Journal of Economic Theory **99**, 59–116 (2001)
doi:10.1006/jeth.2001.2805, available online at http://www.idealibrary.com on IDEAL®

Private and Public Circulating Liabilities

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Received May 8, 2000

Legal and technological changes have made private banknote issue, or its electronic equivalent, possible. We construct a model where private liabilities circulate, either by themselves or alongside outside money. We provide results on existence and multiplicity of equilibria and characterize dynamics near steady states. Our results support Friedman in that circulating private liabilities are associated with endogenous volatility. But implementing Friedman's advice (the government should

[1] To whom correspondence should be addressed. Any views expressed are those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of St. Louis or of the Federal Reserve System.

[2] The authors thank Jerry Bona for several helpful conversations; Luisa Lambertini, Ed Nosal, and an anonymous referee for their comments on an earlier version of this paper; and seminar participants at the University of Rome ("La Sapienza"), the University of Iowa, the Federal Reserve Bank of Cleveland, the meetings of the Society for the Advancement of Economic Theory, the Canadian Macro Study Group, and the Midwest Macro Meetings for their reactions to earlier versions of this paper.

0022-0531/01 $35.00

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ban private currency substitutes) causes significant inefficiency. The proposal of Hayek (that the government should leave currency creation to “the market”) also is often constrained-suboptimal. Both public and private circulating liabilities are required for optimality. *Journal of Economic Literature* Classification Numbers: E3, E4, E5. © 2001 Academic Press

Key Words: fiat money; private money; electronic cash; monetary theory; endogenous volatility.

1. INTRODUCTION

1.1. *Overview*

Two of the most basic questions in monetary economics are:

(1) Do we “need” the government to provide money, or can we rely on “the market” to produce a well-functioning monetary arrangement?

(2) Does an efficient monetary system require a mix of private and government money, or should the government be a monopoly provider of currency and close currency substitutes?

Implicit in the wording of these questions are some very different views about the private provision of currency. Clearly many economists believe that market mechanisms work well, *except* where the creation of money is concerned. But some—perhaps most prominently Hayek [14] and Fama [9]—have argued that, even with respect to money, private market provision can produce desirable outcomes.

On the other hand, many economists have argued that not only should the government print money, but that the government should have a monopoly on currency creation. Friedman [11], for example, argued passionately that allowing private provision of close currency substitutes is a recipe for generating indeterminacy of equilibrium and “excessive” volatility. Therefore, the government should be the sole issuer of circulating liabilities, and the creation of currency substitutes should be carefully segregated from all private credit market activity.

Somewhere between these views lies the real bills doctrine. This theory does not claim that the government should necessarily leave all currency creation to the market. But it does assert that the existence of safe, privately-issued circulating liabilities poses no “threat” to economic well-being and may actually be beneficial.

These three points of view form the core of most received monetary theory. Despite centuries of debate among their adherents, however, a resolution of the differences among them has never been achieved.[3] In

[3] See Mints [17] for a summary of the historical debates on these topics. Smith [23] describes some more modern exchanges.

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