency for less cost than its face value, they receive a profit known as seigniorage. In addition, because the currency itself is a debt owed by the government to the holder, with no interest accruing on this debt, the government receives an interest-free loan.

Private companies also seek ways to profit from the issuance of money substitutes. The American Express Company makes substantial profits from the is-

suance of traveler's checks. When you purchase a traveler's check, you are giving the American Express Company an interest-free loan until you cash the check. The smart card used as a cash purse provides the same profit opportunity—an interest-free float—to the issuer, as does the traveler's check.

As a result, banks and other issuers of smart cards have an enormous incentive to issue large numbers of smart cards and encourage people to hold money balances on them. In essence, smart card issuers reduce the public's demand for government-issued currency, shifting the profits from the government to the private sector.

Falling transaction costs

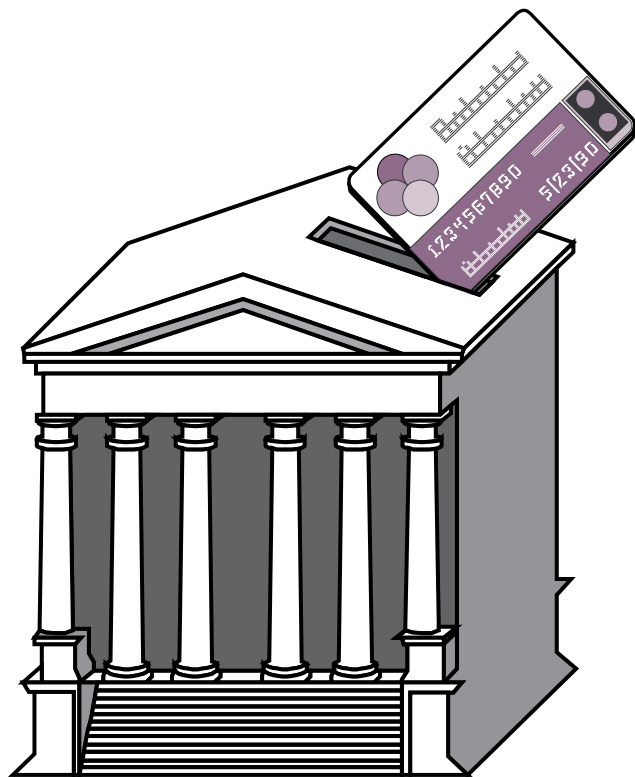
Competition among private financial institutions and others to obtain profits from money issuance, or from providing money substitutes, is driving down the cost of transactions and eroding the central banks' "market share" and control of the functions of money. As we enter the digital age, private competitors of central banks will be in an increasingly advantageous situation, despite legal tender laws.

If you could avoid holding any (non-interest-bearing) currency or coin, and still have the same, or greater, ease and ability to spend, you would probably choose to do so. Further, if you could keep your assets in a form in which they receive higher rather than lower rates of return commensurate with the level of risk, you probably would choose to do so. Finally, if you could take liquid assets, such as your stock portfolio and illiquid assets, such as your home, and turn part of their value into money only at the moment you wish to purchase some other good or service, you would likely choose to take that alternative as well.

Many business firms and some individuals are already partially turning their assets into money only at the moment they need to make an expenditure. They do this by obtaining a line of credit from the bank, using their assets as collateral. When they need to purchase

something, they write a check or make an electronic transfer against the line of credit. In this case, the bank credit performs many of the functions of money. It makes economic sense for the business to operate in this way when the rate of return it receives on its assets is greater than the cost of the line of credit from the bank.

Debit cards often are issued against interest-bearing accounts. Smart cards, which combine the capabilities of a prepaid and debit card, can also be interest bearing. (This is only true with some smart systems; it is not necessarily applicable to those systems that allow anonymous card-to-card transfers.) Almost all electronic money will be interest bearing. Therefore, central bank money almost certainly will decline in importance because of its lack of competitiveness.



The most likely development is that the future issue of electronic money will be primarily through mutual funds. Mutual funds, by having diverse and liquid assets, can offer less risk than traditional banks. With a mutual fund, holders

can cash in all or part of their ownership of the fund at any time, but not at a fixed price. Thus the mutual fund account is as liquid as a demand account deposit at a bank. In some countries, mutual fund shareholders already can write checks and request electronic transfers to third parties against their share balance.

Mutual funds also have the advantage of not being subject to bank runs

fund may decline, meaning each fund holder shares the same percentage decline, as contrasted with the bank deposit all-or-nothing par value system. This means that a holder of a mutual fund share has more risk than a holder of an insured bank account, but this risk is offset by the greater returns the mutual fund holder normally receives. So-called money market mutual funds (which hold highly rated government and corporate debt obligations) are available for those seeking little risk but still higher returns than normal demand accounts.

Reduced inflation risk

As more “money” becomes interest-bearing electronic money, there is less inflation risk because there is no incentive for private banks or other financial institutions to overissue interest-bearing currency, since it increases their own liabilities. The unit of account (e.g., the US dollar) will probably continue to be set by the central bank, even though the use of government money as a transaction medium will decline. But the government will only be able to retain its function of establishing a unit of account if it operates in a deflationary manner. Governments are being disciplined by the market because—in the age of instant global communications and financial institutions—inflation increases immediately cause a capital and currency flight.

Governments increasingly must compete with other governments and private providers of monetary numeraires (e.g., the US dollar, Japanese yen, British pound, Swiss franc). Eventually, some governments probably will define their currency’s value explicitly in the form of a tradable basket of goods and services. Having a universal price, commodities traded on organized commodity futures exchanges are prime candidates. For example, the dollar might be defined as x amount of gold, plus y amount of crude oil, plus z amount of corn. This would amount to a modern version of the old gold standard, but the basket of goods and services will more



Technological advances in electronic banking and commerce threaten to replace paper currencies.

resulting from a loss of confidence. A bank can find itself in a position where its obligations to depositors are greater than its assets. Given that bank deposits have a par value, the first people in the withdrawal queue after the bank’s funds run out get nothing without deposit insurance, and with it, wait long periods to get their funds.

With the mutual fund, increases and decreases in share values in the underlying securities portfolio of the fund are distributed (actually, “marked to market”) on an equal pro rata basis to all of the holders of the fund. The value of the

clearly reflect what the world both produces and consumes and those goods and services more easily measured—metals, agricultural products, energy products, and even insurance rates.

If governments fail to develop explicit definitions of the value of their currencies, the private sector will. Commodity and security indexes traded presently auger the establishment of definitions that could serve the unit of account function of money.

In the economy of the future, most wealth will become divisible and liquid, instantaneously transferable, and, consequently, useable as transactions media. Without the need to withdraw wealth-producing assets to provide purchasing power, as in a monetary economy, and assuming the unit of account is defined by a specific additive quantity of goods and services, there will be no pressures to produce inflation or deflation. All of the requirements to facilitate trade will still be met, and improved upon.

Many of those seeking to regulate digital money, smart cards, the Internet, etc., claim that without regulation, tax avoidance and evasion will occur. But this objection misses the point. Such claims are correct that tax evasion and avoidance will increase—unless the tax laws are changed to reflect the digital reality. It is wrong, however, to assert that more regulation will succeed in

coaxing much more tax revenue from unwilling payers. The digital revolution will make some tax evasion very easy, causing increasing numbers of people to take advantage of it. If a few keystrokes on a computer will avoid tax payments, the temptation to do so will be great.

Smaller government

Reductions in the tax base and tax rates required in the digital age will necessarily reduce the size of government. The relative shrinking of government, however, is necessary for societies to reach their full economic, social and personal potential. Studies of the relationship between economic growth and government spending have found negative correlations for most countries for most time periods—that is, big government impedes strong economic growth.

In conclusion, it is clear that privately issued digital money will increase until nearly all money is privately issued. The increase in digital money will make it more difficult for governments to collect taxes, particularly on financial capital (unless most governments introduce stringent controls). A smaller tax base will force governments to downsize, which is beneficial for economic growth as well as financial privacy. The pressure to downsize government will be felt directly by declining government-owned enterprises, increasing the incentive to privatize such enterprises. 🌐🌐