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Communication

Money and the Invisible Hand: A Correction

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One section of our article "How Would the Invisible Hand Handle Money?" (1994) offered a critical discussion of Robert L. Greenfield and Leland B. Yeager's (1983) novel proposal for a "separated" competitive payments system. We wish to point out here an analytical error in one part of our discussion, a paragraph suggesting that a system of Greenfield-Yeager banks could over-expand in unison without triggering an automatic correction (p. 1741). Actually, arbitrage would constrain the quantity of bank-issued exchange media in the case we posed.

In the Greenfield-Yeager system, bank-issued exchange media are denominated in a unit of account, perhaps called a "valun," which is defined in terms of a bundle (or basket) of commodities. Banks do not redeem their exchange media (currency or transferable deposit or share accounts) directly for actual bundles, but instead offer a more convenient redemption medium, perhaps platinum. The redemption rate is continually adjusted so that the holder of a one-valun bank claim always gets just enough platinum, at current prices, to purchase the goods that make up the valun bundle. If the market price of platinum falls relative to the value of the bundle, for example, the redemption rate (oz. of platinum per one-valun claim) correspondingly rises, so that the purchasing power of valun claims is stable in terms of the bundle of goods.

We posed as a thought-experiment "an in-concert expansion by Greenfield-Yeager banks that proportionately raises both the prices of bundle goods and the price of platinum in terms of exchange media." We observed that "the basket-platinum cross-price would not change, and hence no bank would have to offer more ounces of platinum per one-valun claim redeemed." We then leapt to the erroneous conclusion that "no arbitrage between the market and bank prices of platinum would be triggered," and professed to be puzzled as to how the quantity of bank claims would then be constrained.

In fact, although the banks would continue to pay the same amount of platinum per one-valun claim, this amount would now be greater than the amount of platinum that a one-valun claim could purchase in the market because the very scenario we posed would have caused the market price of platinum to rise. (We somehow lost sight of this discrepancy between the market and bank prices of platinum.) Arbitrage would in fact be triggered, forcing the banks to satisfy the entire market demand for platinum. The expansion would thus be checked, and could not proceed.[1]

[1] For a recent exchange on the question of whether a system of separation and indirect convertibility is generally workable, see Greenfield, William Woolsey, and Yeager (1995) and Norbert Schnadt and John Whittaker (1995).

We regret the error and hope that this correction will help to avoid its propagation.

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