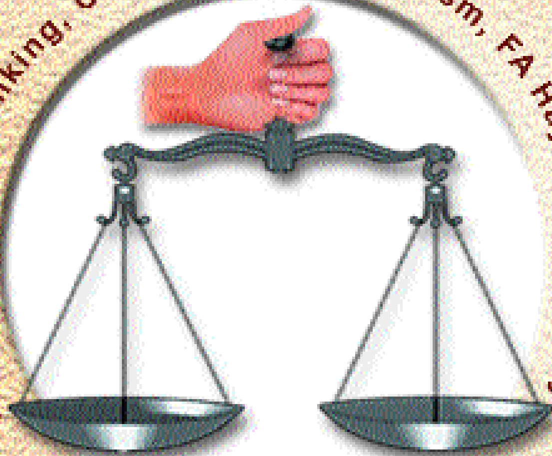
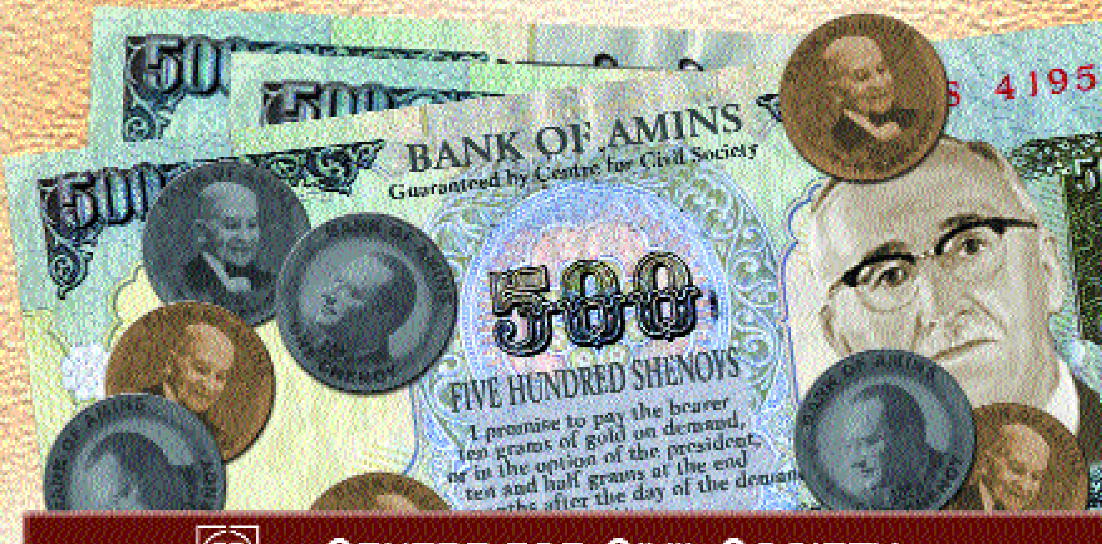
MONEY, MARKET, MARKETWALLAHS

Essays on Free Banking, Civil-Society Capitalism, FA Hayek, BR Shenoy



by R K Amin



CENTRE FOR CIVIL SOCIETY

Money, Market, Marketwallahs

Essays on Free Banking, Civil-Society Capitalism,
F A Hayek, B R Shenoy

R K Amin

ISBN:

Designed and printed by macro graphics.comm pvt. ltd., New Delhi - 110 019

Table of Contents

1. Laissez-faire Money or Free Banking

A question should be asked : If other goods supplied by the free market serve consumer interest better, then why should money not be supplied by the market? If deregulation is the main thrust in all fields of the economy, why then, it should not be so in the field of banking and finance, particularly in the provision of money?

This way of thinking has gained momentum for a variety of reasons: First, the failure of monetary authorities to give stable money was visible soon after the World War II. Consequently there has been, since 1970, a flood of economic literature giving the results of historical studies of the working of free banking in the past. Prof. Hayek's view emphasizes that "the past instability of the market economy is the consequence of the exclusion of the most important regulator of the market mechanism, i.e., money, from itself being regulated by the market process." Prof. Hayek therefore wanted an immense educational task to be carried out, aimed at the abolition of the state monopoly on money supply, which encouraged many economists to study and research "free money" or laissez faire banking. Secondly, soon after 1970, controls over international financial transactions began to go one by one resulting in a great expansion of world trade, which compelled various countries of the world to evolve several new and innovative ways of making payments for their trade transactions. Thirdly Prof. Hayek's view was confirmed when it was understood that the Great Depression of the 1930's, the inflation of 1960's and the stagflation of 1970's were all results of the failure of monetary authorities worldwide. And lastly, as against the wishes of the governments, international banking successfully invented various devices by securitization and derivatives to meet the growing demand for money in the form of near moneys, recently with the application of computers and information technology. E-money has entered the stage—the entire payment system across countries has become so rapid and beyond the control of any government authority that it becomes difficult for any one country, however big and mighty, to manage money effectively. No wonder, there is a widespread demand to denationalize money.

Rationale for Government Monopoly

What was the rationale for a royal prerogative or state monopoly of money? Or what is the case for state intervention in the field of money when the competitive market process is considered better for the rest of the economy? To answer this question, normally four types of arguments are put forth:

a) externalities in money
b) money as a public good
c) conditions leading to natural monopoly which may involve moral hazards in the monetary system, and
d) fear of excessive competition leading to waste of resources and inconvenience to the public.

The first two arguments may not keep us long; they can be answered straightway. The externality of money or money balances has been shown by Paul Samuelson who maintained that there exist positive private costs while there are no social costs in holding money balances. This discrepancy between social and private costs therefore makes it necessary to have government control on money. However, there is a snag in this argument. There are social costs for holding money balances such as costs of keeping watch over fraud and stealing. There are also private benefits such as those accruing from liquidity. It is true, social benefits are immense from having paper currency instead of gold coins: but such benefits cannot be charged just as we cannot charge for the use of language. Sometimes when the market expands and technology develops, we find ways to internalize these externalities just as it happened in the case of cable TV and telecommunications. Besides, the benefits available from money cannot be separated as social and private benefits.

As far as the public goods argument is concerned, the defining two characteristics of public goods: non-excludability and non-rivalness are not found with money or money balances. If money balances are given to A, they cannot be given to B, i.e. one can exclude people and if A consumes money balances, the same money balance cannot be consumed by B, i.e. it is rival in consumption.

In favour of the two major arguments, natural monopoly and fear of excessive competition, we may present several monetary and banking phenomena which led to the state monopoly of money. First, if there are several units issuing banknotes, several types of banknotes may be in circulation. It will be difficult for the public to know the solvency of each banknote. Probably their acceptability may differ from place to place and from person to person. No machinery may exist to detect fraud leading to many unscrupulous people entering the banking trade resulting in chaos and confusion in the field of monetary transactions, with the result that many banknotes either are not accepted or accepted at a substantial discount. Therefore to bring smooth acceptability and unfettered monetary transaction, only one authority (i.e. the state) may be asked to manage the issue of banknotes, so that only one uniform type of bank note remains in circulation and efficient machinery to detect fraud can be instituted.

Let us examine the business of banking. Banks have their liabilities i.e. deposits, to be paid on demand or immediately, say in period 1 while the banks' assets mature after some time, say in period 2. This time lag shows the inherent instability in the working of banks. How can any bank pay for its liabilities if there is a run of depositors for encashment? This indicates the need for some agency to provide liquidity at such times—a lender of last resort, without which there may be a further contagion effect leading to a general bank run, putting the entire banking system in jeopardy. If one bank fails to repay its deposits, depositors in other banks would also run for withdrawal of their deposits lest their banks too fail to repay. It is an open secret that no bank, howsoever sound and solid it may be, can pay all its depositors if they ask for withdrawals at the same time. To save the entire banking system from disaster, it was felt that a Central Bank should step in, in order to make arrangement for immediate payments to restore confidence and stall general bank runs.

However, some economists view this phenomenon differently. In order to stall the genesis of such a bank run, there is a natural tendency on the part of a bank to economise the use of its own reserve. This is possible by expanding the bank so that more and more intra-bank payments arise involving only the transfers in account, i.e. crediting some accounts as receipts and debiting some other accounts as payment without touching the reserve. The limiting case is one huge bank with branches all over the country. Thus, there is an inherent tendency in the banking business to move towards a big bank as the natural tendency that may suggest a need for bank-monopoly. These economists feel that competition in banking cannot be sustained.

There is a third phenomenon in banking which arises when banks begin to act in concert, for creating money by way of loans to their customers —which may lead to waves of booms and depressions. If one bank increases its liabilities, its reserves would surely be depleted; but if simultaneously, other banks also do so, the first bank would receive more money, building up its reserve. If all act in concert, none should worry about its reserves because the multiplier related to reserve money and total stock of money would increase and banking system can manage with the same amount of base money or reserve. It means that the multiplier for determining total money supply would change leading to booms and depressions in the economy. The question is : How do we avoid or control these waves of booms and depressions say without some conscious efforts to control money supply or influence the multiplier?

Related to this there is a fourth phenomenon, which raises the basic issue of banking system, i.e. the natural tendency towards over-issue of paper money. If banks are allowed to issue paper money for which the cost is negligible, while in exchange they receive valuable assets, yielding handsome returns, they will, if left unchecked, not have the incentive to issue as many banknotes as possible, leading to more currency in circulation than what is needed. In that case there is on one the hand the fear of unscrupulous, dishonest, evil forces entering the banking business and on the other hand, there is a fear of inflation, even hyperinflation in the economy.

To guard against such phenomena it was felt that the government or its agent, the central bank, should take a monopoly of bank note issue to bring uniformity in note issue and guard against fraud. Moreover it should also act as a lender of last resort to stave off crises of confidence and inherent instabilities in the banking system. It should also be entrusted with the responsibility of determining the right quantity of money to avoid booms and depressions resulting from excess issue of money when banks act in concert or dishonestly issue money without proper reserves. To this end, the responsibility of the monetary authority was vested in the central bank. Thus the central bank has acquired a monopoly of note issue, its notes are legal tender, it is the banker to the government, it controls credit, and acts as lender of last resort.

How has the system of a central bank as monetary authority worked so far? To answer this question, Prof. Hayek wrote: "I think it is very urgent that it becomes rapidly understood that there is no justification in history, for the existing position of a government monopoly of issuing money. It has always—since the privilege of issuing money was first explicitly represented as a royal prerogative—been advocated because the power to issue money was essential for the finance of the government, not in order to give us good money, but in order to give to the government access to the tap, where it can draw the money in need by manufacturing it." (Taking away 2 lakh Sterlings of Goldsmiths from the vaults of London Tower by a Stuart King in the 17th Century, and a similar incident in Italy during the 15th Century as well as the present practice of deficit financing on a large scale by almost all countries in the world is a sufficient testimony of Prof. Hayek's view). If Prof. Hayek is right, can free money avoid all such phenomena and also give us some advantage over the modern system of government managed money?

History of Banking

Historically, we have had an experience of free banking in various countries during different periods of time. During the free banking experience, either gold or silver was used as base money and convertibility of banknotes to the base money was taken for granted. While the present day literature of free money makes studies under three different situations such as (a) Gold or Silver or some other commodity as base money, (b) Fiat money or moneys as base money and (c) free money without any base money. For (b) & (c), we do not have any historical experience except rational arguments based on certain developments, which are shaping in modern times but without proper testing. Therefore, we shall make a somewhat detailed study of the situation (a) and give a brief outline of possible developments in situations (b) & (c).

Let us take the question of competitive note issue. Historically there are several countries in which at one time or the other, there were conditions of free banking with the least restrictions by the government or the central bank. Scotland (1716-1844), New England (1820-1860), and Canada (1817-1914) are typical examples where during these periods free banking with commodity base money prevailed. In the US there was apparently free banking before the Civil War. Besides these countries, during the 19th century, Australia, China, Columbia, Switzerland, France, Sweden, Spain, Ireland were other countries where some amount of free banking was in existence.

Probably, most of the evils of free banking such as multiple-note issue, lack of information about the solvency of the bank, excess note issue, note issue as a result of speculation, narrow and restricted acceptability of banknotes, are found mostly in the US. In the US it did not work so well because there were several inhibiting restrictions such as prohibition of branch banking, contractual obligation to convert notes into gold on demand, prohibition on rate of interest to be paid on demand deposits; all these led to creating crises of confidence in banks. Moreover, there were conflicts between state and federal regulations, which did not allow banks to work smoothly and freely.

If we examine the Scottish experience as against the US experience, we find that by developing branch banking or by mutual agreements between banks, notes of different banks were made widely acceptable without any discount. There was also a private clearing system among banks by mutual agreement so that notes issued by members of clearing banks were widely acceptable without any difficulty. There was even a secondary market of different types of banknotes where information regarding solvency of different note issuers was obtained, and such information was reflected immediately in the prices or discounts of different notes. In the secondary market, insolvent, dishonest, inefficient units were detected and weeded out. In a regime of note issuing monopoly, the business community could not have adequate information about reserves or any other fraud taking place. At the same time, it could not obtain adequate information about the market situation so it would always fail to act in time to prevent loss of confidence.

Let us now refer to the Lancashire experience (1790-1830) regarding the use of discount bills of different amounts and also with different dates of maturity. The discount bills were issued by local traders and were circulated as money without any difficulty. On the contrary people found such discount bills more convenient since they bore some rate of interest and were money in the true sense. During that period Bank of England notes were available but were not used in circulation by the public. This shows that money is what people accept as money; not what the state declares as money.

During the period of the Bullion Committee discussions, we do not find any significant criticism of the working of the country banks in England and Scotland. David Ricardo in all his writings did not find fault with them while there was a good deal of controversy regarding the working of Bank of England. Ricardo was vehemently critical of the Bank of England's role in causing the depreciation of money and high prices of bullion and other essential commodities. Adam Smith, while examining the working of Scottish banks did not find any fault with them. On the contrary, to him, if convertibility was assured, there could never be any excess issue of notes. If bankers adhere to their norms, they meet the needs of trade and cannot have any over-issue. During this period, there were in Scotland, various inter-bank agreements to accept each other's banknotes at par; there were clearing house bank arrangements where exchange at par of various banknotes was effected. And at several places, secondary markets of banknotes were developed where the solvency of each issuer was tested. If there is free money in modern times, one would expect development of various ways, such as issuing mutual fund accounts, or commercial papers, or bank receipts, or some mortgage-backed derivatives, dispensing the need of any commitment for base money which may act as near-moneys. Can we have a regime of free banking again?

F A Hayek and other economists have made various suggestions regarding the possibilities of establishing moneys which can guarantee the value in terms of purchasing power of different types of baskets of goods and services, thereby dispensing the need of any base money. This may seem to be imaginary at present, but may be a reality in the near future if we look to monetary developments that are taking place in international transactions. There is no gold standard at present, yet large-scale international payments are effected without difficulty.

Can we not conceive a situation of fiat money without the state monopoly of note issue? Or how can we keep the government aside and create an institution, which can supply us such fiat type money? This was a question posed even before Ricardo's times as early as the time of Bullion Committee discussions in the first and second decade of the 19th century. Ricardo did not want to give an authority of fiat money to Bank of England or to the government. He wanted to establish a National Board of Currency that would look after the issue of fiat money whose quantity is fixed under normal circumstances. If in the event of emergency this fixed amount is to be exceeded, it can be done with the permission of parliament and that to by specifying an amount by which the fiat issue is to be exceeded. In Ricardo's scheme, there was neither a central bank nor any power to the government nor any possibility of exceeding the fixed amount without the knowledge of the public. Ricardo did not want the use of bullion for internal circulation of money; he needed gold only to meet the requirement of international transactions and hence his Ingot plan which England adopted in 1925 about one hundred years after his death. This is one way of creating fiat-type money without base money. Ricardo wanted to do away with gold for internal transactions while the present system of international financial transactions using computer and e-money do away with gold in foreign exchange. Are we not much ahead on the way to fiat money without any base money at all?

Keynes was not the only man who described gold as a barbaric relic. So did Plato and even Ricardo did not want gold to be taken out from the depths of the earth, only to go as deposits in the depths of bank's vaults in so far as internal circulation of money was concerned. The euro-dollar development is a further step to do away with gold in international transactions.

Hayek also conceives of a situation where different types of fiat moneys may exist; if brand names are well developed. Then banks may issue their fiat money assuring its value in terms of some kind of purchasing power or linked to some index numbers. One can even conceive of the situation in which such fiat moneys that are redeemable in terms of value of certain commodity or a basket of commodities. We should remember that the purpose of saving is different for different individuals. Some savers may wish to ensure stability of value in terms of food items, or in terms of a general living index or in terms of a given basket of goods and services. Banks issuing fiat moneys can cater for such diverse needs, bringing in circulation different fiat type moneys. If Germany's hyper-inflation (1923-24) could be controlled by issuing currency with the backing of land, and in modern times for years together inflation at a rate of more than 30 to 40 percentage points can go on in Latin American countries with paper money—without any type of convertibility—then it is easier to think that Prof. Hayek's conception of money can easily work. Competition of banks for such fiat type moneys would ensure the survival of the fittest and weed out inefficient units. Thus, in a situation of commodity base money, or fiat-type moneys as conceived by Ricardo or Hayek, or value assured money without any base money, the free banking system may work. One can even show that it can work with all the smoothness or without any harmful state interference.

Working of the Free Banking System

If free money can be established, can it overcome the problem of systemic crisis (or bank run as it is normally known)? In this regard we should answer three related questions:

(1) Is the fear of bank runs so serious in the real world as it is usually made out to be?

(2) To what extent are the legal restrictions imposed by central banks or the state really responsible for aggravating the crisis or preventing its solution?

(3) In a free-money situation, can we devise new methods or arrangements with a view to preventing such bank runs at all, or to bring into operation immediate steps to stop it from aggravating?

Answers to these three related questions would not only indicate the feasibility but also the superiority of free money in practice.

Historically such bank crises were never serious except in the US. In all other countries where free banking with commodity base money had worked such crises were rare, and only in exceptionally few cases, serious. Differing experiences between the US and other countries may have been due to the presence of a larger number of restrictions in the US. Sometimes such crises elsewhere had occurred due to over-confidence arising from the fact that the central bank would act as lender of last resort and bail out defaulters. Many countries where free banking was working avoided the occurrence of crises even without any central bank or without any other private arrangement working as a lender of last resort.

In the US, there were occurrences of wildcat banks and loss of confidence in banks from time to time. Many times such occurrences were due to lack of branch banking, so that banks were confined to particular local areas. Due to different state and federal laws a correspondence system could not be developed. Moreover legal restrictions were severe, such as prohibition of suspension of paying money on demand deposits and insistence on receiving demand deposits without paying any rate of interest, etc. There was no possibility of suspending redemption of notes or deposits temporarily or offering any rate of interest by way of compensation on delayed payment. Due to the different state and federal laws, many bankers were induced to adopt unfair means in banking and above all, there was no effective money market for immediate encashment of the banks' assets. At the same time action taken by the Federal Reserve System was mostly delayed and half-hearted. All these restrictions at cross-purposes were responsible for wildcat banking or somewhat frequent bank failures in US during the 19th century. While during the period of the Great Depression i.e. 1929-1935, it was the fear or rumour of depreciation of dollar that led to bank runs, there was no loss of confidence in the working of banks.

Many times restrictions imposed on banks to maintain reserves have led to bank runs with contagion effects. The famous story of a German Chancellor who asked two taxis to remain standing at every taxi stand while allowing the third to go with a view to ensure availability of taxis, found that in spite of adequate number of taxis in the town, no one could use them because on each taxi stand, two taxis remained non-working. Similarly, in case of reserves of base money, which may be adequate to meet the demand and even changes in demand. But the rigidity in rules of reserves may not allow them to alleviate the loss of confidence by helping each other. The commonsense of the business community, if allowed to work, could evolve practical solutions for helping each other. In a free money situation, the reserves will be freely used; the use of reserves of others could be obtained by giving higher rate of interest. This will be possible because banks will also be eager to avoid bank run spreading to them. If there is a development of asset-backed derivatives, the market in such derivatives would easily solve the situation. Studies of past experience have indicated that central banks have acted as lenders of last resort usually too late and the banks could never obtain enough and timely information about the demand for money. While in free banking, the remedies for changes in demand are applied at points where they should be really applied. Such action is being taken automatically and hence there is no chance for any initial change in demand to develop into a serious proportion by way of contagion action.

Let us again take another situation where banks are free to issue banknotes as well as to have deposits created by them. Many times there are changes in demand for banknotes as against bank deposits. Sometimes the public would like to have more of banknotes and less of deposits, although they do not wish to change their total stock of money. In the present system when the public switches over from deposits to banknotes, banks' reserves may be depleted which may initiate a crisis because some of the banks would attempt to build up their reserves as they had to issue more banknotes. In free banking, there would be no such need. Banks themselves can switch over from deposits to banknotes and vice versa—without making any changes in their normal reserves, which they consider necessary to meet ordinary demand for base money. In the present system, we have a needless crisis, while in free banking there will not be any crisis because there is no cause for loss of confidence. Changes in demand between different types of moneys, or even near-moneys are likely to happen from time to time. This can be met without difficulty in free money, but not in the present system of managed money.

The current situation encourages reckless and dishonest people to enter the banking business because central banks, acting as lenders of last resort, have to save them even though they do not deserve any help. In fact such dishonest banks are saved in order to save the whole banking system while they cannot be weeded out for lack of a competitive system.

Many a time, such crises have occurred because of an inflationary situation or changes in nominal rates of interest as a result of the monetary policy of the central bank. Thus, not the regulatory function, but the monetary function of the central bank becomes the cause for a crisis of confidence. It means that the central bank becomes the cause of crisis and then begins to kill it, achieving no useful purpose while creating lot of economic troubles. Thus those whose duties are to provide stability to the banking system create crises of confidence.

Can free money devise new mechanisms in order to deal with any possible bank run? It can. Imagine a change in the nature of checking services. Instead of issuing cheques payable to demand deposits, they could well be made payable in equity of mutual fund accounts. They could be made payable, say in units of Unit Trust of India, or in terms of commercial papers which are generally transacted in big volume on daily basis in money markets. Even some standard derivatives may be considered appropriate for checking services. These devices are not perfect substitutes for demandable bank debt because such derivatives involve the possibility of changes in value, while some deposit holders may prefer immediate payment without loss of value. A demand deposit system has another advantage: it keeps depositors eternally vigilant about the solvency of banks. Although such devices may help in preventing bank runs to some extent, we may need another type of bank-run proofing arrangement. In fact, we can have one such device if we are prepared to give up the condition of immediate payment on demand for a right to suspend the payment temporarily, say for 15 days or one month. Such a step involves payment of interest and the longer the period of suspension, higher the rate of interest. This kind of “option clause” system was used in Scotland during free-banking era to give breathing time to banks in danger to salvage their position. If such an arrangement is evolved, contagion action would be checked and bad banks can be weeded out without any side effects. In this connection it has been pointed out that the option clause available in the Scottish Banks was never used and hence its efficacy cannot be safely vouched for. But, one can say that the fact that such an option clause existed may have been a strong deterrence against bank runs and hence was not used at all. Instead of being a deficiency the non-use of the option clause may well be a virtue in the banking system. It may happen that a bank may go under although it did not use the option clause. This may be so because the bank may feel that it had not acted as it should normally have and hence it may feel that it could not save itself by putting into effect the option clause. But if the bank is essentially sound it can save itself during the general bank-run by the use of option clause. At least it can prevent the contagion of the bank-run.

A third run-proofing arrangement can be to ask banks to make an adequate capital base or some provision of double liabilities to shareholders of banks. At one time in the past, in Sweden and Scotland, such arrangements were made. We can evolve some arrangement of private deposit insurance so that depositors are assured of the safety of their deposits. The existing arrangement of tax-funded deposit insurance schemes by the government lacks competition and incentives, which private deposit insurance could provide and probably such arrangements may work better in a free money regime. Can we say that such run-proofing arrangements may work even when we have fiat-type moneys or competitive payment systems without base money? Probably, as in modern times, in almost all countries paper notes are not convertible in gold, they are fiat moneys and as we have discussed earlier in regard to Hayek's proposals, a guarantee in terms of general purchasing power may bring about a system without any base money. All the run-proofing arrangements discussed by us earlier could work without any difficulty in other two regimes i.e. in fiat type moneys and paper moneys without base money. In the era of computers and information technology there is a greater possibility that such arrangements could work better.

We can also say that arrangements evolved in free money systems would solve the problem of industrial fluctuations more easily than in today's regime of managed money. We have noticed how central banks have failed to prevent inflation in 1970s and failed to solve it in 1980s. In most cases, central banks have worked according to political needs or to safeguard the interests of the state as perceived by them, instead of in the general interest of economic growth and stability. They have acted too late, and many times the lack of in-time information remained the principal reason for the failure of monetary policy. The Keynesian argument that an increase of money supply has a healthy impact on trade and commerce was first tried out as early as

1705 by John Law and failure of his policy was witnessed by the world as early as 1716, in France when John Law himself established his bank with that aim. (See article by J.K. Horsefield, “Duties of a Banker” published in paper in English Monetary History edited by T.A. Ashton and R.S. Sayer). John Law recommended his scheme for Scotland but Scotland did not accept it. While in a free money system, the rate of interest is allowed to be adjusted automatically to natural rate of interest resulting in no divergence between real and nominal rate of interest. This fact would eliminate chances of business fluctuations arising from monetary factors.

At this stage, a question can legitimately be raised: what is the purpose of such an exercise of free or laissez faire money when the world over the state is in total control of monetary system? Surely, one cannot even imagine that any body will give up this monopoly when they have so many benefits! Is there any hope that governments will give up their powers? Still, there are various reasons for us to go through such an exercise. First, this concept can act as a benchmark for monetary policy. It may indicate to the government concerned where regulations can be relaxed, or between the two alternatives available for restrictions which one should be adopted. Second one does not know when any country or even the international monetary payment system may face an unprecedented crisis. In such an event, the authorities concerned are ready to grasp at any straw. And therefore the world may adopt free money system if a well thought out alternative is readily made available. Have we not noted the change from command economy to market economy since the 1980s? Who knows such a change in banking and financial system may come about in the beginning of the 21st century? Third, even in the field of monetary system, we notice a good number of changes towards deregulation. For instance, the world over there is a demand for an independent central bank. The International Monetary Fund and the World Bank are no longer in control of the international payment systems. The international banking system has changed dramatically since 1975. Various derivatives have been evolved which minimise the use of fiat or bank money. There is already a march away from government money in the domestic market. The nature of commercial banks has changed radically. We now have bank receipts, commercial papers, credit cards of different types and various types of mutual funds, which today constitute the major portion of monetary transactions. Central banks have had to give up many regulations, and the use of banknotes and coins is becoming more and more limited.

Nobody talks of convertibility of paper money in gold in domestic transactions and even in international transactions, payment in gold no longer takes place. On the contrary, the payment is also received in Dollars or Yen and the major key currencies maintain their stable relationship by way of changes in the rate of interest. Can we not hope to hasten this process and obtain fiat type moneys with guarantee in terms of some values, which can work without central banks, or any monetary authorities, only through the market process? Can we hope to reach this stage in the beginning of 21st century? We are progressing far more rapidly than expected. When Hayek wrote about denationalisation of money he did not expect that information technologies would bring changes in financial systems of the world so swiftly. We have the euro-dollar mechanism providing stateless money and safe and profitable investment avenues. We have the Internet, a communication system which is outside the control of any one country. We have the semiconductor chip enabling any individual to assess large amount of monetary data from all over the world in a very swift manner. We have public key encryption which enables any individual to communicate anywhere in the world without anybody else's knowledge about it. We have a system of smart cards providing individuals the freedom to deal in electronic money for buying and selling without the knowledge of anybody else. All these developments work with a much lower cost and so swiftly that one can say that there is a "digital liberation." Computer bits which perform the functions of money work anywhere in the world and can work for any individual and work so swiftly and with so low a cost that it can safely be said that we can distinctly see the freeing of money from the clutches of government. We only await some ground rules to be established for the working of free money. Anyway, the Government is loosing its grip over money management and it will have to fall in line because electronically transacted debits and credits will become the principal mode of payment very soon. Thereby both private money and government money may exist side by side and inefficiency of government will soon make its money very insignificant and relatively less useful.

So far we have tried to show that from past experience competitive money can solve various problems which arise when we go for paper money and deposit banking. Can we expect the same results when the development is rapid due to synchronisation of the profound changes, which we find during the second half of the 20th century (i.e. the use of computer on a large scale and development of communications technology)? Both of them have led us to the development of e-money & e-commerce heralding the new information age. How do we see the development of money and banking with respect to free money regime in the 21st century? Will there be a regime of free money? Or, free money along with government money? Or, looking to government behaviour, will it try to throttle the development of e-money such that it can still control as before and continue the regime of managed money? These are pertinent questions need to be answered.

The regime of managed money can be said to be artificial because the growth of money is due to its evolutionary process and hence it does not need any control, direction, or regulation. Obviously there cannot be a concept of monetary policy, or the "right quantity" of money or even money to act as "neutral money". Money has been brought into existence by the market process. It is an economic good and it is the market process, which would cure it if defects in its working were developed. It is the market process, which would decide what the right quantity of money should be. The monopoly of money by the state was unnatural, a hurdle in the evolutionary process and if it goes out in the 21st century it would be better for the use of money in the economy. Money as an economic good will give better services.

Development of e-money is a continuation of the same process of evolution of money. There is nothing revolutionary about it except its speed, cost-efficiency and privacy. It covers the whole world; connects two concerned parties without the intervention of any third party; works with the speed of light. It can be operated without any obstacle from national boundaries. It is truly universal. In short, it efficiently solves all the inconveniences of direct barter that we were trying to solve since long. We have not been able to provide a more efficient device than the use of e-money.

Right in the beginning we have had tobacco, barley, cowrie shells, as money. We then used metallic money, and of late paper money and deposit money. We need some token to work as medium of exchange for our transactions. Ideally the device should be speedy, portable, divisible, storable, Human ingenuity has always invented various devices to meet needs but every invention works both ways: meeting needs on one hand and creating some problems and difficulties on the other. During our endeavour, we try to obtain the first as much as possible and try to avoid the second as far as possible. So is the case with money too.

No longer is it necessary for both parties, buyer and seller, to effect the transfer of deposits from one account to another as was necessary up till the recent past. Again it is not necessary to do this work by writing a cheque or by telegraphic transfer. We can do this through smart cards without going to a bank or without writing a cheque or without sending a telegraphic transfer. Smart cards and microchips show our bank balance and also undertake transactions. Thus the advent of multiple forms of digital cash on smart cards, credit cards, debit cards and the internet has changed the monetary system. Although these new devices are not legal tender, they work more efficiently than the legal tender money. Currency as such is no longer required. On the contrary to use currency as medium of exchange is more inconvenient. There is a risk involved in holding currency; there is a loss of interest in holding it whereas there is no risk in having cash by a smart card and we earn a rate of interest in addition. Already there is a decline in the use of currency in most advanced countries. We have noted earlier how despite the existence of Bank of England notes, discount bills were used in the Lancashire area (1790-1830). The same may happen if the government does not come in the way acting as a spoilsport. Truly, money is what money does. Smart Cards and credit cards are more accepted as money than the legal tender currency of the central bank.

The use of e-money is so popular, speedy and widespread that it has already taken its roots in the developed countries like USA, Canada, Western Europe and Japan. It is now widely used in e-commerce in the emerging economies like South Korea, Taiwan, Singapore and Malaysia. China and India both have adopted it almost in all big transactions. Banks in India have already started issuing various types of electronics cards and use of the computer is visible even in the rural areas of India. The introduction of e-money is on so large a scale that it cannot be curbed by any government action. The time to nip it in the bud has gone. Now it is a grown up child and cannot be done away with. One country howsoever big and mighty it may be, it cannot take steps to curb the progress of e-money.

What is then the effect on central banks of the growth of this kind of e-money? It seems that even though the government may declare it's own currency as legal tender, the commercial world may not accept it as a common medium of exchange. At the most the central bank money may remain as one among many moneys. Its existence as a sole medium of exchange is gone. Moreover, there will not be any definite relationship between the government money and other types of moneys or money-substitutes and hence by changing the amount of government currency, the government would not be able to change the total supply of money. Although the government is an important economic participant, and it can exert some influence in domestic transactions, it becomes relatively insignificant in international transactions. With increasing globalisation, monetary policy will have very little meaning or influence.

The only wise course for the governments of various countries is to evolve ground rules for the working of e-money and see that they are observed by all. The sooner this task is achieved the better, because free money will soon come into existence not only in developed countries but in developing countries. At any rate, as Hayek wanted, the monopoly of government money should go, and if at all the government money exists, it may be as one of many moneys and not the only money.

Suggested Readings

Chekland, S.G. 1975. Scottish Banking: A History 1695—1973. Glasgow: Collins.

Cowen, Tyler and Randall Krozner. 1989.: Scottish Banking before 1844: A Model for Laissez Faire?" Journal of Money, Credit and Banking (May): 221—31.

Diamond, D.W.,and P.H Dybvig. 1983. "Bank runs, Deposit Insurance, and Liquidity." Journal of Political Economy (June): 401—19.

Dowd, K. 1989. The State and the Monetary System,.Hernel Hempstead: Phillip Allan, and New York: St. Martin's Press.

——. (ed.) 1992. The Experience of Free Banking. London: Routledge.

Dows, Kevin 1988. "Option Clauses and the Stability of a Laissez Faire Monetary system." Journal of Financial Services Research (December): 319—33.

____. 1991. "Option clauses and Bank suspension." Cato Journal (Winter): 761—74.

____. 1993. Laissez Faire Banking. New York: Routledge.

Gherity, James. 1995. "Option Clause in Scotland." Journal of Money, Credit and Banking.

Glasner, D. 1989. Free Banking and Monetary Reform. Cambridge Mass.: MIT Press.

Goodhart, Charles A.E. 1988. The Evolution of Central Banks. Cambridge, Mass.: MIT Press

Gorton, Gary B.1985. "Bank Suspension of Convertibility." Journal of Monetary Economics: 177—99.

——, and Donald J. Mullineaux. 1987. "The Joint production of Confidence: Endogenous Regulation and Nineteenth Century Commercial Bank Clearinghouses." Journal of Money, Credit and Banking (November): 457—68.

Greenfield, Robert L., and Leland B. Yeager. 1983. "A Laissez Faire Approach to Monetary Stability." Journal of Money, Credit and Banking (August): 302—15.

Hayek, F.A. 1978. 2nd Edition. Denationalisation of Money. London: Institute of Economic Affairs.

Jonung, Lars. 1985. "Economics of Private Money: The Experience of Private notes in Sweden 1831—1902." Manuscript, Stockholm School of Economics.

Meulen, Henry. 1934. Free Banking: An outline of a Policy of Individualism. London: Macmillam.

Rothbard, Murray N. 1988 "The myth of Free Banking in Scotland.: Review of Austrian Economics 2:229—45

Sechrest, Larry J. 1993. Free Banking. Westport, Conn.: Quorum Books.

——1988. "White's Free Banking Thesis: A Case of Mistaken Identity." Review of Austrian Economics2: 247—57.

Selgin, George A. 1988. The Theory of Free Banking. Tiotowa, N.J.: Rowman and Littlefield.

——. 1993. "In Defense of Bank Suspension." Journal of Financial Services Research (December): 347—64.

——, and Lawrence H. White. 1994. " How would the Invisible Hand Handle Money?" Journal of Economic Literature (December): 1718—49.

——. 1996. "In Defense of Fiduciary Media." The Review of Austrian Economics 9: 83—107.

Shah, Parth J. 1997. "The option clause in Free-Banking Theory and History: A Reappraisal." The Review of Austrian Economics 10: 1—25.

Smith, V.C. 1936. The Rationale of Central Banking. London: P.S. King.

Timberlake, Richard H. 1984. "The Central Banking Role of Clearinghouse Associations." Journal of Money, Credit and Banking (February): 1—15.

White, Lawrence H. 1984. Free Banking in Britain: Theory Experience and Debate, 1800—1845. Cambridge/New York: Cambridge University Press.

——. 1990. "Scottish Banking and Legal Restrictions Theory: A closer look." Journal of Money, Credit and Banking (November): 526—36.

Yeager, Leland B. 1985. "Deregulation and Monetary Reform." American Economic Review (May): 103—7.

2. Understanding Capitalism in the Post-Communist World

If we look at the present day world in terms of socialism and capitalism, we find almost all countries claiming to be “Capitalist.” Socialism, as a creed, as well as a policy, seems to be dying out. Especially after the collapse of communism in Russia and in Eastern Europe since 1989, nobody talks of ‘Central Economic Planning’ or ‘Socialism’ in which means of production are owned by the state. Socialism of the Marxist variety is surely dead and gone. Today, we have liberalization, market friendly economy, competition, globalisation, as fashionable words.

Even die-hard communists in India were listening quietly to the speech of Manmohan Singh, Finance Minister of India in July 1991, when the U-turn in India’s economic policy was taken so suddenly. India has adopted liberalization since then, but no socialist protested. The communists and the Left both in U.K. and Italy revised the basis of their Marxist ideology, and accepted the role of the market as the principal method of efficient allocation of resources. The Labour Party in England changed its manifesto radically, in which the market economy was accepted without ‘ifs’ or ‘buts’. We may then ask: Is it really so? Are we all really capitalists? Have we said good-bye to planning commissions? Have we all given up the slogans like nationalization, or ever-expanding public sector should achieve the commanding heights of the economy? Do we all consider socialism just as a past event, a matter not to be remembered at all?

A closer look at the prevailing situation does not suggest all this. Socialism still seems to be raising its head here and there and from time to time. It is still growing in new shapes as if rising like a Phoenix from its ashes. It is probably planning to comeback with a bang. Do we not notice that even China, which started economic reforms in 1978 – probably the first major economy to give up socialism and adopt liberalization – did so in order to achieve socialism through market? For China, the market is an instrument to be used to push the country ahead on the socialist path. Even today, China has not reduced her public sector and while giving land to farmers on long-term lease contracts, say, for 50 years, they are not ready to give the right to sell or to transfer or to bequeath the leased property. The huge amount of foreign investment, which they have received, has not been a direct investment. They managed to get a large percentage of it via non-resident Chinese, and via Hong Kong, which is now an autonomous island-state under their sovereignty.

Conditions are not very different in the western democratic countries. The policy of deregulation and privatisation was adopted in Britain by Margaret Thatcher in 1979 and in the US by Ronald Reagan in 1982. Germany (West Germany before 1989) pursued a liberal policy since 1950. Yet the government budgetary expenditure of these countries still form a major part of their economies. (More than 40% of GDP, see Table 1). The state is still a Leviathan. Socialism, instead of working in the field of production, i.e. by nationalizing the means of production, has started working in the field of consumption. Socialist thinking is now applied to the distribution of income and wealth, and the state is considered the main instrument to obtain distributive justice.

Welfare State: Socialism Reincarnated

What is this new avatar, or incarnation, of socialism? It is the modern welfare state, which considers itself to be the institution responsible for the welfare of its people. To provide its citizen's a minimum standard of living, schools and hospitals, assist in their social calamities, like broken marriages and illegitimate children. In short, the people should be provided with social and economic security, from day one, (actually even from prenatal care) to the grave, when the body is buried or cremated. It is this which explains why, despite privatisation and deregulation, the state is still a Leviathan, a be-all-and-end-all for citizens, whatever may be the form of government, democratic or not.

TABLE 1: The Size of Government in OECD Countries, 1960–1996
(Total Government Outlays as a Percentage of GDP)

	1960	**1970**	**1980**	**1990**	**1996**	***Per cent Increase 1960-96***
Australia	21.2	25.5	34.0	37.7	37.5	*16.3*
Canada	28.6	35.7	40.4	47.8	46.4	*17.8*
France	34.6	38.9	46.1	49.9	54.7	*20.1*
Germany	32.4	38.6	48.3	45.7	56.0	*23.6*
Italy	30.1	34.2	41.9	53.8	52.7	*22.6*
Japan	17.5	19.3	32.6	31.9	36.9	*19.4*
New Zealand	27.7	34.4	47.0	50.0	42.3	*14.6*
Sweden	31.0	43.7	61.6	60.8	66.1	*35.1*
UK	32.2	32.2	39.2	44.9	42.3	*10.1*
USA	28.4	32.5	33.7	34.8	34.6	*6.2*
Average	28.4	33.5	42.5	45.7	47.0	*18.6*

Source: James Gwartney, Randall Holcombe, and Robert Lawson: "The Scope of Government and the Wealth of Nations", *Cato Journal*, 18–2, Fall 1998, p. 164.

There is another phenomenon, which strikes us. At the slightest provocation, the forces of the Left begin to make noises in chorus against liberalization. During the New York Stock Exchange crisis in 1987, the Left blamed liberalization, and some of them even began to see it as the last blow to capitalism as Marx had predicted. The same was the case when, in developing countries, high foreign debts lead to a debt-trap in the 1980's. During Mexico's balance of payment crisis in 1994–95, the Left was at its loudest. Even the exchange-rate instability and onslaught of depression in Asian Tigers, in 1997–98, have been cited as instances of the failure of the free market economy. Indeed, India has already started thinking to revise her policy of liberalization, and the Left forces, which were dormant so far, have started waking up and attacking capitalism, which can be easily seen from the manifestoes of most of the national political parties in the general elections of 1998 and 1999. Is it because there is fundamentally something wrong in the ideology of capitalism? Is it true that it works on the basis of selfish human nature? Is there really no invisible hand that converts private vice into public virtue? Is there anything lacking in the present-day thinking about capitalism that gives rise to hopes for socialists to revive their creed from time to time? These two aspects—the Welfare State as benevolent, and the suspicion that capitalism lacks moral basis, make social thinkers begin to think of an alternative social philosophy at the slightest trouble arising in the working of capitalism?

Moral Sentiments Underlying Capitalism

Was there anything wrong in the writings of the classical thinkers, especially Adam Smith, who is considered as the Apostle of free economy? Or is anything wrong with the welfare state, which leads to perverse democracy, and unlimited government? In fact, there was nothing wrong in the classical thinkers like Adam Smith. Probably Adam Smith has not been read fully or he has been interpreted rather narrowly. His thoughts as expressed in the wider perspective of social cooperation was presented by him in the *Theory of Moral Sentiments* published first in 1759 and revised from time to time till 1790, a year before his death. Whereas *The Wealth of Nations*, first published in 1776, was hardly revised. If Adam Smith is read in the context of his earlier work, *The Theory of Moral Sentiments*, probably the suspicions arising about capitalism, and its feasibility and stability may be easily avoided.

We should remember that the free market economy, as conceived by classical thinkers as well as modern free-market supporters, was supposed to work and thrive in conditions of freedom where the role of the state as an institution *using force* to guarantee freedom is limited and there exists the sense of individual responsibility. All three, market forces, limited government, and individual responsibility go together to establish a true liberal society. It means that we reject the other fundamental philosophy for social cooperation which considers society as a collective, or a corporation, which should be managed by a board of management with a view to achieve a given objective. This view is totally opposed to liberty as viewed by the classical thinkers. It is also opposed to the working of a free market economy. In fact, the liberal view of social cooperation, in order to establish a civil society is consistent with free markets, limited government, and individual responsibility. It means that we should aim at establishing a civil society for social cooperation, in which liberty is granted to all individuals by the state, in order to enrich one's own life by way of self-fulfilment, self-help, and self-expression through mutual aid. As the state has coercive powers it should be limited in its areas of functioning. Civil society would evolve various institutions, which would work on a voluntary basis giving freedom to individuals. Since civil society works by mutual co-operation, and on a voluntary basis, it would prefer the path, which yields a degree of satisfaction that no other path can achieve. Moreover, since it works by trial and error, and moves step by step, balancing various alternatives, the path so selected by civil society ought to be stable, and better than any other alternative.

The market is mainly criticized as immoral because it is based on the basic instinct of human beings—selfishness. It has been suggested that in capitalism, what matters is, on one hand, the result of an individual's endeavours, and on the other, whether others are prepared to pay for it, i.e., only the cash-nexus matters. In this sense, what we find in it is ego, and rational calculation of costs and benefits. We do not find virtues like trust, altruism, fraternity, or brotherhood. Thus it is mere selfishness, which explains the working of capitalism. It is this view of capitalism, which inspired a man like Marx to attack it, and it continues to inspire others even today. By depicting capitalism as based on self-interest, instead of selfishness, and thereby making it amoral, instead of immoral, does not save it from criticism. If it is amoral, a mere instrument, it can be used by socialists also, and then in that case, we find that we do not achieve what we could achieve by capitalism. Further, by adding an adjective to self-interest, and converting it to enlightened self-interest, we open the doors for the socialist to prescribe morals by asking what we mean by enlightened self-interest? Any prescription from outside, or from above, smacks of authoritarianism. Therefore, let us go back to Adam Smith, to understand the true moral basis for the market forces to work efficiently.

For Adam Smith, the human being is a social animal, and cannot live without social cooperation. He would like to have such social cooperation, for enriching his own life, or, for self-expression and self-fulfilment. He writes:

> How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the future of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it.[1]

It means that man is interested in the good fortunes of others, not to gain anything for himself, but seeing the good fortunes of others as his happiness. Man essentially wishes to have a good society, in which what exists is not a war against each other, but a sort of good, peaceful and prosperous civil cooperation. According to Smith, such a good conduct is not spontaneous, but each citizen has to cultivate good habits, take interests in each other, help each other by way of mutual aid associations. There is, according to Smith, a basis in human nature, which leads him to such civil society. He writes:

> Nature, when she formed man for society, endowed him with an original desire to please, and an original aversion to offend his brethren. She taught him to feel pleasure in their favorable, and pain in their unfavorable.[2]

Thus nature has endowed man not only with desire of being approved of, but also with a desire of being what ought to be approved of. Both “praise” as well as “blame” are in human nature.

There is a second channel in human nature, which leads to social cooperation. It is founded on the desire for:

> … praiseworthiness and in the aversion to blameworthiness: in the desire of possessing those qualities and performing those actions, which we love and admire in other people; and in the dread of possessing those qualities, and performing those actions, which we hate, and despise in other people.[3]

Thus the first channel through which social cooperation is sought may establish moral conformity and the second promote moral autonomy. According to Smith there was also a third channel, which is higher than the first two, and it is that of:

> All seeing Judge of the world, whose eyes can never be deceived, and whose judgements can never be perverted.[4]

Thus man has a fear of God. He therefore stood for a virtuous life, ever becoming nobler and nobler, lest Almighty God be unhappy with him. This desire for a virtuous life is seen when he asked to do the right thing according to one’s own sense of duty. He was clear as to where his duties lay.

> … to feel much for others and little for ourselves, that to restrain our selfish, and to indulge our benevolent affections, constitutes the perfection of human nature, and can alone produce among mankind that harmony of sentiments and passions in which consists their whole grace and propriety.[5]

Thus Smith was harnessing self-interest. But, for him, self-interest was not enough. We have a duty to pursue self-interest unselfishly. It means that according to Smith, a good society is one in which people took personal responsibility to make the society a better place for all to live happily, peacefully, and prosperously.

Here we ask: Is such an enlightened self-interest as shown by Smith, enough? In fact, it is still not enough. Because, as convincingly shown by William Ropke in his book, *A Humane Economy*, that market ethics are on an intermediate plane. He writes:

> It is not the summit of heroes and saints—selfless dedication and contemplative calm, but neither is it the low lands of open or concealed struggle in which force and cunning determine the victor and the vanquished.[6]

Thus the moral climate of market is lukewarm, but is adequate to foster honesty, a spirit of give and take, encouragement to productivity. In the field of economy, i.e., production of goods and services, it is enough. But this market, if just left at this stage, is not likely to be stable. It may go wrong anytime. It is constantly in danger of "*straying from the ethical middle level, unless it is buttressed by strong moral supports*."

Therefore Ropke further writes:

> The market, competition, and the play of supply and demand do not create these ethical reserves; they pre-suppose them, and consume them. These reserves have to come from outside the market—self-discipline, a sense of justice, honesty, fairness, chivalry, moderation, public spirit, respect for human dignity, firm ethical norms—all of these are things which people must possess, before they go to market, and compete with each other. These are the indispensable supports, which preserve both market and competition from degeneration.[7]

Thus not only Ropke, but even other economists, such as Frank Knight, FA Hayek, James Buchanan, and earlier classical economists, like JS Mill and others believed that economic behaviour ought to be constrained by moral limits.

We could see in our presentation of the working of market forces that we do not depend solely on innate nature of human beings, which would automatically lead to good society, if not interfered by the state. In fact, human nature needs to be cultivated by habits, and by evolving morals in the society. These morals, habits, or traditions are also not irrational or just taboos. They are rational, but evolved through experience, and trial and error – rationally done by individuals while cooperating with each other. Every market process depends on the acceptance and preservation of private property, and the observance of contracts freely entered into by individuals among themselves. It requires the preservation of liberty by the state, by providing protective rights to each individual. Even Adam Smith stated:

> Commerce, and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payments of debts from all those who are able to pay.[8]

Thus we find that the hard-boiled 'economism,' say in terms of maximizing utility by way of making rational economic calculations, is dangerous, because we cannot allow economic freedom to be separated from its moral environment. The sphere of the market is to be regarded as a part of the wider general order. Ropke has said:

> How could a genuine market, an area of freedom, spontaneity and unregimented order thrive in a social system, which is the exact opposite in all respects? [9]

It is clear that market forces are supposed to work in the climate, which is congenial to virtuous life, or in a society wherein conditions of freedom prevail. The competitive market economy has also the morality of its own: honesty, a spirit of give and take, respect for the right of property, and inherent desire to observe and fulfil contracts of each other. Beside this, there ought to be a general moral climate, in which men and women cooperate with each other, have also a sense of duty to carry society on a higher and nobler plane, where virtues are rejoiced, and vices rejected.

Majoritarian Democracy and the Therapeutic State

The welfare state and the development of perverse democracy have led the state to be a Leviathan, thus creating an offensive climate in which capitalism fails to function. We need a limited government, and the development of a sense of individual responsibility in every citizen, which the present day democratic state does not provide.

During the last quarter of twentieth century, when socialism was on its way out, many socialist thinkers tried to hang on by way of shifting their strategy: instead of socializing the sphere of production, they wanted to socialize the sphere of distribution. And for this, socialists began to emphasize on equality in the sphere of consumption. They separated the two spheres of the economy—production and distribution, and argued that there is no reason why both of them should be governed by the same set of principles.

According to them, production may be governed by technological rules without interference. But the distribution of income and wealth should be governed by rules evolved by society, which can be changed so as to satisfy social needs. Economists and especially those who are familiar with the working of the market process know very well that the same rules work for production as well as for distribution. In fact, both these spheres are interwoven and cannot be separated. Distribution takes place simultaneously during the process of production. The price system determines the distribution of income, and the income of each productive service is determined by the prices paid to the factor services, which in turn determine the cost of production. Any attempt to separate the cost of production from the income of the factors of production would lead to inefficiency, and mal-allocation of resources. Yet, the greatest genius of the twentieth century, Albert Einstein believed in this fallacy of dichotomy of laws for production and distribution. Even great thinkers like George Bernard Shaw and Bertrand Russell were victims of this fatal conceit.

In fact, the present day state, especially under representative democracy is more powerful than what it used to be in the earlier days of kingship and aristocracy or feudal regimes. Originally, representative democracy as symbolized by parliament was evolved to defend the rights of the people against the tyranny of absolute rulers. Parliament fought against the divine rights of kings or against the king who believed that he could do no wrong, who believed that he was the state. One can easily remember – the *Magna Carta* of 1215, Cromwell's *Commonwealth* of 1649, *Bill of Rights* of 1789, and the French and American revolutions. Unfortunately the same Parliament, especially in the second half of the twentieth century turned out to be even more powerful than absolute kings—even more royal than the kings were! There is not a single act, which cannot be done by the state; the state is now the be-all-and-end-all, in so far as its citizens are concerned. It is this concept of the state, which has led to several perverse developments in present day representative democracy.

This concept has led the public to argue that market forces should be replaced by democracy because democracy reflects more correctly the wishes of the people. Such a view is justified by democratic accountability. But this view is erroneous and fraught with dangers because such accountability depends on majority opinions, which in turn are taken at intervals of 4 to 5 years; each individual's rational calculations are not taken into account; changes taking place almost continuously, are not taken care of; and even necessary changes are not made in time. This majoritarian democracy has induced people who wish to control the state, to various vote-catching devices, which has led to short-termism, emergence of pressure groups and prevalence of special interests over general interest. Since the state rules by making laws, and enforcing them, the state is also entitled to amend, alter and interpret these laws, which induce special interests to work for changes favourable to them, although such changes may be against the interest of the general public. These special interests, in course of time, capture parliament and corrupt the whole process of elections. In fact, even majority rule does not remain, since acts are made by parliament, which may not represent the majority at all. This 'majoritarian democracy' does not necessarily reflect the views of the majority, because politics works by compromises. For example, a small group, whose support is required to form a majority can get what it wants. If the electorate is equally divided, between the government and the opposition, say, 45% on each side, the remaining 10% determine the balance of power and therefore can have their say and get their demands accepted, although if such demands are put to vote by way of referendum, they may not get majority support. Even so-called majoritarian democracy does not work by the majority rule in the true sense of the term.

There was also another development in the nineteenth century, which led the state to act as a therapeutic state in which several victims reside. According to Oakeshott:

> Here a state is understood to be association of invalids, all victims of the same disease and incorporated in seeking relief for their common aliment, and office of government is a remedial engagement. Rulers are the directors of a sanatorium from which no patient may discharge himself by a choice of his own.[10]

This belief in the welfare state probably began in the eighteenth century, at first in Prussia in the days of Frederich the Great (1740–1786). In those times the breeze of liberty was blowing fast all over continental Europe, especially in France and Germany. This new breeze of liberty brought the dissolution of the old certainties obtained by way of belief, occupation, and status available in the feudal set-up. Those who enjoyed such certainties and opposed liberty welcomed this new idea of the therapeutic state so that they can again obtain their lost certainties under a paternalistic protection of the state. Therefore they soon began to obtain the status of victims, i.e., their adverse position needs to be put right by the state.

We see around us today, most of the people who have asked for a victim status: blacks against whites, women against men, backwards against forwards, poor against rich, south against north, developing countries against developed countries, the widowed against the married, old against young, and so on. Thus under one pretext or other, people have started demanding victim status for hospitalisation—special privileges, reservation, assistance from the state. In this game, caste, colour, sex, religion, race, language, education, age or any convenient pretext is taken for discrimination. The victims can justify anger or hatred against any section of society. Women can even put violent demonstrations against men and yet they are to be excused because they have been kept in an inferior position for centuries. The victims' status provides a rationale for a compensation to be paid to them because they suffered atrocities or were exploited by others for many centuries. The Mandal Commission in India, for this reason, has asked for reservations in government services and in educational institutions for socially backward communities. Once one acquires a victims' status, his or her bad behaviour is to be excused by the rest, as such a victim is no longer required to show any personal responsibility even for maintaining himself. It is also difficult to criticize such victims because the non-victims will have to show repentance and therefore will have to remain on the defensive while dealing with victims.

Both these changes: majoritarian rule, and the concept of a therapeutic state, led socialist thinkers to ask for equity in distribution of income and wealth, in the name of social justice. The socialism of today in its new avatar is making the state a main instrument of achieving social justice, which, all said and done, means, "distributive justice." All giveaway schemes can be presented in the name of social justice. Doles are to be given to all victims in society—sick, uneducated, illiterates, unemployed, aged, handicapped, poor, children, widows, orphans, illegitimate children, single parent families, pregnant women, the weak and the feeble, minorities, the displaced, the refugees. They cannot be asked, as to what extent they are responsible for their victim status or why do they not try to help themselves so that they cease to be victims? In the developed countries like America, Britain, Germany, France, Sweden; such victims are ever increasing in number. They do not leave the hospital once admitted. More and more people are being added to such victim status and the state is required to spend increasingly larger and larger amounts of money. Consequently, it has been difficult for the state to control fiscal deficit, or control inflation, raise money by taxation, and avoid fraud, crime, and waste of resources. The family system in all the western countries has come to a breaking point. The majority of births are illegitimate. About 40% of families live without marriage, and number of divorced couples is increasing day by day. Hardly do we find a couple aged more than 50, without a broken marriage. Western democratic countries, despite their wealth, find it difficult to meet the wasteful expenditures incurred on education and health care. All this has created a combatant society in which the moral fabric is simply shattered.

All this is in the name of 'social justice,' which as a term is very confused and misleading. Confused, because justice can only be done by a living human being. There is no organic entity called 'society.' Therefore a society as a unit cannot think, and hence cannot do any justice. Thus, social justice as a term is misleading. If by social we mean people, or common people, it is difficult to lay our hand on 'people,' or 'common people.' In fact, every one talks about what he or she thinks to be right in the name of people. If we mean by social as what the majority of people think to be right, i.e., not as a collective unit, but as a group of people in a meeting of shareholders, whose votes are obtained on a given issue, then all those programs taken up in the name of social justice should have been referred to the people for their majority decision, i.e., by referendums, which is not being done. In the working of the welfare state, or in the search for distributive justice, the 'visible hand'[11] of the state works in a totally perverse manner. When invisible hand works in the private sector, private vices turn out as public goods. When the visible hand works in the public sector, public goods turn out as private vices.

Help does not go to the real victims. Mostly those who are not real victims, receive the benefit. Welfare programs to provide employment to the unemployed create more unemployment in the society. People lose their spirit to work for their living, and prefer to remain lazy, and unemployed. The developed countries have by now found the evils arising from welfare activities, but developing countries are still energetic for a welfare state and hence we find a competition among various political parties in India to provide more and more giveaway schemes and then turn blind eyes to their failures.

Yet the paradox remains—world opinion is coming round to liberalization. It wants markets to operate as freely as possible, at the same time it wants the state to undertake more and more functions so as to treat all victims who come up in the vote-catching devices of majoritarian democracy. Thus we want liberalization to work in a Leviathan state where people are seeking victim status, owing no responsibility for their disease, or making no effort to lift up their fortunes. Thus we put all morals aside. What is then the way out? How can we make market to work efficiently? How can we have limited government and individual responsibility?

Before we come to the way out, let us be aware of the fact that we receive various shocks while living in a risky society. Society has been likened to a laboratory with no scientist in charge. The moment we adopt globalisation, we have to give up several traditional certainties. The state is called upon to deal with such risks which cannot be foreseen and which cannot be statistically calculated. It means that there are certain risks, which nobody knows. I am aware of this fact, but I still leave the matter to be solved by scientists, universities, or social bodies depending on voluntary association. Allow others to preach freely—even live ideally and give sermons to live an ideal life. I only suggest that the state should not undertake the responsibility to attend to such unforeseeable and incalculable risk.

Civil Society is the Solution

The way out is to create a civil society in which all welfare needs are organized by society without the help of the state, or without politics. Instead of organizing them on compulsory basis by the state, it should be done on voluntary basis. We should remember that human beings have a desire to help, a desire to feel happy when someone progresses. He feels pain when he sees someone unhappy. Even a thinker like Rousseau believed that compassion is a natural feeling in men and Smith has already said that we feel much for others. Ropke has also said that the market functions in an atmosphere of freedom, spontaneity, entrepreneurship, honesty, respect for other human beings. These virtues can flourish in a civil society enjoying freedom and organizing welfare activities either in families, or in wider groups, or in the community by way of mutual aid, friendly societies, insurance companies, all working on a voluntary basis. Thus confining the state to a limited sphere of defence, maintenance of law and order, the preservation and protection of private properties, and due provisions for the fulfilment of private contracts entered into between individuals or enterprises. Beyond that, the state acts as an arbiter, referee, or an umpire for public services. If we take out the welfare services from the responsibility of the state, the state becomes limited, and the welfare functions are looked after by community without politics or by families, which would create the sense of individual responsibility in the people to lift themselves by their own bootstraps. In the post-communist world, we should strive for civil-society capitalism.

Notes and References

1. Adam Smith, *The Theory of Moral Sentiments*, Indianapolis, Liberty Fund, 1982, p. 48.
2. Ibid. p. 212
3. Ibid. p. 227
4. Ibid. pp. 228-229
5. Ibid. p. 71-72.
6. William Ropke, *A Humane Economy*, London, GS Ward Wolff, 1960, p. 123.
7. Ibid. p. 125.
8. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Indianapolis, Liberty Fund, 1981, pp. 9-10.
9. Ropke, *A Humane Economy*, p. 124.
10. M. Oakeshott, *On Humane Conduct*, Oxford, Clarendon Press, 1975.

3. Professor F.A. Hayek: A Life of Knowledge

Professor Hayek was known by various names: he was just Friedrich in his close family; he was Mr von Hayek in the official record of the British government; he was F A Hayek in academic and intellectual circles; he was Friedrich August von Hayek for his socialist critics, especially Clement Atlee, Prime Minister of England during 1945–1950. We will know him here as Prof. Hayek.

Prof. Hayek was born on May 8, 1899, during the last year of the nineteenth century and he died on March 23, 1992, just before the advent of the new millennium. Thus he lived almost throughout the whole twentieth century. His work dealt with the most important controversy the world has ever faced—socialism versus capitalism. The world faced a dilemma; Which is the best way to achieve social coordination? That is the interaction of various individuals with each other, in time and space, in their pursuit to obtain goods and services they need for a happier life. Although this dilemma has been in existence for the last several centuries, it had taken a very acute form in the beginning of the twentieth century, it's solution saw the light of the day only at the fag end of the century. It was Prof. Hayek who more than anybody else made that possible.

Social Co-ordination

By and large, there are two ways to obtain social co-ordination. The first is to allow every individual to prepare one's own plan to demand and supply goods and services which one proposes to consume or produce and negotiate with others so as to implement one's plan by trial and error. This system is known as capitalism or the market system. The other device is to follow the command of some central authority—which has prepared its own plan regarding what to produce, how to produce and for whom to produce. The decisions in such a case, are given from above, a politburo, a 'high' command. To achieve the objectives of such a central plan, there should be public ownership of means of production and the central authority should be capable of executing its own decisions. This is known as socialism. Which of them is better? Which one is lasting? Which one is natural? These are some of the questions posed.

It is necessary to mention here that both these concepts were variously presented. Socialism for some people was communism or fascism or democratic socialism, or mixed economy or social economy or just state interference in economic matters by way of controls, permits, rationing or fixation of prices and income. Capitalism has been called by some people as commercial capitalism, or industrial capitalism, or new capitalism, or competitive capitalism or free market or catallaxy. But the dividing line is working in a centralised or a decentralised manner, working from above or from below, taking decisions from above or from below or following compulsion or voluntary activity in implementing the decisions. By and large, anything central, compulsory, coming from above or pre-designed is socialism, while anything in contrast is capitalism.

Socialism equals Slavery

Over a span of seven decades, Prof. Hayek ceaselessly fought against socialism through his lectures, articles, and books and showed it as a way to disaster, degradation, slavery and poverty. There is hardly any progress, any creative work, or flowering of culture and civilisation in socialism. Only mean and base people come to the top and the society lives in an offensive climate of terror and conflict. For a large society like India it is impossible to have any reasonable level of social order under socialism. Because of a fatal conceit of constructivism, (the belief that society has been created by men and hence it could also be shaped by men as they like), the waves of socialism, the demand for it and the experiment of social organisation in that direction are likely to arise from time to time. Such experiments are not likely to survive any longer than they have in the past and the heavier the dose of socialism, the sooner they would die. Even in Soviet Russia, in the 1950s (after Stalin's death) palliatives were introduced in terms of prices.

The Market Process

On the other hand, the capitalistic way of bringing social co-ordination is a better way; it leads more or less to the efficient allocation of resources, a more just and agreeable distribution of income, and if implemented in its true spirit it would lead to eradication of poverty because it brings growth of the economy along with benefits to all strata of society. There is a trickling down effect in a competitive society, which is absent in a socialist economy. Market processes meet our needs perfectly well when we have differences in men and materials and the world remains ever changing. The market process may or may not be the perfect way for social co-ordination, but it is still the best amongst the ways known by human society. So far mankind has not been able to find out any better way than the market.

Although this market process is likely to be assaulted from time to time by constructivists, or utopians, or power hungry people, yet the market way of organising our utilisation of resources is so natural, so simple and so rewarding, that mankind could not give it up for long. It would come up even if the market is controlled, interfered, tampered and truncated. Wherever free and competitive forces are allowed to work, they work successfully. If they work over the whole economy, society cannot obtain a better situation than what it can obtain under any other circumstance. By giving these ideas and also after seeing the fulfilment of them from around 1970 till his death, Prof. Hayek once and for all gave a deadly blow to socialism and kept the torch of capitalism burning high at least for our own foreseeable future.

How did Prof. Hayek come to this conclusion? What are the intricacies or complexities of his analysis by which he could establish the superiority of the free market over planning?

Knowledge and Economics

Prof. Hayek unveiled his ideas in his presidential speech before the Economic Club of London in 1936. The title of his lecture was "Knowledge and Economics," which he published as an article in 1937. Here we find his most original contribution to economics, and also the turning point in the thinking about the market process. Later he developed this theme in his articles on knowledge and competition such as "Use of Knowledge in Society" or "Competition as a Discovery Process," or "Pretence of Knowledge," in which he elaborated his main theme given in the 1937 article. How did he come to this stage in 1936? What led him to come to such a profound and original contribution?

Before coming to this understanding, he cleared various decks. First he changed the whole approach to economics. He pointed out that in the mainstream of economics, we assume that relevant data has already been given. For example, we assume the following in the situation of perfect competition:

- There are many players (buyers and sellers) and no one buyer or seller commands more than a very small share of the market.
- All players are price takers, not price makers. Consequently, the price is known beforehand to all.
- The good is homogenous.
- There are no restrictions on entry and exit of players.
- There is perfect information available in the market to all players.
- There is perfect mobility of resources.

We try to find out how equilibrium is achieved between buyers when they go to the market with a given income as well a given price and sellers who bring to the market their produce. In fact what is really required to be done is to find out this data, which we assume to have been "given." All this data that we assume is actually unknown to us, we have to find it out. In addition, this data is initially unknowable for us. In fact it is the market process that discovers this data. The perfect competition model assumed away this very market process and supposes that we "somehow" know the outcome of this process. In his article on "Knowledge and Economics," Prof. Hayek suggested that with the help of market prices we obtain the information, which was not available to us before. Normally we do not know what are the preference maps of various individuals; we do not know how much supply of factor services can be made available by each individual. It is through balancing at the margin (marginal utility and marginal cost) with the help of prices we obtain the knowledge. He thus challenged the whole objective of economic theory in order to put his ideas in the right perspective. He showed how we adjust ourselves to the unknowable by obtaining relevant information through prices.

Methods of Analysis in Social Sciences

The second important issue, which he cleared, was in regard to the methodology appropriate to conduct research in social sciences. There was a tendency on the part of most economists to adopt the method of induction, which is appropriate to natural sciences. But social sciences differ considerably from natural sciences. Acts can be separated in natural sciences from the whole where laboratory experiments under controlled conditions are possible because all concerned elements remain the same or can be kept the same under controlled conditions. We can also find out the sequel of consequences in natural sciences. It is not so in social sciences where one has to deal with human beings who are not all the same. In fact man is a bundle of various impulses and that is why some times we find the same man acting differently although apparently all other conditions seem to remain the same. Historical evidence is also not completely reliable although it may give us the idea of series of possibilities. There is no provision of laboratory experimentation in social sciences to find out the consequences of a certain action. Therefore, according to Prof. Hayek, one has to rely on empiricism and try to draw a series of possibilities, some of which may turn out as reality. The inspiration for such a difficult methodology was Karl Popper's book *The Logic of Scientific Discovery* published in 1934. Hayek could then defy the positivists who depended heavily on induction as a scientific method of inquiry even in social sciences. Thus, he evolved his individualist and compositive methodology for inquiry in the field of social sciences.

The moment Prof. Hayek had the justification of empiricism in social sciences; the way to arrive at evolutionary theory was made easier. He was already very impressed by Carl Menger's *Principles of Economics*. In Menger's book the spontaneous growth of certain social institutions was beautifully described. Along with money, language and common law, according to Menger, the growth of the market was also spontaneous. The description of the evolutionary process given by Menger also impressed him. Hayek had pursued the study of psychology and had written a monograph on how the sensory order comes into existence. He knew about neural impulses, which work in a complex way in the human mind. The neural impulses create a picture of a pattern of possibilities of various consequences in future, which lead to a creation of a vision or a perception in our mind. This pattern of future possibilities lead us to take action. Such actions, on the basis of expectations, are taken in the manner of step-by-step movement or a "little more of this" and "little less of that," by various individuals. In moving this way, some simple rule of behaviour is evolved, which most people begin to follow. Such rules of behaviour eventually lead to the evolutionary process, which brings into existence some type of design or order. Thus equipped with empiricism and description of evolutionary process by Menger, it was but natural that Hayek arrived at the market process as an evolutionary event as well as the way co-ordination is achieved by adjustment of each individual with mutually interested persons on the pattern of possibilities of consequences in future. Every one before Prof. Hayek right up from Bernard Mandeville to Carl Menger referred to this evolution as the work of the invisible hand or just as a natural process. But nobody except Prof. Hayek had explained the way the evolution was taking place, or how and for what reasons such an evolution is taking place. Prof. Hayek explained threadbare all intricate and complex forces working in the evolutionary process and thereby made the invisible hand "visible."

This evolutionary process is not stagnant, nor is it a bolt from the blue. It is a constantly moving process because each individual can affect it in a small way but cannot fix its shape or design. Nor does it remain stagnant so that others can copy it. It is constantly moving. The earth revolves, but we human beings on earth do not feel this movement. Similarly without our noticing, the working of the market process, say through the price mechanism, makes adjustments to our changing opportunities in the plans of demand for, and supply of, goods and services. Thus by 1936 Prof. Hayek came to a true picture of the working of the price mechanism in the market process. Moreover for him, the competitive process in man is natural; if competitive processes were freely allowed, prices in the economy would help us to arrive at right decisions about what, how, and for whom to produce. To the extent this freedom and competition are restricted, our economic set up becomes deficient to that extent.

Price Mechanism

Here it is necessary to clear the haziness, which has cropped up in the history of socialism in the twentieth century. It is said that the controversy on socialism based on economic factors, started first by Ludwig von Mises in his book,"Socialism," which he published in 1922. There, Mises suggested that without the calculating mechanism, which is available in the form of prices in capitalism, socialism cannot make an efficient allocation of resources. Since in socialism, there is no market, there are no prices and hence there is no way to make calculations. Hence socialism is impracticable. Although Prof. Mises meant that without competitive prices based on free enterprise and private ownership of means of production, we cannot arrive at right decision regarding what, how and for whom to produce. But the way he presented his case led to confusion in several minds. He said: "The problem to be solved in the conduct of economic affairs is this: There are countless kinds of material factors of production…There are millions and millions of workers and they differ widely in their ability to work… Technology provides us … with numerous possibilities…which of these potential procedures and plans are the most advantageous?" He answers that question by saying that "It is then obvious that these questions cannot be answered by some calculation in kind…we need a common denominator." It is this way of presentation that led to a fruitless controversy and debate mainly in 1930s.

Really speaking, the function of prices is not just calculation as suggested by Prof. Mises. In that case it is an *a priori* view of prices as if they are given. They only help in making calculation easy, so that one can easily indicate the different proportions of factors of production to be combined. If this is a correct view then it can be easily countered. Why not give the economy the shadow prices beforehand so that calculation difficulty does not remain at all and socialism becomes practicable? Some people even argued that there is no need of giving even shadow prices to others; even the authorities can keep the shadow prices with them and make use of them. Moreover, mathematical formulae could do the same job. Later on it was argued that when computers are available, what is the need of having prices as a calculation device?

The whole calculation controversy, which started in 1930s ended without any fruitful result.

Therefore it was Mises who started this *jehad* against socialism and raised its pitch to a high degree but because of a misunderstanding about the role of calculation, Prof. Mises could not demolish socialism and establish the superiority of market process, and thus the *jehad* ended with a whimper.

How did Prof. Hayek explain it better? Or, according to Prof. Hayek, what is the role prices play in the market process which brings better social order? The role of prices in the market process can easily be described by giving examples of three phenomena found in our practical life. In the first place, it can be compared with the telecommunication system by which information is transmitted by way of signals to those who need that information for the execution of their plans of action. If the prices of cement go up, the message is given to those who are consuming cement. They are being told that cement is now more scarce as compared to other commodities and it should be used sparingly. It is also simultaneously a signal to cement producers that since the cement prices are now higher, they should expand their production, even by spending somewhat higher amount of money. They can pay a little more to those who are working in the cement factory and thereby attract others in order to expand their total output. This type of adjustment will begin to take place. Since the changes in price affect both the consumers as well as the producers, the distribution of income is also affected simultaneously. The higher income of those factors working in the production of cement in turn will raise the consumption of other goods by them. And this kind of ripple effect spreads far and wide over the greater part of the economy as a whole.

Due to the interconnection of production and distribution, prices in the market provide both information as well as incentives. The greatest beauty of the price mechanism is that signalling is done to those who need it and it is done to the extent it is necessary. No more, no less. The signalling by prices immediately changes the expectations about the future possibilities and the immediate plans of those who are affected are changed in consonance with the change in prices. Thus prices collect the information or knowledge, transmit the information to those who need it and provide the necessary incentive to act according to the information received. All this without any cost, and that too in no time.

No other mechanism, for example, the planning authority, can work so efficiently. In the central plan, there comes into existence a third party to whom information is to be imparted both by consumers as well as by producers. In this process *who* knows that correct information has been given! Who knows that what the consumers wanted to convey has been understood by the planning authority in the way consumers wanted? How can the planning authority find who would need what information? Who would do the sorting out process? All these processes are not only excessively costly; they are faulty also because there may be confusion caused in collecting information and transmitting it to those who need it.

Secondly, prices are in a way like locks in irrigation canals because they enable us to divert the resources where they are needed and store them when they are not needed. Prices enable us to store goods and services, guide us to send them where we need and to the extent we want. The use, as well as the storage of goods and services, is totally controlled by prices.

Thirdly, prices can be compared with the cybernetic system, i.e., the nervous system in the human body. If there is a fly on the leg, the brain is immediately informed of it. The brain in turn, the moment the information is received, immediately or simultaneously commands the hand to reach the leg and get rid of the fly. The signalling, as well as incentives, works in unison like a marching platoon and all this works without a failure and also without a cost. Probably the beauty of its working is that it is providing information where it is needed and giving incentives to those who need them, and to the extent and at the time when needed.

But one should remember that incentives and signalling synchronise because of the system of private property and competitive processes. Knowledge, is diffused among millions of buyers and sellers; one authority cannot collect it all. There is some type of knowledge, which can be used only by the man who has it. Sometimes knowledge cannot be given to someone else. Some type of knowledge cannot be transmitted in a correct manner. That is why the entire process of signalling and incentives is to be done in a system of free competition and on the basis of private property. The price system works in a manner we have described only under this circumstance. It leads then to efficient allocation of resources and just distribution of income; meeting all types of expected as well as unexpected changes and differences in the relative scarcities among the individuals. Thus the price system of the capitalist system works better than any other system we have known so far.

Prices are not *a priori* or given to us; they are evolved in the market process which itself is a spontaneous process. Similarly, the institution of private property, the social institution of family, and the rules regarding contractual obligations and honesty, have come into existence on their own in a spontaneous manner. They are due to nobody's design. They have been evolved by trial and error on the basis of the pattern of future possibilities and evolving into a perception, which comes out as reality. Fortunately all the institutions on which capitalism stands: free market, money, law, morality of honesty, right of private property and family are social institutions which have spontaneously evolved and remain in constant adjustment to changes which take place from time to time. They smoothly adjust to all types of changes and differences. It is not a stagnant process, but like a stream of water in the river, it goes on. Hence according to Prof. Hayek, this institution of capitalism will survive while all its alternatives known so far will have to die sooner or later. This is the greatest contribution of Prof. Hayek to the twentieth century.

Prof. Hayek asked the state to remain minimal and limited; he asked all utopians to restrict themselves to persuasions and sermons, never to use the instrument of the state to introduce their own whims in society. He demolished all constructivists who described themselves as social engineers. He asked them to divert their energy elsewhere, not in the field of social reconstruction through the instrument of the state.

In conclusion, it is interesting to note that Prof. Hayek faced many paradoxical positions in his private as well as in his public life, which was mainly academic and intellectual. This paradox served as a turning point in his career. Before he shifted to London in 1932 from Vienna, he had a love affair with his cousin whom he wanted to marry but could not due to some misunderstanding. He married another woman and shifted to London. But how fortunate he was in this shift! He left Vienna just before the time the intellectuals began to shift from Central Europe because of the growing offensive climate of fascist forces. And how fortunate he was to plunge immediately into a controversy with the Cambridge don and famous economist J.M. Keynes especially on unemployment, theories of capital, interest and trade-cycle, and the role of monetary and fiscal policies. Here he had to fight against Keynesian thoughts of cheap money and deficit financing and increasing state expenditure to boost employment. He succeeded in his task, but not immediately. It was only when the world faced the situation of stagflation, i.e., rising prices and falling production, that people realised the truth in what Prof. Hayek had said forty years earlier. Then the main criticism of capitalism was the Great Depression of the 1930s and while in London he discovered an answer by developing fully the theory of the market process, which we have described earlier.

Again he faced a social calamity. After World War II, he visited his family and met his cousin—his first love and found that she was open to marrying him. Prof. Hayek divorced his first wife and married his cousin, which led to social exclusion both in London and Vienna. Moreover, the publication of his most famous work attacking socialism, *The Road to Serfdom*, created a very hostile climate in academic and intellectual circles for him. He decided to shift to Chicago in 1950. In Chicago he worked for the practical alternative to socialism and published his *Constitution of Liberty*. Although he was a professor of social and moral philosophy, he remained in the centre of intellectual life, which was at a very high level in the department of economics. By and large the social climate in the U.S. was not comfortable to him. So he decided to shift from Chicago to Freiburg in Germany. He was there from 1962 to 1969. He retired from the University of Freiburg at the age of 70 and shifted to Salzburg in his own native country, Austria.

Again at Salzburg, he had a number of problems including health and working facilities. Here he did not find the academic facilities suitable to him; he also suffered from depression and he sold almost half of his very extensive library—obviously for financial reasons. He lost his mother in 1967.

The Noble Prize in Economics in 1974 was a godsend and marked a turning point in his life. It enabled him to come out from social and academic wilderness. One has just to remember that there were people, who wondered whether Prof. Hayek is still alive, when he was awarded the prize. He was almost written off from the academic circle but soon after the award, he was filled with youthful vigour and worked like a young intellectual form 1975 till his death in 1992. He shifted again to Freiburg and began to write profusely. Before he died, he wrote his final book, *Fatal Conceit: The Errors of Socialism*, which dealt a fatal blow to the now dwindling idea of socialism. He could see the fall of the Berlin Wall and breakdown of central planning all over Central and Eastern Europe including Russia. He could see the waves of economic reforms in China, U.K. and USA. He could see the privatisation and deregulation almost all over the world. He died at the ripe age of 93, after showing the better way for social co-ordination to the twenty-first century.

4. Professor B R Shenoy: In a Hayekian perspective

Professor B R Shenoy is very often compared with Professor F A Hayek. Strong similarities do exist, but there are dissimilarities, or at least differences of emphasis between them. In this article, I have made an attempt to bring out the similarities and dissimilarities between them, so that one can make a proper assessment of their contribution to economic analysis and the social and political philosophy they held.

Austrian Roots

Both of them were firmly rooted in the Austrian School of Economics, established by Carl Menger in 1871. While it may be natural for Prof. Hayek to adopt the Austrian system, since he was born, brought up, and educated in Austria, it was really unusual for Prof. Shenoy to be an Austrian thinker when in India there was hardly any economist who knew about it. Prof. Shenoy was educated at Benares Hindu University from where he obtained his M. A. degree in economics standing first in his class. He probably acquired his roots in Austrian economics during his association with the London School of Economics (LSE) from 1929-1932.

When he was in London, prominent economic thinkers in London as well as in Cambridge were both confused and disturbed. They could not analyse the depressing economic conditions that arose in England as well as elsewhere in the world especially after the return to Gold Standard. The world as a whole was facing a great depression and was on the brink of disaster. Almost everyone seemed to have lost faith in the market mechanism as propounded by English classical economists like Adam Smith, David Ricardo and John Stuart Mill. They were all in search of an alternative. For some thinkers, the alternative was abolition of the market mechanism as done in Russia at that time, while for some others, the alternative was large scale interference by the state with a view to correct defects in the working of the price mechanism. The latter was the approach followed by Cambridge economists led by John Maynard Keynes. There was also a third alternative—an arrangement that preserved both individual freedom as well as the market, if a correct diagnosis of industrial fluctuations was obtained. The Austrian School had made such an attempt, and Professor Shenoy seized an opportunity to pursue that third alternative when he joined LSE in 1929.

Before Prof. Shenoy attended Hayek's lectures on "Prices and Production" at the LSE in 1931, he was already working on capital theory as propounded by Austrian economists, especially Böhm Bawerk. He was dissatisfied by Keynes' Fundamental Equation in the *Treatise on Money*. In his attempt to criticise the Keynesian Fundamental Equation he published his first article, "An Equation for a Price Level of New Investment Goods" in the Quarterly Journal of Economics (QJE) in 1931. In this article he pointed out various defects in the Keynesian equation, which later Keynes himself accepted and decided not to publish the second edition of his *Treatise on Money*.

Prof. Hayek's lectures on Prices and Production at the LSE in 1931 confirmed the efforts of Prof. Shenoy and he was immensely encouraged to pursue Austrian Economics even more rigorously. As a result of his in-depth studies, he published his second article "Inter-dependence of Price-Levels," (QJE, 1933) which bears the testimony of his total commitment to the Austrian theory of capital and trade cycles. We find confirmation of this commitment in his later writings, such as publications of two articles: "The Classical Theory of Savings," (*Indian Journal of Economics*, 1944) and "Static Equilibrium Theories of Savings," (*Indian Economic Review*, 1953). This trend was also visible in his book *Post-War Depression and Way-Out*. Surprisingly in his *Post-War Depression and Way-Out* we find a clear analysis of the possibility of rising prices and falling production or simultaneous existence of inflation and unemployment resulting from the shift of resources from consumption industries to investment industries and vice versa. Prof. Shenoy had identified what was later known as stagflation.

Prof. Hayek was vindicated in the 1970's, when the world witnessed the conditions of stagflation in various countries, thereby nullifying Keynesian theories. However, even though occurrences of rising prices and falling production cropped up in India from time to time as Prof. Shenoy had predicted, his policies were not resurrected in India.

Intellectual and Social Alienation

Like Prof. Hayek, these Austrian roots in Prof. Shenoy led him to rigorously pursue the establishment of a free society based on individual freedom and the market economy. At Chicago, Prof. Hayek almost gave up the technical study of economic analysis and concentrated on social and political philosophy. It became necessary for Prof. Hayek to follow that path after the publication of *The Road to Serfdom* in 1944, as he was considered an untouchable in the intellectual and academic circles in England and (to a lesser extent) in the US. For Prof. Shenoy, the same happened in India. The Russian planning model adopted in India after 1955-56 forced him to concentrate his attacks on planning, socialism, state-expansion. Prof. Shenoy was a member of the panel of economists of the Planning Commission during the second five-year plan (1956-61). His "Note of Dissent," severely critiquing the plan resulted in him being kept aloof and even ignored by economists both in government, and in the universities. Some people described him as a "Cinderella" in Indian economics, while others went further to call him a madman.

Both of them faced this situation squarely with courage and determination. They stood up as a minority of one against the tide. Their grip on economic analysis was so sound that no one could challenge them in print. They answered all queries and criticisms raised by others. Both wrote profusely in favour of their philosophy in the press, periodicals and learned journals. Both of them were on a *jehad*. Prof. Hayek spoke more on the market process and role of prices both as signals and incentives. Prof. Shenoy concentrated on deficit financing and the need to have a stable rupee in India. Both of them proved to be prophetic. Prof. Shenoy's analysis about deficit financing, its inflationary effects and the evils of inflation resulting in smuggling, lop-sided investment, controls, perverse income shift, capital starvation of agriculture, increase in economic wastage, etc proved to be right. Similarly Prof. Hayek was also proved right when the Berlin Wall fell and communism from Russia, Central and Eastern Europe was thrown out lock, stock and barrel.

Trysts with Government

For both, their calling was to be academicians and professors, teachers in the true sense of the term. Prof. Shenoy was brilliant from childhood. He stood first class first in MA (Economics) at Benares Hindu University. His parents wanted him to enter the Indian Civil Service. It was natural for intelligent young men to opt for such a career. Prof. Shenoy could have easily entered the ICS if he wanted to but he did not. Any government job was unsuitable to him, in fact suffocating for him. He wanted to pursue the truth as he saw it. He could not put up with anybody's dictates. He never felt at home at the Reserve Bank of India and the International Monetary Fund when he was there during 1945-1953, although it was a very prestigious position. He was most comfortable as University Professor of Economics in Gujarat University. He would prefer to remain so till the end of his life.

How could he be comfortable in the RBI? When Prof. Shenoy took up his appointment in 1954 in Gujarat University, he resigned from his substantial post in RBI and kept a lien on it for six months. Having taken up his Professorship he wrote an article on "Foreign Exchange Rate of the Indian Rupee" in the *Times of India,* in which he showed how overvalued the Indian rupee was. He criticised the foreign exchange control policy, which attracted the attention of C. D. Deshmukh, then Finance Minister of India, who reminded him of his lien. Prof. Shenoy immediately took off his lien in order to maintain his academic freedom.

Prof. Hayek's parents would have liked him to go for a diplomatic career; but he preferred to be an academician. Surely both of them would have been like fish out of water if they were forced to work for any government. Incidentally, during their youth both of them had a strange sojourn. Prof. Hayek spent more than a year in the Austrian Army on the war front in Italy in 1917-18, while Prof. Shenoy spent some time in Nagpur jail while participating in the Freedom Movement in 1922-23.

Reaching Out

Along with all such similarities between the two, there were some dissimilarities, at least of differences in emphasis, among them. Prof. Shenoy had the gift of the gab; his expression was so serene that anyone would listen to him with full attention. His exposition was flawless, faultless, and with gusto. He always presented his case with facts and figures and his manner of exposition was such that every one in the audience was kept spellbound and convinced. It was for this reason that many economists avoided participating in debates with him. I have never heard so effective a speaker on economic matters. I still remember the lecture on “Foreign Aid in India” delivered by him on the occasion of a celebration of the Golden Jubilee of the Indian Economic Association at Chennai when Prof. C.N. Vakil of the Bombay School of Economics was in the chair. The audience was kept spellbound and captivated; the Chairman himself changed his position to be able to look at Shenoy throughout the fifty minutes he spoke. Since it was a golden jubilee celebration, the audience was full of economists both from India and abroad. I have never heard a lecture like that in my life. Even Prof. Vakil was impressed and said so in his presidential remarks “We are so convinced that I need not add anything.”

Once, when both Piloo Mody and I were Members of Parliament in the fourth Lok Sabha, I took Piloo to a symposium on “PL-480 and its Monetary Effects,” which was organised by the Economic Research Centre. Apart from Prof. Shenoy, we heard various speakers including Prof. M. L. Dantwala, Prof. D. T. Lakadwala, Prof. Anjaria, and Prof. Adarker. By the end of the symposium Piloo remarked “What a giant Prof. Shenoy is; all others were just pygmies.”

Not only was Prof. Shenoy extremely effective in his lectures before learned gatherings; he was even more effective in his personal talks, one to one. I remember two memorable incidents: Once in Delhi in 1971, I took him to meet Ashok Mehta for a casual discussion over lunch. Ashok Mehta was former deputy chairman of the Planning Commission and a cabinet minister for several years and a leading exponent of socialist philosophy. Both knew of each other and knew also very well what their views were on the social, political and economic problems India was facing. As soon as they began to discuss Indian planning, Prof. Shenoy, without any break, presented his views with all facts and figures such that Ashok Mehta just kept quiet and heard them as if he was in full agreement. Ashok Mehta had in the past faced many intellectual giants without being awed by anybody but this time while facing Prof. Shenoy he heard him without the blink of an eye.

There was another incident, which is vivid before me even today. I wanted Chaudhary Charan Singh to know what the problems of India were and what could be done to solve them. So I took him to Prof. Shenoy’s residence in Delhi. After some formalities, Prof. Shenoy began to describe the conditions of Indian farmers, the rural populace, and agriculture itself. He chalked out an alternative policy so effectively that Chaudhary Charan Singh heard him quietly with deep interest. At times, the scene was like a pupil hearing his teacher. Prof Shenoy's conversation was very fruitful because Chaudhary Charan Singh was a Home Minister, Finance Minister and a Prime Minister during the sixth Lok Sabha as well as being a foremost Gandhian thinker and a great defender of the rural masses.

It was really for such reasons that I wanted Prof. Shenoy to be in Parliament. There was one chance in 1968 to get him elected to the Rajya Sabha from Gujarat. After the fourth General Elections in 1967, the Swatantra Party had a sizeable strength in the Gujarat Assembly and the party could easily elect one member for the Rajya Sabha.

I persuaded him to stand, and he was agreeable, but alas, the Swatantra Party leaders who used to describe him as the No. 1 economist of India and the architect of the party's economic programme did not encourage my efforts, and my plan failed. I was sure that the whole Lok Sabha would have flocked to the galleries of the Rajya Sabha to hear him speak on the budget or on important debates pertaining to economic matters! The Party would have gained a lot.

Family Life

Prof. Hayek and Prof. Shenoy also had contrasting personal lives. Prof. Shenoy had a happy and contended married life. His wife Ansuyaben Shenoy was a cultured and urbane lady. She held the same social and political philosophy; sometimes she was even more wedded to economic freedom. She stood by him through thick and thin, always ready to help him in all respects. As their inheritance, they gave to the world their daughter Sudha Shenoy who is a chip of the same block. Sudha is at present a leading member of the Austrian Economic School. Ansuyaben Shenoy looked after Prof. Shenoy's work even after his death in 1978. One cannot say so in the case of Prof. Hayek who divorced his first wife in order to marry his cousin with whom he had a love affair in his young age before he married his first wife. None of Hayek's children took up studies in economics.

Sometimes Prof. Shenoy was the proverbial absent-mined Professor who remained preoccupied with his work. I remember an occasion when my astrologer friend who was adept in reading the future by measuring the shadow of a man, asked him the name of his son. To this question Shenoy could not reply! In vain he tried to remember the name but could not. My astrologer friend then asked him whether it is like the name of the Buddha, like Gautam or Siddharth? And instantly he said "Oh Yes, Siddharth." Isn't forgetfulness natural in Professors?

We can also point out one important difference in ideology between the two in the field of monetary policy. According to Prof. Shenoy, deficit financing or creation of money in order to meet the requirements of increase in national income cannot be described as inflationary. It means that creation of money in proportion to increase in national income is non-inflationary. Prof. Shenoy is in the good company of Prof. Milton Friedman in this regard, however Prof. Hayek disagrees with this view. Prof. Hayek believed that the market would decide to what extent increase or decrease in money is required. There cannot be any rule for that and there cannot be any authority to decide that. Of course both of them were violently against any attempt to adopt a cheap money policy.

There is also another striking dissimilarity between the two: when Prof. Shenoy died in 1978, there was hardly any possibility of anyone accepting his prescription in India. I remember when I saw him two days before his death, in hospital; he was worried about his failure to convince the Government to give up their socialistic policies. He was worried about the pathetic condition of the people, as well as of the Indian economy. He prayed to God to give wise counsel to the Indian government. There was indeed a small consolation for him when the Janata Party came to power in March 1977 (it removed food zones immediately), but that too dissipated. With high hopes he had written an article “Economic Growth with Social Justice” which he submitted to Janata Party in 1977. Although doubts about planning were already visible elsewhere, there was some hesitation to turn to the market mechanism as an alternative in 1977. It was 13 years after his death that the Government of India agreed to take the U-turn as he had suggested, and even then it was done in a half-hearted manner—a sort of limping liberalism. In contrast, when Prof. Hayek died in 1992, he could see that his policy prescriptions were already being pursued almost everywhere in the world.

THE CENTRE FOR CIVIL SOCIETY is an independent, nonprofit, res-earch and educational organization devoted to improving the quality of life in India by reviving and reinvigorating India's civil society. India will be peaceful, harmonious, and prosperous, not by simply imitating other societies, but by building a system that complements, adapts, and elevates its culture and traditions. Towards that goal, the Centre provides a forum to enhance public understanding of the nature, role, and significance of civil society.

WHAT IS CIVIL SOCIETY? Civil society is an evolving network of associations and institutions of family and community, of production and trade, and of piety and benevolence. Individuals enter into these rela-tionships as much by consent as by obligation but never under coercion. Civil society is premised on individual freedom and responsibility, and on limited and accountable government. It protects the individual from the intrusive state, and connects the individual to the larger social and economic order. Civil society is what keeps individualism from becoming atomistic and communitarianism from becoming collectivist. Political society, on the other hand, is distinguished by its legalized power of coercion. Its primary purpose is to protect civil society by upholding individual rights and the rule of law.

RELATION BETWEEN CIVIL AND POLITICAL SOCIETY The rampant growth of the political society—the institutions of government—since independence has become a hindrance to the flourishing of civil society in India. It is only by rethinking and reconfiguring the political society that India will be able to achieve economic prosperity, social peace and cohesion, and genuine political democracy. The "principle of subsidiarity" demarcates the proper arenas for civil and political society, and for local, state, and central government within the political society. The prin-ciple suggests that the state should do only those things that people cannot do for themselves through voluntary associations of civil society. The functions thus assigned to the state must be entrusted first to local gov-ernments. The functions that local governments cannot perform should be given to state governments and only those that state governments are unable to undertake should be delegated to the central government.

THE CENTRE'S ROLE The Centre's activities are based on this under-standing of civil and political society. It endeavours to broaden the public debate on critical economic and social issues and to provide innovative, effective, and enduring solutions. The programs and publications of the Centre help guide public policy and private initiative to rebuild and streng-then civil society. The Centre commissions rigorous studies from scholars and communicates findings to targeted groups—policy makers, opinion leaders, and the media—and to the general audience through lectures, seminars, and conferences, and by publishing books, reports, and commentaries.

The motivation behind the Centre is the poignant paradox of intelligent and industrious people of India living in the state of destitution and des-pondency. The Centre was inaugurated on August 15, 1997 signifying the necessity of achieving economic, social, and cultural independence from the Indian state after attaining political independence from an alien state.

Though the Centre collaborates with all on specific issues, it accepts direct support only from the civil society. The Centre's activities can be summarized under two groups: policy research and advocacy, and education programs.

Policy Research and Advocacy

Dialogues provide a forum for discussion of topical policy issues from diverge perspectives. Issues covered: Anti-dumping Rules, Sustainable or Sustained Development, Competition Policy, Abuse of VIP Security, Watershed Development, Self-Regulation in the Civil Society, East Asian Crisis, Education Alternatives, Liberalization.

Self-Regulation in the Civil Society edited by Dr Ashok V. Desai explores voluntary alternatives to state regulation for assuring quality and safety of goods and services. Rs 100

Agenda for Change edited by Bibek Debroy and Parth J. Shah outlines precise and comprehensive reforms for various departments/programs of the government. *Out of Print*

Kissan Bole Chhe by R. K. Amin is a broad sweep of the evolution of agriculture with a specific focus on India's agricultural policy narrated through the life story of a farmer. Rs. 200

Friedman on India, edited by Parth J. Shah, with a foreword by Deepak Lal has articles that Milton Friedman wrote on the Indian economy during his visits to India in the fifties and sixties critiquing the policies of planning and correctly predicting their disastrous results. Rs. 75

Policy Studies provide scholarly analysis of important public policy issues. The topics include Economic Freedom and Economic Growth, Private and Political Markets, Taxation, Labour Laws, Telecom Services, Environmental Policy, and Intellectual Property Rights.

Research Internship encourages college students to engage in grassroots research to collect primary data over a period of two months during the summer vacation.

Education Programs

Liberty and Society Seminar aims to provide college students a greater understanding of the larger world—society, economy, and culture—from a classical liberal framework that emphasizes limited government, rule of law, free trade, and competitive markets. It has been held in Ahmedabad, Bangalore, Calcutta, Delhi, Devlali, Hyderabad, Lucknow and Mumbai.

B R Shenoy Memorial Essay Competition attempts to increase awareness about ideas and principles of civil society. The last two topics were "Education: The Role of Markets," and "Markets, Morality, and Prosperity."

How Markets Work: Disequilibrium, Entrepreneurship and Discovery by Israel M. Kirzner elucidates the views of Ludwig von Mises and Friedrich Hayek of the market as a process, competition as a discovery procedure, and entrepreneurship as the engine of economic growth. Rs. 50

Business Journalism Workshop discusses national and international issues to enhance the information base of business journalists. With the help of Swaminathan Aiyar, *Economic Times*, it has been held at Delhi, Hyderabad, and Chennai.

Liberty and Civil Society Workshop introduced ideas of economic freedom, role of civil society in social infrastructure, and new public management to IAS and other all India services at the National Academy of Administration, Mussoorie.

Issues in Civil Society; Economics in One Lesson is a one-day program for college students in Delhi to discuss issues of their interest and concern.

Resource Centre

The Centre maintains a library of several thousand books, publications of a large number of public policy research institutes, and computers with internet access. The library is open to the public. The Centre plans to open similar resource centres throughout India.

Laissez-faire Books

Through arrangements with publishers and distributors, the Centre makes available for purchase books promoting its principles and ideas.