What do we know about Currency Competition?

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The paper presents a critical analysis of the proposals of Hayek and Vaubel for unregulated competition among private money suppliers. Because of externalities, time inconsistencies and moral hazard, these proposals are detrimental for outside money and, at best, dubious for inside money.

I am skeptical about the price theoretical foundations of Vaubel's[1] policy recommendations. This skepticism extends to the work of *von Hayek* (1976, 1977), which initiated our current concern with the optimal monetary constitution. Specifically, I have the following problems with the Hayek-Vaubel analysis.

A. Both, Hayek and Vaubel, neglect the distinction between inside and outside money. Their discussion of competition among outside monies is based on an invalid premise.

B. There are Pareto-relevant externalities in money demand decisions which justify the use of lumpsum taxation to create a real return on money.

C. In contrast to the market for an inside money, the market for an outside money is destroyed by the coexistence of more than one firm in the market.

D. Vaubel and Hayek fail to distinguish between the dynamic problem of time inconsistency and the static problem of monopoly power. In the absence of binding money supply announcements, the time inconsistency of profit maximizing policies rules out *any* unregulated private organization of the market for outside money.

E. The analysis of competing inside monies pays too little attention to the problems of uncertainty, information asymmetries, and time inconsistency that are endemic to debtor-creditor relations.

In the following, I shall discuss these points one by one.

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1 Vaubel's analysis of external effects in the money market is presented in *Vaubel* (1984). My comments here cover that analysis as well because at the May 1984 meeting, it was presented as an integral part of the argument.