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## Friedrich Hayek On Monetary and Banking Systems Reforms

### Abstract

Throughout his life, Friedrich Hayek worked towards prescribing a monetary policy under which the world economy would again enjoy the stability it had known under the classical international gold standard system. This paper presents three banking and monetary systems that were pivotal in the history of banking and closely scrutinized by Hayek. The paper outlines those systems, summarizes Hayek's comments on each and then discusses the recent literature on the subject in the light of Hayek's influence.

### Keywords

Friedrich Hayek, Monetary Policy, Gold Standard, Monetary Reform

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## **Introduction**

Throughout his life, Friedrich Hayek worked towards prescribing a monetary policy under which the world economy would again enjoy the stability it had known under the classical international gold standard system. The history of that quest is revealed in several books and numerous academic papers as well as lectures and interviews. His reflections enable us to follow the evolution of his thinking as he worked to eliminate inconsistencies. I believe modern economists seeking remedies for modern monetary and banking problems would do well to follow the path Hayek laid out.

This paper describes three banking and monetary systems that were pivotal in the history of banking and closely scrutinized by Hayek, outlining those systems and summarizing Hayek's comments on each, before discussing the recent literature on the subject in the light of Hayek's influence.

The first section deals with monetary and banking theory in order to understand the origin of money and the development of banking and bank note systems. The second section explains the origins of competitive private banking and administration of money without a central bank using the example of banking in Scotland. The third section analyzes the monopolization of money by the state and the administration of the international gold standard system by central banks. The fourth section traces the process whereby governments gradually abandoned the classical gold standard system and replaced it with "monetary nationalism" by undermining the convertibility of bank notes to gold. This is the now familiar system of central banking with fiat money. Finally, in the fifth section the article concludes with Hayek's own reflections on each of these stages in the history of banking and provides a brief description of his alternative.

## **I. Monetary and banking theory**

It was Carl Menger (1892) who first explained that money is an institution which originates not in a decision by an individual or a group of people but as a spontaneous order arising out of countless uncoordinated efforts to overcome the problems and inefficiencies inherent in bartering.

The history of money and banking reveals a trial and error process whereby individual traders, imbued with entrepreneurial spirit, created a market for specific commodities in high demand in order to improve the efficiency of bartering. Menger (1892) highlights the exchange of salt and slaves within Africa, the demand for wax honeycombs in the upper Amazon, cod in Iceland and Newfoundland, snuff in Maryland and Virginia, sugar in the British West Indies, elephant tusks in the Portuguese colonies in Africa and India and packets of tea in northern Asia and Siberia. He notes that trade in these commodities continues to this day.

A similar tendency to use metals, especially silver and gold, emerged over time in a variety of societies with different customs and cultures. Experience proved that the qualities of silver and gold in particular make them attractive proxies for value and hence for use as money because they were: 1) valued both as ornaments and as a medium of exchange; 2) divisible in powdered form yet could be recombined into any desired quantity in either granular or solid form; 3) homogeneous commodities with minimal scope for differentiation; 4) easily transportable without loss of value; 5) durable in the sense that they lost value due to wear only over very long periods of time; 6) relatively stable in value over time; and 7) difficult to counterfeit.

To avoid the risks and inconvenience of transporting metallic exchange media some merchants specialized in establishing storage facilities where clients could place their coins for safekeeping. A 'warehouse receipt' issued against the deposit itself assumed a value

approximating the value of the commodity in storage. Initially, this value pertained only to the individual named in the receipt and could only be transferred by endorsement. Later the value was transferable without endorsement, with the result that the bearer of the receipt was entitled to exchange it for the value indicated. Warehousing charges were determined by competition and defined in various contractual arrangements. Warehouses specializing in the storage of currency became known as banks and the receipts they issued as bank notes.

At first, bankers limited the printing of bank notes to the value of metals on deposit, but they soon realized that the commodity money held would only rarely be redeemed by customers. Hence, it became practicable to print money in excess of deposits on hand, in which case it was backed only to the extent of some fraction of the deposits held at a given time. Fiduciary media supported by fractional reserves are thus only partially backed by reserves of valuable commodities on deposit.

## **II. The origins of competitive private banking**

In one of Hayek's last articles on monetary issues ((1979) p. 313-314) he explained that:

Ever since the development of capitalism it has never been allowed to produce for itself the money it needs; and if I had more time I could show you how the whole crazy structure we have as a result, this monopoly originally only of issuing gold money, is very largely the cause of the great fluctuations in credit, of the great fluctuations in economic activity, and ultimately of the recurring depressions. I think if the capitalists had been allowed to provide themselves with the money which they need, the competitive system would have long overcome the major fluctuations in economic activity and the prolonged periods of depression. At the present moment we have of course been led by official

monetary policy into a situation where it has produced so much misdirection of resources that you must not hope for a quick escape from our present difficulties, even if we adopted a new monetary system.

This conclusion is supported by the research Vera Smith (1936) undertook in her doctoral thesis under Hayek's supervision. She studied the development of central banking in different contexts: those of England, Germany, France, the United States and Scotland. In England, for example, Smith highlights a preliminary stage wherein traders deposited their balances of coins and bars of gold or silver with goldsmiths. At the time, entry into this proto-banking field was not restricted, but this lasted only as long as the business was insufficiently important to attract the attention of legislators.

The inclusion of Scotland among her examples makes Smith (1936) one of the original works on free banking. This aspect of her work was further developed in the subsequent contributions of Ludwig von Mises (1949), Lawrence H. White (1984), George Selgin (1988) and Kevin Dowd (1992), among others. Collectively these authors enhance our understanding of what constitutes a private banking system, one totally free from any state intervention.

It is not easy today for the general public and even modern economists to imagine a system where money and banking lack government control or intervention. But in the literature, we find references to free banking as a theory and even to some historical cases in which there was a competitive private banking system. Under such a system, different companies can freely enter and leave the banking market and print their own banknotes. This is the antithesis of monopoly power over the issuance of currency, a power today normally vested in central banks.

Banknotes issued in a free-banking regime are not necessarily a currency. In this system the currency – normally gold or silver as indicated in the previous section – had already been spontaneously selected by the market. Private issuers and banks are able to print banknotes backed by deposits of this commodity money.

Here it is useful to consider the case of Scotland. The Bank of Scotland was founded by a group of merchants in 1695, just one year after the Bank of England. It was granted a twenty-one-year monopoly by the Scottish parliament. Almost immediately the Scottish bank implemented a policy of opening branches and began to issue notes worth an even one-pound sterling.

Historians explain that there were no restrictions on entering the banking business in Scotland, provided shareholders were willing to accept unlimited liability for debts incurred by the company. Banks soon appeared around the country, despite the absence of any enabling legislation. Neither were there any restrictions on the number of partners and, after a short period of experimental banking in which some fraudulent operations appeared briefly, banking rapidly became concentrated in the hands of a few sizable and financially robust corporations. There are cases in the literature where the soundness of banks apparently able to ‘create money out of nothing’ is challenged. However, the overall system imposes a limit on the demand side.

One of the instances of fraud was instrumental in improving the institutional robustness of private banking. Vera Smith (1936) points out that the Ayr Bank collapsed in 1772 after it over-issued banknotes. This failure did much damage to the reputation of the smaller banks. In response they quickly adopted an inter-bank clearing mechanism whereby the notes issued by different banks were offset against each other. This mechanism reduced the exposure that occurred when a bank accumulated a sizeable balance of notes in a bank which subsequently failed. Banks with branches adopted a similar clearing mechanism almost from the outset. The net effect was the rapid development of deposit banking and lending techniques relative to the rate of similar developments elsewhere.

As Ludwig von Mises explains in his *Treatise of Economics* ((1949) p. 444): “It is obvious that an expanding bank would very soon find itself in a difficult position in terms of clearing with the other banks.” However, the failure of a bank operating irresponsibly is quite

a different matter than the systemic bankruptcy of an entire system, something witnessed on a number of occasions in the course of the twentieth century.

Mises ((1949) p. 447) admits that some people may ask:

“[W]hat about a cartel of the commercial banks? Could not the banks collude for the sake of a boundless expansion of their issuance of fiduciary media? The objection is preposterous. As long as the public is not, by government interference, deprived of the right of withdrawing its deposits, no bank can risk its own good will by collusion with banks whose good will is not so high as its own. One must not forget that every bank issuing fiduciary media is in a rather precarious position. Its most valuable asset is its reputation. It must go bankrupt as soon as doubts arise concerning its perfect trustworthiness and solvency. It would be suicidal for a bank of good standing to link its name with that of other banks with (a) poorer good will. Under free banking a cartel of the banks would destroy the country’s whole banking system. It would not serve the interests of any bank.”

As the system develops, some banks earn a reputation for reliability, and beyond that point the stability of the system is difficult to breakdown.

Vera Smith (1936) notes that in Scotland in 1826 there were three ‘chartered’ banks (with 24 branches), 22-stockholder-owned banking companies (with 97 branches) and 11 private banks, while at the same date England was still passing legislation allowing joint-stock banking and the Bank of England had yet to open a branch.

Why then was this system abandoned? Mises ((1949) p. 447) explains that “... governments interfered precisely because they knew that free banking keeps credit expansion within narrow limits.”



### **III. Monopolization of money by the state**

Elsewhere in Europe, private banking did not enjoy the same latitude as in Scotland. Private banking initiatives were quickly overtaken by political events. In the British case, for example, the Bank of England was established in 1694. Charles II came to rely heavily on credit from London banks. The debt was such that in 1672 the Treasury suspended payments. In seeking alternative sources of funds, William III and his government accepted the plan of a financier named Patterson to found an institution that would become known as Governor and Company of the Bank of England. It was basically an agreement between the government and a corporation in which lending on easy terms was exchanged for specific privileges. Within only a few years those privileges included a monopoly over issuing bank notes. Thus, between 1694 and the early nineteenth century the British Treasury benefited from low-interest loans offered by the Bank of England to finance the government's fiscal deficits. Historians confirm that privately issued money had already disappeared in London by 1780. During this period the smaller provincial banks were accustomed to taking their cash balances to the Bank of England, and also to seeking help there when faced with liquidity problems. Hence the Bank of England quickly assumed all the characteristics we now routinely associate with central banking.

In France the story was similar. Historians emphasize the privileges granted to John Law in 1716 for Banque Générale; these ended badly with the closure of the bank only five years later, following the profligate issue of paper money. Although some banking companies did subsequently open their doors for such transactions as exchange and discounting, this lasted only until 1776 when a new central bank, the Caisse d'Escompte, was founded as a limited liability company by Turgot, the French minister of finance. From the very beginning, the bank was associated with the government and in 1783 an advance to the Treasury of 6,000,000 French francs caused a run on the bank that ended with it suspending payments.

In 1792, a decree prohibited the establishment of banks issuing notes. However, it was repealed in 1796-97, thereby encouraging some discount banks in Paris to start issuing banknotes again. The freedom that prevailed briefly among the French banks seems to have proved extremely satisfactory, and no disaster occurred. Unfortunately, however, the situation did not survive the relentless march of political events.

The centralizing mania of Napoleon, and the difficulties encountered in trying to obtain credit from institutions which lacked confidence in the government, led him to short-circuit the process by exploiting the potential benefits of a bank established under the auspices of government. In 1800, he persuaded the shareholders of the Caisse des Comptes Courants, one of the most successful banks, to dissolve the company and turn it slowly into a new entity: the Bank of France. The original capital of the Bank of France was 36,000,000 French francs, partly obtained from the Caisse, in part by public subscription and partly from the national debt.

The wait for the end of free banking in France was short. The famous Loi du 24 Germinal an XI ( April 14 1803) gave the Bank of France the exclusive privilege of issuing banknotes in Paris. It also forbade the establishment of new banks with the right to issue banknotes without the explicit consent of the government. Furthermore, the government retained the right to regulate the volume of notes circulated.

Constant pressure from the state to obtain funds from the bank again led to suspension of payments, prompting Napoleon to blame the bank and implement reforms which provided the state with sufficient control over its affairs to ensure uninterrupted funding of government needs.

Historians show that the absence of free banking in France led to a profound delay in banking matters in comparison to the practices developing not only in Scotland, but also in

England. This was particularly true in the provinces where there were no banks. Attempts to open branches failed in the absence of an established clearing mechanism.

The Bank of France continued to enjoy privileges, as the French franc had been decreed legal tender throughout the country, while the notes of the provincial banks were only negotiable within their respective localities. A decree of 1848, under which provincial banks merged with the Bank of France and became its branches, completed the process.

Since then there has been a public monopoly over the issue of money in France. These changes occurred in time to hamper the progress of the industrial revolution. The credit shortage was acute in the provinces but also affected Paris.

The cases of England and France in terms of their banking history are illustrative of the early development of the central banking system throughout much of continental Europe. In each instance this occurred when a single monetary authority obtained the privilege of issuing money in exchange for monetizing government deficits.

In one of the few references Hayek makes to free banking and to the work of Vera Smith ((1976) p. 90) he notes that:

This debate turned on the question whether commercial banks should have the right to issue bank notes redeemable in the established national gold or silver currency. Bank notes were then very much more important than the scarcely yet developed use of chequing accounts which became important only after (and in part perhaps because) the commercial banks were in the end definitely denied the right to issue bank notes. This outcome of the debate resulted in the establishment in all European countries of a single bank privileged by governments to issue notes. (The United States followed only in 1914.)

Nonetheless this arrangement worked relatively well, initially. Each bank, despite having the privilege of issuing money throughout the nation, limited credit expansion because it was constrained by the amount of gold maintained as a reserve. Although instances of inflationary policies did occur in the early days of central banking, they were limited by the requirement to maintain parity with gold.

This marked the advent of the gold standard system. As Hans Sennholz (1979) explained, the world had an international currency provided the gold standard was maintained. This came into existence without international treaties, conventions or institutions. The gold standard provided an international medium of exchange with minimal risk. When the major countries adopted gold as their common currency, the world had international currency convertibility with exchange rates determined by parity with gold.

It was the First World War that caused serious damage to this system. Central banks acceded to governments in need of extraordinary levels of financing for the public expenditure required by the conflict. England, for instance, broke “the rule of the gold standard” by issuing a huge amount of sterling without support and could not sustain the convertibility to gold after the war. The same happened in France and other European countries. The only exception was the United States, which emerged as a creditor nation, and persisted with the gold standard (Hayek, 1925).

Although it is true that the U.S. maintained a gold standard for a while, the benefits of the international system no longer existed. The final step in the expropriation of money and the passage into what Jacques Rueff called “the Era of Inflation” occurred on August 15th, 1971, when U.S. President Nixon suspended convertibility to gold in international payments.

## **IV. Replacement of the classical gold standard with “monetary nationalism”**

Adherence to the gold standard made no sense once the major economies ceased to respect the ‘rule’ and central banking spread to other countries. International exchange imbalances in the Depression increased the attraction of the central banking mechanism and its use became widespread in the 1930s when it was adopted by Latin American countries and Canada. Because central banking precluded the spontaneous development of private banking, abandonment of the gold standard gave rise to “monetary nationalism”: a central banking system with fiat money.

Hayek ((1937) p. 73) immediately anticipated the three fundamental problems with this arrangement:

[T]hat there is no rational basis for the separate regulation of the quantity of money in a national area which remains a part of a wider economic system; that the belief that by maintaining an independent national currency we can insulate a country against financial shocks originating abroad is largely illusory; and that a system of fluctuating exchanges would on the contrary introduce new and very serious disturbances of international stability.

The next forty years showed Hayek's predictions were indeed correct. Discretionary management of monetary policy proved incapable of moderating the business cycle or inflation, and instead exacerbated their impact.

Beginning in the seventies, some critical literature began to emerge advocating rules designed to limit the discretionary application of monetary policy. Thus, the Friedman rule of setting the increase in the money supply by a constant percentage rate every year (from 3 to 4%) irrespective of business cycles (Friedman (1969)); the Taylor rule that sets the nominal interest subject to a target of real GDP growth and inflation (Taylor (1997)); the rule of inflation

targeting (Bernanke and Mishkin (1997)) along with several others, made it possible to reduce inflation throughout much of the world to single digits at the beginning of the twenty-first century, without the gold standard.

It is important to emphasize that, despite success on the inflation front, monetary rules were at best impotent and probably harmful in terms of their effect on the business cycle. The United States, for example, has in recent decades experienced a number of financial tsunamis in the shape of the S&L savings and loan (S&L) crisis in 1987, the dot-com crisis of 2001 and the subprime crisis of 2008 (O'Driscoll (2009); Ravier and Lewin (2012)).

## V. Conclusions

The previous sections lead us to conclude that the performance of the banking system has deteriorated over time. No system is perfect, but each new alternative (only) seems to add to the list of problems with the prior arrangement, without overcoming the problems identified previously. Hayek's observations on the alternatives presented in previous sections, considered here in reverse order, give some insight into the development of his thinking regarding a more promising solution.

Hayek was highly critical of "monetary nationalism", meaning the management of currency by a monopolistic central bank which imposes an inflation tax by overshooting monetary targets.

The systemic difficulties outlined above are not merely a consequence of the 'knowledge problem': they are compounded by the problem of incentives discussed in recent years by James Buchanan and others in their work on public choice.

This led Hayek ((1979) p. 1) to state that if we are ever to re-establish sound money, the solution would likely not be provided by the public sector:

[I] am more convinced than ever that if we ever again are going to have a decent money, it will not come from government: it will be issued by private enterprise, because providing the public with good money which it can trust and use can not only be an extremely profitable business; it imposes on the issuer a discipline to which the government has never been and cannot be subject. It is a business which competing enterprise can maintain only if it gives the public as good a money as anybody else.

Hayek ((1943) p. 161) therefore recognized the superiority of the international gold standard relative to “monetary nationalism”, notwithstanding its flaws. He praised the international gold standard as follows:

The gold standard as we knew it undoubtedly had some grave defects. But there is some danger that the sweeping condemnation of it which is now the fashion may obscure the fact that it also had some important virtues which most of the alternatives lack. [...] [T]he gold standard had three very important advantages: it created in effect an international currency without submitting national monetary policy to the decisions of an international authority; it made monetary policy in a great measure automatic, and thereby predictable; and the changes in the supply of basic money which its mechanism secured were on the whole in the right direction.”

However, Hayek persistently resisted a return to that system. He complained that this system was not flexible enough to supply the demand for liquidity quickly enough:

The really serious objection against gold is rather the slowness with which its supply adjusts itself to genuine changes in demand. A temporary increase in the general demand for highly liquid assets, or the adoption of the gold

standard by a new country, was bound to cause great changes in the value of gold while the supply adjusted itself only slowly. And by a sort of delay action the increased supplies often became available only when they were no longer needed. (Hayek (1943) p. 177-178)

As we observed in the second section, this problem could potentially be solved under a system of fractional-reserve free banking using the gold standard. Hayek, however, chose to ignore this option.

The gold standard was already history and, recognizing the insuperable difficulties inherent in its reinstatement, Hayek ((1937) p. 88) turned his attention to a compromise between two alternatives:

It is important here first to distinguish between the need for some ‘lender of last resort’ and the organization of banking on the ‘national reserve’ principle. ... It is far less obvious why all the banking institutions in a particular area or country should rely on a single national reserve. This is certainly not a system which anybody would have deliberately devised on rational grounds and it grew up as an accidental by-product of a policy concerned with different problems. The rational choice would seem to lie between either a system of ‘free banking’, which not only gives all banks the right of note issue and at the same time makes it necessary for them to rely on their own reserves, but also leaves them free to choose their field of operation and their correspondents without regard to national boundaries, and on the other hand, an international central bank. I need not add that both of these ideals seem utterly impracticable in the world as we know it. But I am not certain whether the compromise we have chosen, that of national central banks which have



no direct power over the bulk of the national circulation but which hold as the sole ultimate reserve a comparatively small amount of gold, is not one of the most unstable arrangements imaginable.

In his later work, Hayek never came out in favor of an international central bank because he recognized that a competitive framework was the only sure way to avoid the difficulties that inevitably ensue from problems of knowledge and incentive.

Competition is needed in order to ensure efficiency and high quality in every market. Hayek shows that there is no reason to deny competition in the money market. In short, those currencies that lose value more quickly will be displaced by others in the market which better serve their function. The competitive process thus becomes a market-driven obstacle to inflation and an institutional guarantee against instability.

Hayek's praise of the benefits of competitive markets included the market in money (for example, 1976, p. 51). The fact that he did not go so far as to advocate *laissez faire* in the field of banking is therefore an inconsistency of importance.

Given that his mentor, Ludwig von Mises (1980, 1978), had strongly supported free banking and the gold standard, and given Hayek's own emphasis in that lecture and elsewhere (Hayek [1945] 1948, 1960) on evolved institutions and market competition as irreplaceable means for social coordination, it is puzzling that Hayek did not endorse the ideal of free competition among money-issuing banks operating on a market evolved commodity standard. He instead suggested that a centrally directed system of money creation can, in principle, better foster economic coordination. (White (1999b) p. 753-54)

Hayek never understood that a single reserve commodity selected by the market –as gold or silver had been – was a spontaneous order which arose through the unaided efforts of

private banks. The potential advantage of fractional reserve deposits backing money issued is that it avoids the deficiency of the gold standard when it comes to matching supply to fluctuating demand.

By not considering this option, Hayek (1976) had to focus all his attention on the denationalization of money and currency competition, and although in his 1976 model he incorporated these into his practical proposal for private banknote issuers, he provided no mechanism for the clearing of obligations in notes of different denominations. The only regulatory process was competition between the “fiat monies” issued by the government and private bankers.

The concrete proposal for the near future, and the occasion for the elimination of a much more far-reaching scheme, is that:

The countries of the Common Market, preferably with the neutral countries of Europe (and possibly later the countries of North America), mutually bind themselves by formal treaty not to place any obstacles in the way of free dealing throughout their territories in one another's currencies (including gold coins) or of a similar free exercise of the banking business by any institution legally established in any of their territories.

This would mean in the first instance the abolition of any kind of exchange control or regulation of the movement of money between these countries, as well as the full freedom to use any of the currencies for contracts and accounting. Further, it would mean the opportunity for any bank located in these countries to open branches in any other on the same terms as established banks.

And then he adds:

As soon as the public became familiar with the new possibilities, any deviations from the straight path of providing an honest Money would at once lead to the rapid displacement of the offending currency by others.

In the free banking system, which operated in Scotland and which we summarized in Section II, the coin was gold, while bank notes were only substitutes for that metal. In the system that Hayek (1976) provides, however, each bank –whether public or private– can issue its own fiat money, build its reputation and try to limit risky behavior in a framework of competition. Selgin and White, however, explain that such a system is inconvenient due to the multiplicity of units of measurement, which gives rise to the temptation to embark on a concerted and unlimited expansion of the money supply. (Selgin and White (1994) p. 1734-35, White (1999) ch. 11)

Concerted expansion is avoided under a system of free banking due to the clearing system created by the banks. Under competition with fiat money, no such clearing mechanism is possible because there is no commodity money supporting bank notes. For Hayek, the need to prevent banks from expanding the money supply either individually or in concert with other banks requires banking institutions which are responsible for maintaining the stable purchasing power of money on offer. Hayek concentrated his attention on market competition in the absence of a clearing system.

One can imagine that Hayek did not defend free banking to the extent that White (1984), Selgin (1988) and Dowd (1992) do because the eight years between 1984 and 1992 were the last years of his life and he was not a participant in the debate. However, in these concluding comments it may be useful to recall the words of Hayek ((1979) p. 4) shortly after the publication of his 1976 book as one way of addressing this hypothesis. There Hayek acknowledged that his thinking had evolved and that he had some new conclusions to offer.

I do believe that if today all the legal obstacles were removed which prevent such an issue of private money under distinct names, in the first instance indeed, as all of you would expect [and White also], people would from their own experience be led to rush for the only thing they know and understand, and start using gold. But this very fact would after a while make it very doubtful whether gold was for the purpose of money really a good standard. It would turn out to be a very good investment, for the reason that because of the increased demand for gold the value of gold would go up; but that very fact would make it very unsuitable as money. You do not want to incur debts in terms of a unit which constantly goes up in value as it would in this case, so people would begin to look for another kind of money: if they were free to choose the money, in terms of which they kept their books, made their calculations, incurred debts or lent money, they would prefer a standard which remains stable in purchasing power.

This question was answered, perhaps indirectly, by Professor White (2008), when he explained that under the gold standard evidence indicates that growth in the stock of gold has been slower and steadier than under the current stock of fiat money.

It will be a matter of debate whether a return to free banking, with the gold standard, will return that stability to the price of gold, or whether the current instability we see in the metal in the beginning of the twenty-first century will persist. It is conceivable that this volatility occurs because today gold is not money, but rather a hedge against weak fiat money and hence a good investment.

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