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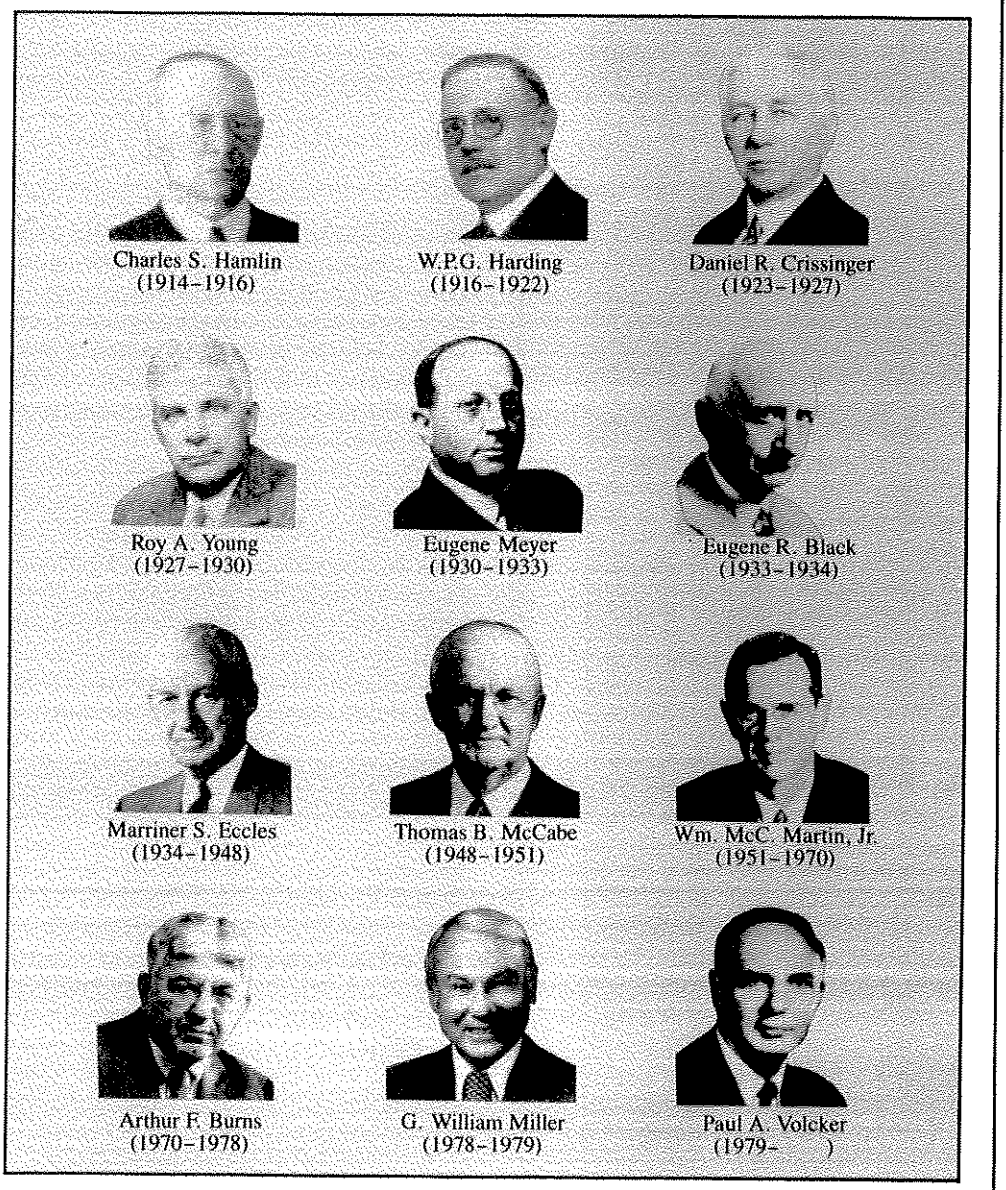
Manhattan Report

On Economic Policy

Is Central Banking Obsolete?



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Manhattan Report

On Economic Policy

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Editor's Notes

The last decade has witnessed enormous changes in the structure and the role of our financial institutions. Deregulation coupled with the increasingly integrated nature of world financial markets has hampered the ability of central banks to dictate the course of monetary policy. As the pace of financial innovation quickens and the ability of private financial institutions to, in effect, "create" money grows, the question which emerges is: are central banks obsolete?

This *Manhattan Report* explores the implications of the ongoing revolution in financial markets and its impact on central banking. Milton Friedman, at a forum sponsored by the Manhattan Institute, addresses the issue of monetarism, both as a macroeconomic theory and as a practical tool for achieving steady, non-inflationary economic growth. He concludes that a sound macroeconomic policy can only emerge through a drastic structural reform of the Federal Reserve System. Developing a similar theme, an article by John G. Greenwood, editor of the *Asian Monetary Monitor,* evaluates the Japanese experience with monetarist policies and its relationship to Japan's evolving financial institutions.

For an historical perspective on central banking, Joe Cobb, staff economist at the U.S. House Banking Committee, interviews Richard H. Timberlake, Professor of Finance at the University of Georgia and author of *Origins of Central Banking in the United States.* Looking to the future, an article by *Manhattan Report* assistant editor Andrew P. Clark explores the possibilities of competitive currencies and other innovations in money as they affect the central bank's capacity to conduct monetary policy.

Finally, a Manhattan Institute roundtable discussion takes an in-depth look at the future of our monetary institutions and presents both theoretical and practical arguments for reform.

Table of Contents

Has Monetarism Failed? 3
by Milton Friedman

The Japanese Experiment In Monetarism 1974-1984 5
by John G. Greenwood

The History of Central Banking 8
an Interview with Richard H. Timberlake

Denationalizing Money 14
by Andrew P. Clark

The Future of Monetary Institutions 16
a Roundtable Discussion

Has Monetarism Failed?
A Manhattan Forum with Milton Friedman

Milton Friedman—There are three things that monetarism is, and they're very different from each other. There's *monetarist theory* which has to do with understanding how changes in the quantity of money affect the economy. There's *monetarist policy* which has to do with recommendations about the way the monetary authorities conduct their business. And then there's *vulgar monetarism*. Vulgar monetarism comes in two varieties—a British variety and an American variety.

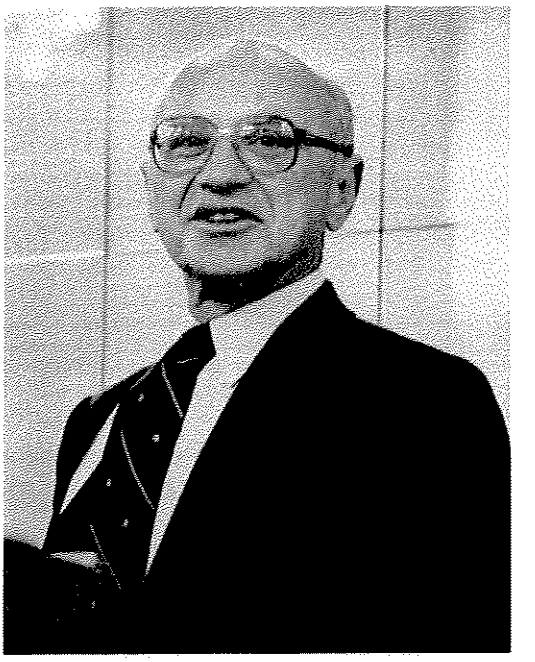
In Great Britain, vulgar monetarism is everything that Margaret Thatcher has proposed, whatever it may be. If Margaret Thatcher proposed that taxes be lowered, that's monetarism. If Margaret Thatcher proposed that some of the nationalized industries be privatized, that's monetarism.

The American variety is a little different. In the American variety, monetarism is anything that the Federal Reserve System has done since October 6, 1979. Both varieties of vulgar monetarism are a misuse of the term.

Monetarist theory is really a variation of an old theory that goes back hundreds of years. It's the quantity theory of money and it is applicable to a very specific set of economic relationships. It concerns the quantity of money in the economy and its impact on aggregate spending, prices, and real income. It's basic macroeconomic theory. Monetarism in this sense has nothing to do with the question whether you should have a market economy or a socialist economy. In fact, the countries in the world that in the past twenty years have come closest to following a strict monetarist policy are Red China and Russia. Both have maintained stringent controls over the quantity of money.

The basic propositions of monetarist theory are straightforward. A rapid increase in the quantity of money will be followed by a rapid growth in aggregate spending. The first impact is likely to be on output. Subsequently, it will be on prices. Over the long run, the effect will be entirely on prices, and not on output. Generally, about six to nine months elapse between a drastic change in the rate of monetary growth and the corresponding change in aggregate income and economic activity; about two years elapse before the change in the rate of monetary growth is reflected fully in the price level. That's monetarist theory.

Monetarist policy, on the other hand, is a set of prescriptions for the way a monetary authority, like the Federal Reserve, should act, once they have accepted the premises of monetarist theory. Historically, monetarist policy has become associated with a particular prescription—slow, steady monetary growth. That is not a necessary implication of monetarist theory. A believer in monetarist theory still can favor an activist monetary policy as a way to offset other changes in the economy—what William McChesney Martin of the Federal Reserve used to describe as, "leaning against the wind." The problem with leaning against the wind is that you have to lean against the right wind, which is next year's wind. Unfortunately, the people in Washington don't know what next year's wind is any better than we do.



Milton Friedman

The result is that the monetary authorities have typically made matters worse when they have tried to use changes in the quantity of money to offset other disturbances. They have leaned against the wrong wind in the wrong way, and as a result, they have been a source of uncertainty and instability in the economy.

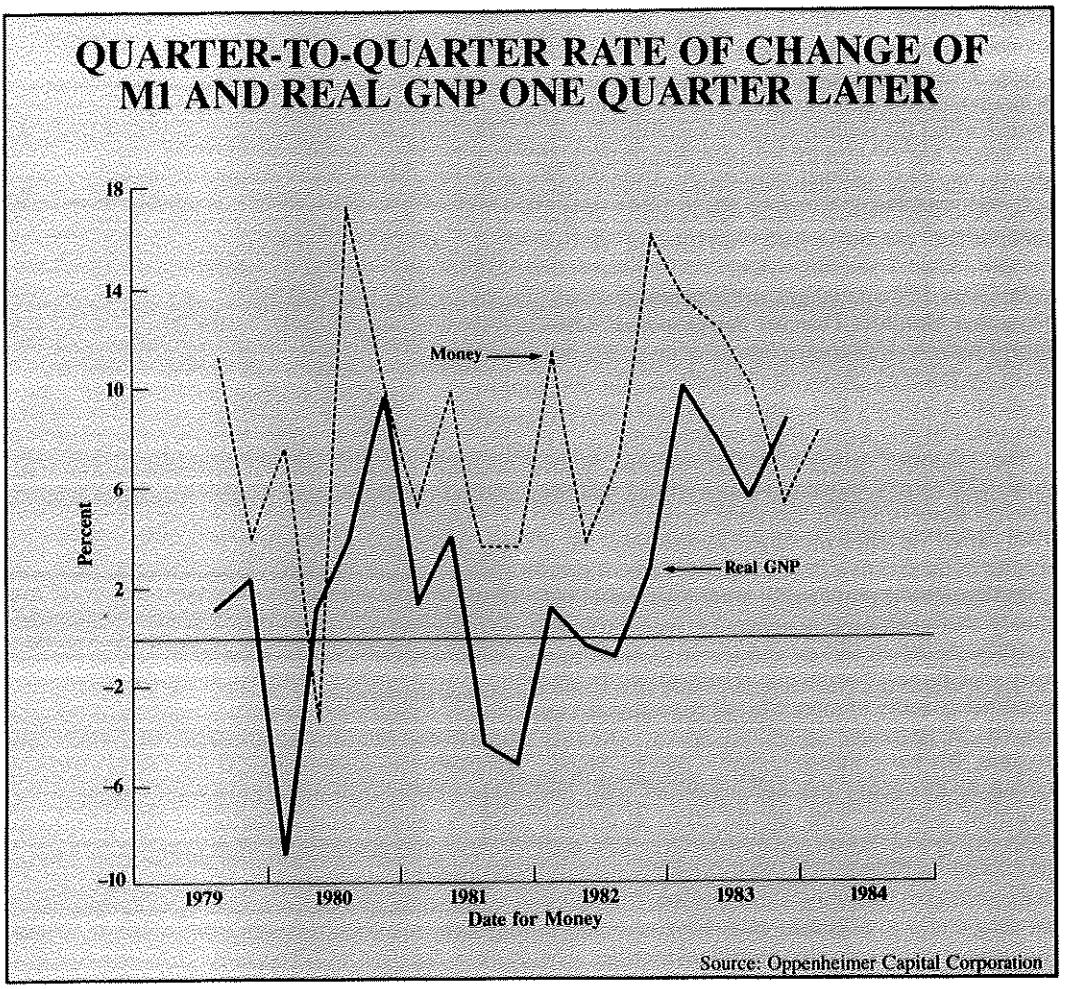
That's why those of us who believe in monetarist theory and who have examined the way policy is implemented generally have concluded that it would be desirable to have a monetary policy that produces steady growth in the quantity of money.

Has monetarism failed? In terms of the acceptance of the quantity theory of money and monetarist ideas obviously not.

At first, opponents ridiculed monetarism. Then they adopted it and called its early proponents extremists, even as they embodied it into their own statements. That's what's been happening to the quantity theory of money. So in that sense, monetarist theory has not failed.

What about monetarist policy? In terms of controlling inflation, the evidence has been overwhelming. Monetarist policies, and *only* monetarist policies, have been successful in stemming inflation. Leaving aside China and Russia, the country that has come closest to following a satis-

"There have been wild swings, both up and down, in the rate of monetary growth. And those wild swings have, in turn, produced a highly unstable economy."
—Milton Friedman



factory monetary policy has been Japan. Since 1974, Japan has followed a policy of slow, steady monetary growth that has brought the rate of inflation down from 25 percent to under 5 percent a year. Wherever in the world the rate of inflation has come down, it has been the result of reducing the average rate of monetary growth. There has been no other formula, anywhere. In that sense, monetarist policy has also succeeded.

That leaves us with the final category of monetarism—namely vulgar monetarism. Vulgar monetarism, as interpreted by the news media to be whatever the Federal Reserve has done since October 6, 1979, is not a monetarist policy. As I mentioned before, an essential feature of an effective monetarist policy is that the rate of monetary growth should be steady and predictable.

What has been the experience? Since the Federal Reserve rhetorically accepted monetarism on October 6, 1979, monetary growth has been more unstable than in any comparable historical period since the Federal Reserve was established. There have been wild swings, both up and down, in the rate of monetary growth. And those wild swings have, in turn, produced a highly unstable economy. In that sense monetarist policy has not really been tried.

What about the future? So far as monetarist theory is concerned, it will continue to be the bread and butter of monetary economics. There is probably no set of principles in economics for which there is more empirical support than the basic principles of the quantity theory of money. As for monetarist policy, I am doubtful that we shall get a satisfactory monetary policy in this country without a major change in the institutional structure of the Federal Reserve.

There's a tendency to personalize policy; to talk about a Burns policy, or a Volcker policy, or a Martin policy. I believe that's wrong. Those personalities are spokesmen for the system. It is a system that has a large bureaucracy, that operates according to internal laws of its own. We're not going to get a satisfactory monetary policy, unless we get major structural changes in that Federal Reserve System. Such reforms are long overdue. □

The Japanese Experiment in Monetarism 1974-1984

by John G. Greenwood

John G. Greenwood is an economist at G.T. Management (Asia) Ltd. and the founder and editor-in-chief of the Asian Monetary Monitor.

The conduct of monetary policy in Japan since July 1974 contains many lessons for students of monetary theory. Broadly speaking the Bank of Japan has adopted a *monetarist* policy in practice while avoiding the use of monetarist rhetoric in its official statements. To evaluate the Bank of Japan's achievements since 1974, it is useful to distinguish between the *strategy* and the *tactics* of monetarist policy. Monetarist *strategy*, broadly conceived, means the adoption and control of an intermediate target variable such as the money supply in order to influence the behavior of the overall economy. The *tactics* of monetary policy involve the detailed machinery of execution whereby the authorities succeed or fail in achieving their intermediate objectives.

On the question of *strategy*, the evidence from the Bank of Japan since 1974 provides powerful support for monetarist theory. Low, steady monetary growth has had a highly beneficial impact on the Japanese economy. When it comes to the detailed *tactics* of execution, though, there is much about the Japanese experience which runs counter to the type of open and flexible financial market operations that monetarists favor. When the Bank of Japan started its monetarist experiment, it utilized its extensive network of regulations and controls over the nation's banking system to achieve its monetary objectives. It was only as the policy evolved that the Japanese monetary authorities moved towards more open financial markets—bringing their tactics more closely in line with their overall monetarist strategy.

Japanese Monetary Strategy, 1949-1974

In April 1949, the yen exchange rate was pegged at 360 yen per U.S. dollar, a yen-dollar ratio which remained rigidly fixed until August 1971. Between 1971 and 1974 there were a series of changes in the exchange rate, but always with the intention that Japan would return to a rigid parity. Since the *price* or *value* of the yen was fixed, the quantity of money in Japan had to adjust to whatever level was consistent with equilibrium in the balance of payments. Money growth accelerated whenever there was a balance of payments surplus and declined in years when there was a balance of payments deficit. In effect, it meant that Japanese economic activity and its inflation rate were tied to the "dance of the dollar," rising in response to expansionary forces emanating from the United States, and falling in response to contractionary forces. Despite some partial offsetting measures by the Japanese monetary authorities, the 1970s found the Japanese economy increasingly subject to the growing disturbances affecting U.S. financial markets.

John G. Greenwood

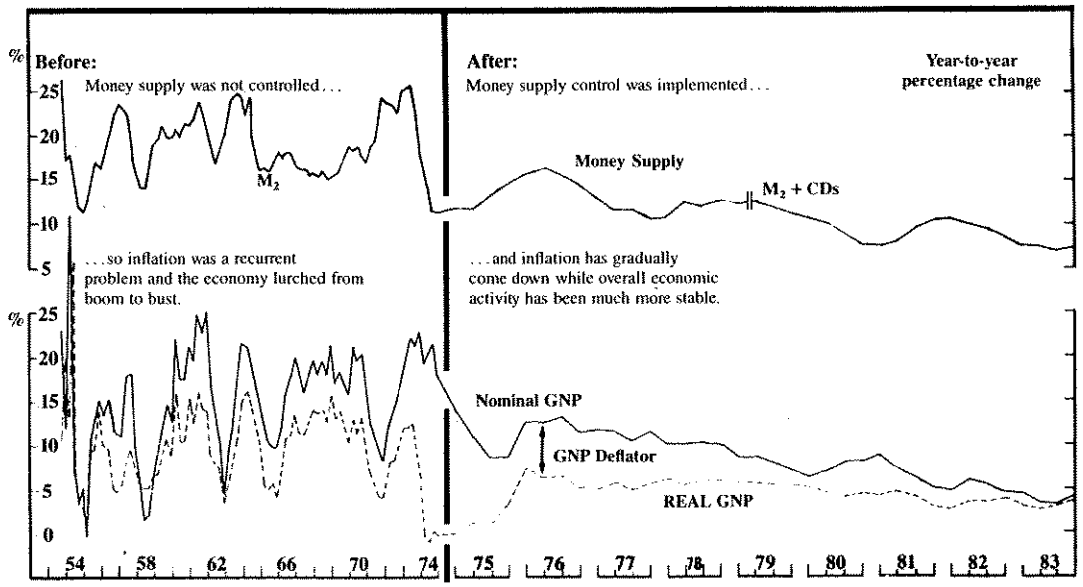
Finally in the summer of 1974 when consumer price inflation had reached 25 percent, the Bank of Japan decided to abandon the policy of maintaining a fixed exchange rate and adopted instead a policy of controlling the broadly-defined money supply, M2.

Japanese Monetary Strategy, 1974 to the Present

In July of 1974, the Bank of Japan announced its intention to restrict the year-to-year growth of M2 to within the 10-12 percent range. At the time of the announcement, few people were cognizant of the major change that was taking place in the conduct of policy, and generally the Bank of Japan has continued to maintain a low profile with regard to its switch in policy. Since that time, the broad strategy of the Bank of Japan has been to control M2 within a narrow range while allowing the yen to fluctuate fairly freely on the foreign exchange market. It's true that there continues to be occasional official intervention in the foreign exchange market, but this has never been permitted to compromise the primary policy objective, namely a specified growth rate for M2.

The Bank of Japan has compiled a remarkable record of never having deviated from its pre-announced figure by more than one percentage point. The Japanese financial community has become so used to the predictability of the Bank of Japan's announcement and its success in achieving the predicted outcome that as an item of financial news the announced monetary growth rate is

Japanese Money Supply and Real Growth



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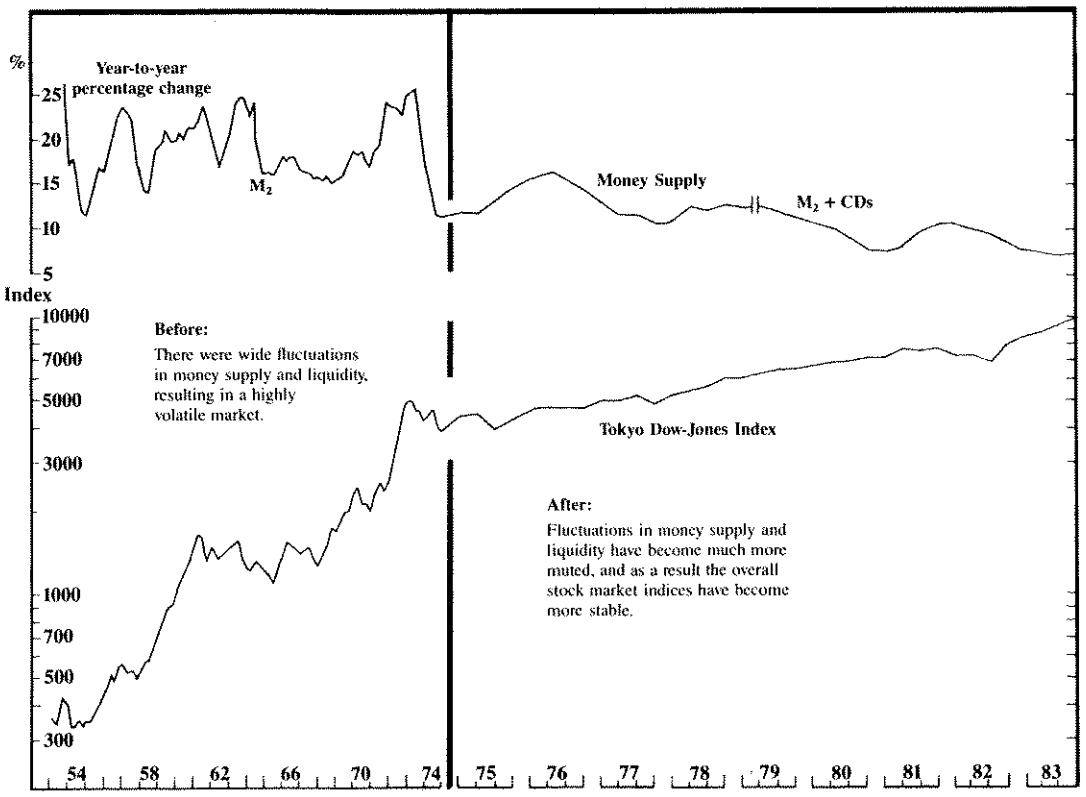
Japanese Money Supply and the Stockmarket



Source: G.T. Management (Asia) Ltd.

". . . the policy of money supply control started out by using what many monetarists would regard as reprehensible means."
—John Greenwood

treated as no more than a minor formality.

The results of the strategy of reducing and stabilizing monetary growth in Japan have been remarkable. Over a period of years, lower monetary growth has reduced inflation from double-digit rates to about 2 percent annually. It is still true that Japanese import and wholesale prices (which are heavily influenced by the prices of imports) fluctuate widely with the yen and the business cycle abroad. However, whereas under fixed exchange rates such fluctuations affected the *aggregate* price level via monetary expansions or contractions, under a floating exchange rate regime with stable monetary growth these fluctuations only affect *individual* prices while the aggregate price level remains stable.

More stable monetary growth has also stabilized the growth rate of the economy. Japan remained insulated from the two American recessions of 1980 and 1981-82. There was some impact on the *composition* of Japan's GNP (e.g. net exports declined), but only a minimal effect on aggregate GNP. Japan's real average growth rate has remained close to 4 percent, and the variability of the growth rate is less than half that of the pre-1974 period.

There is evidence to indicate that steady monetary growth has also produced more stable capital markets. This is a more complex proposition to demonstrate because at the same time as the underlying conditions were becoming more stable, the Japanese authorities were obliged to allow the markets for credit and capital to become more flexible. This flexibility was the result of an effort on the part of the Bank of Japan to bring its tactics more into line with its overall monetary strategy.

The Tactics of Japanese Policy since 1974

During the era of fixed exchange rates, credit-rationing was a normal feature of Japanese financial markets. The Bank of Japan kept the official discount rate at artificially low levels in order to direct "cheap credit" to favored industrial sectors via the banks. The apparatus of credit rationing by the central bank was also extended to the commercial banks in the form of loan controls (known as "Window Guidance"). When the strategy of controlling monetary growth was first introduced in 1974, the tactics employed were to set loan ceilings consistent with specified monetary growth rates.

The method was initially successful, mainly because the loans of Japan's city banks accounted for almost 85 percent of their total assets in 1974, and the banks subject to loan ceilings accounted for over 90 percent of the deposits included in M2. As long as the central bank offered city banks advantageous discount facilities compared with money market rates, they were reluctant to transgress its objectives. Thus despite the worthy ends, the policy of money supply control started out by using what many monetarists would regard as reprehensible means.

Gradually the contradictions between the Bank of Japan's strategy and its tactics have been reduced. At a theoretical level this is happening for a fundamental reason. According to monetary theory, a central bank can control the money supply only if it regulates the quantity of high-powered money or the monetary base. To do this it must allow the *price* or *value* of money to adjust freely.

Adhering to this theoretical argument, the Bank of Japan has abandoned rigid control of the exchange rate, which has enabled it to make significant progress towards monetary base control. On the domestic side, however, progress in liberalizing interest rates has been slowed by a number of factors: the unwillingness of the Ministry of Finance to sell government debt at free-market yields; the refusal of the Ministry of Posts and Telecommunications to set competitive interest rates on postal savings deposits in the huge Post Office Savings System; and finally the continued squabbling of vested interests in the private sector (e.g. the banks and securities houses).

Nevertheless, interest rates in Japan are substantially freer than they were a decade ago. Savers and borrowers have a wider range of choice. The Bank of Japan, itself, has shifted its tactics, relying more on the purchase and sale of domestic financial instruments to adjust the monetary base and less on changes in reserve requirements, official discount rates, and credit controls. Perhaps the most serious obstacle remaining to an open market approach to monetary policy is the authorities' continued predilection for regulating market shares of the nation's city banks. Until the Bank of Japan is willing or able to allow "free" banking competition as opposed to maintaining what it judges to be "fair" competition, it seems unlikely that it will move to fully impartial open market operations.

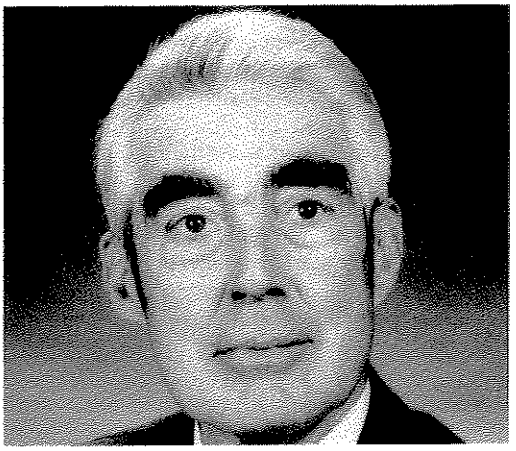
Conclusion

While not all the Bank of Japan's tactics for monetary growth are compatible with economic freedom, it cannot be denied that Japan's overall monetarist strategy has been a success. Whatever the shortcomings of tactics, from an empirical point of view it is clear that gradual *reductions* in the rate of monetary growth have brought down inflation, and more *stable* monetary growth has reduced the amount of fluctuation in the business cycle, bringing greater stability to long-term capital markets. These results bear out Milton Friedman's prediction twenty-five years ago that stable monetary growth would "contribute to the avoidance of major economic disturbances . . . promote a degree of stability in short-run economic activity. . ." and "expand the area of economic freedom and promote a more efficient utilization of resources." □

The History of Central Banking
an Interview with Richard Timberlake

Richard H. Timberlake is a Professor of Finance in the College of Business Administration at the University of Georgia. He is the author of Origins of Central Banking in the United States, *Harvard University Press, 1978.*

Joe Cobb, the interviewer, is a staff economist at the U.S. House Banking Committee and Executive Director of the U.S. Choice in Currency Commission.



Richard H. Timberlake

Manhattan Report—Many people find it hard to imagine how a banking system could exist without a central bank. Has this always been the case?

Richard Timberlake—Central banking is more or less a modern phenomenon. Money, as we know it, has existed for 2,000 years. Central banks, on the other hand, have only been around for roughly 200 years. Obviously, the monetary system can work without central banks.

MR—Most people believe that without a central bank, a fractional reserve banking system, such as we have now, would be unstable. Do you agree?

Timberlake—Not at all. I think it's more unstable *with* a central bank, at least the way central banks operate today. A central bank today is a government agency that is trying to maximize revenue to the government. It is not an institution that has as its first mission stabilization of the economy. If there were no central banks, we would have a private commercial banking system which could just as easily furnish currency and demand deposits to the economy. The commercial banking system that we had in the United States prior to central banking was a fairly stable system.

MR—This was during the so-called free-banking period before the Civil War.

Timberlake—That period has received a lot of bad press partly because of a misinterpretation of the data. Economic historians who looked at the bank note reporters and counterfeit detectors that were published during that era concluded, at first, that there were a great deal of bad bank notes or counterfeit currency in circulation.

What we've only discovered recently is that the bank note reporters never removed bad notes from their lists, even when the notes had gone out of circulation. These lists of depreciated bank note currency just kept accumulating the serial numbers of bad bank notes which greatly exaggerated the amount of spurious currency in existence at any given point in time.

MR—What about bank failures during the free-banking period?

Timberlake—The cause of bank failures in the free-banking era is, again, subject to much historical misinterpretation. Recent studies have shown that the "wildcat" problems with free banking occurred because banking was *not* free. Rather, the so-called "free" banks in many states were required to buy state government bonds as part of their total assets in order to legally engage in banking activities. When the market value of the bonds fell in a recession, the banks—having printed notes with the *par* value of the bonds as collateral—were unable to redeem the notes and often went out of business. The critical fault was the requirement that the banks buy state government bonds—again demonstrating that where there is an economic problem it usually has political roots.

MR—But isn't the main argument in favor of a central bank that it can stop a panic by supplying an unlimited amount of cash?

Timberlake—Technically a central bank can do that. But it's also true that the commercial banks, themselves, erected a system to prevent financial collapse which worked remarkably well and without any danger of generating inflation. This system was composed of the clearinghouse associations that appeared in the latter half of the nineteenth century as deposit banking became widespread. Clearinghouses issued notes that were illegal; that is, they violated any one (or all) of three existing laws prohibiting the issue of private currency. Nonetheless, the historical records from the period indicate that none of these notes was ever repudiated. No one ever lost anything from the issue of private clearinghouse certificates or other clearinghouse currency.

MR—If that set-up worked so well, why did the Federal Reserve System emerge in the first place?

Timberlake—Ironically, the Federal Reserve System was established to *reduce* the role of government intervention in the monetary system. It was set up to prevent the kind of tinkering with the currency that had been going on over at the Treasury Department. During the early 1900s, the Treasury kept piling up fiscal surpluses which took the form of gold and silver currency and "other legal tender." The Treasury injected those balances into its accounts at national banks when the demand for

"Ironically, the Federal Reserve System was established to reduce *the role of government intervention in the monetary system."*
—Richard Timberlake

money was seasonally high. During slack seasons of the year, the Treasury then let its bank balances be drawn down. This system worked fairly well but it made the Treasury, which was a political agency, an overseer of monetary policy. The general consensus was against such an arrangement and it was urged that a non-political central bank be created to carry out the perceived seasonal adjustment to the money supply.

The Federal Reserve was supposed to take away the discretionary authority of the Treasury. It was meant to be a self-regulating adjunct, subordinate to the gold standard. This particular characteristic was emphasized time and again. Yet, in twenty short years, the gold standard was a ghost, and the Fed was omnipotent. So the Fed simply assumed a role that was specifically denied to it in its incorporation.

MR—If the Fed didn't start out with instructions or the power to act as a central bank, how did its role grow so large?

Timberlake—The history of the Federal Reserve is typical of a government regulatory bureau. First, a minor social problem is perceived—in this case, occasional, extraordinary, seasonal demands for currency. Second, Congress creates an agency that has limited authority to deal with the problem—the early Federal Reserve System. The new agency begins to assume functions that were never intended within the authority delegated to it by Congress—open-market operations in government securities. Then the agency fails to function properly at a critical time and turns a minor problem into a world catastrophe. That's how we got the Great Depression of the early 1930s. The Fed, blaming the Depression on its lack of real power to affect the economy, convinced Congress to expand its functions through the Banking Act of 1935. That's how we got the Open Market Committee and reserve requirements used by the Fed today.

With its greatly expanded functions the Fed hasn't done much better. Yet the cry is for still more power, which it received with the Monetary Control Act of 1980. Where it goes after this can hardly be good. The only cure I see is to abolish it completely.

MR—Some people have argued that a way of reducing the power of the Fed would be to reinstitute a gold standard. Do you agree?

Timberlake—That would be one way of taking power away from the Fed—power that was never intended for its use, and I agree that it would be preferable to a central bank. However, I would certainly not support a phony gold standard, such as the type we had in operation from 1934 to 1971. That wasn't a gold standard; that was a central bank standard operating behind a facade of gold.

A true gold standard is one in which the government specifies one constant—the mint price of gold—the relationship between a weight of gold and a number of dollars. After that, it leaves the monetary system alone to regulate itself through the market system of prices.

MR—During the nineteenth century, the Bank of England maintained this kind of central banking operation, but there were widely reported fluctuations in price indexes and employment levels. How does this square with the idea that the gold standard was a source of economic stability?

Timberlake—Most of the instability that you read about under the gold standard came from some special intervention of the government. For example, in the United States during the Civil War, the federal government issued greenbacks and suspended conversion of dollars into gold. That set up a tremendous monetary disequilibrium for the economy to handle. It did handle it; but the result was inflation. Then the subsequent return to the gold standard necessitated a deflation. All of this disequilibrium occurred because of the original issue of the paper money by the central government. The same thing occurred in England during the Napoleonic Wars of the early nineteenth century, when the Bank of England was relieved of the obligation to redeem its notes with gold. It then issued enough paper currency to cause an inflation, and subsequently, a deflation when the stock of currency was reduced to reinstitute the gold standard.

MR—Are there other ways of constraining central banking institutions? Is there anything else that would operate as effectively as a real gold standard?

Timberlake—You could have a monetarist rule which would prescribe a fixed rate of growth in the monetary base. That would also eliminate the Fed's discretionary interference.

An even better option would be to revoke entirely the government's license to create money. Between 1789 and 1862—over seventy years—the federal government issued only a token amount of money and the economy prospered in a way that the world has not seen before or since. Money is an economizing device that is produced by an industry. It is similar to a communications industry or a transportation industry. When you think about it without the prejudice of existing arrangements, there is nothing about the money industry that suggests the necessity of government. It can (and should) be strictly private.

MR—The Federal Reserve System enjoys a lot of support among the business and financial community precisely because of its ability to be political and discretionary. Many important business executives in the United States regard flexibility or the capacity to respond to sudden shocks and surprises as a necessary power of government.

Timberlake—Essentially what you're saying is that they don't believe that the market system can

"Recent studies have shown that the 'wildcat' problems with free banking occurred because banking was not *free."*
—Richard Timberlake

Few Free Banks Appear to Have Been Wildcats

State	Number of Free Banks in 1838-63	Closed Below Par After Less Than One Year	Percentage of Total
New York	449	16	4%
Indiana	104	23	30%
Wisconsin	140	2	1%
Minnesota	16	7	44%
Four States	709	48	7%

Federal Reserve Bank of Minneapolis Quarterly Review/Fall 1982

handle untoward shocks that occur in specific markets. Unfortunately, a lot of industrial leaders and businessmen, such as Lee Iacocca, don't seem to understand how markets work. They call for national industrial policies and a general laying on of hands. If they succeed, they will have only succeeded in killing the goose that lays the golden eggs and in fouling their own nests to boot.

MR—One of the arguments against the stability of the market system is the experience of the Great Depression. When the stock market collapsed and the economy followed, many people believed that the market failed, with the government being required to step in and bring it back.

Timberlake—Well, in the first place the correlation between the stock market collapse and the Great Depression is coincidental and not causative. In 1942 there was a great stock market collapse, too, but the economy rolled along. The stock market is just one market out of many, and it was due for a shakedown in the late twenties. That is, stock market prices were inflated relative to the yields on stocks. But that didn't mean that the monetary system had to collapse the way it did. The fault lay with the Federal Reserve, which had taken over the clearinghouse and emergency currency functions from private clearinghouse associations twenty years earlier. The Fed simply didn't do its job. It sat around in typical bureaucratic fashion and argued with itself about what should be the proper policy. If the Fed had done nothing except keep the supply of conventional money constant, instead of allowing it to contract precipitously, there never would have been anything like the Great Depression in terms of length and depth.

The difference between the Fed as a lender of last resort and the clearinghouse associations in the same role was that the Fed, as a governmental central bank, introduced a discretionary political element into monetary decisionmaking and thereby divorced the authority for determining the system's behavior from those who had a self-interest in maintaining its integrity.

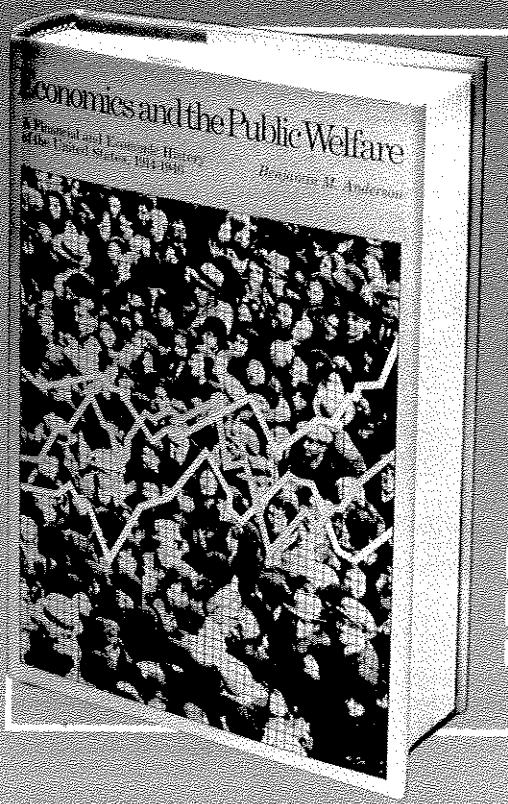
MR—Do you think that central banking institutions such as we have in the United States will become obsolete as the world economy and systems of payment become more integrated?

Timberlake—No, I don't think that the extension of world markets will make central banks obsolete. I think central banks are fundamentally undesirable in a free society, but as long as there are national monetary systems to be controlled, central banks will be there to control them. It's too lucrative a source of revenue for the governments that own the central banks to let them get away. Unless, of course, private enterprise monies develop independently of the central bank and simply crowd out government currency because of their better quality. Then, I think you could argue that central banks could be somewhat limited in what they do. But it's no more likely that central banks will simply fade away than it is that governments will limit themselves to constitutional functions. The two are part and parcel of the same malaise.

MR—What do you feel is necessary to turn people's way of thinking around on central banking?

Timberlake—This question is, again, simply part of a more comprehensive and fundamental question: What does it take to make people aware of the dangers of political, collective decisionmaking and turn in favor of a more decentralized market system? In a truly free system focused on individual decisionmaking, a central bank would be an anomaly. Government production of money would be no more acceptable than government production of clothing or computers.

The proper role for government policy was phrased by Friedrich Hayek in his *Constitution of Liberty*. He said, essentially, that the best thing a government can do is to provide an institutional and legal structure—in general, the "conditions"—in which an orderly arrangement of economic and social behavior will be worked out by the undesigned human actions of the individuals who live in that society. The difficult task is how to get people to understand that a system unplanned and undesigned by authorities is optimal. Intellectually, I think that the war has been won. Unfortunately, extending that intellectual victory into the political arena is a Herculean task. We just have to keep presenting our theoretical and empirical evidence to the public. That's one constituency that even the most arrogant politician cannot ignore. □



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—Benjamin M. Anderson
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by Benjamin M. Anderson

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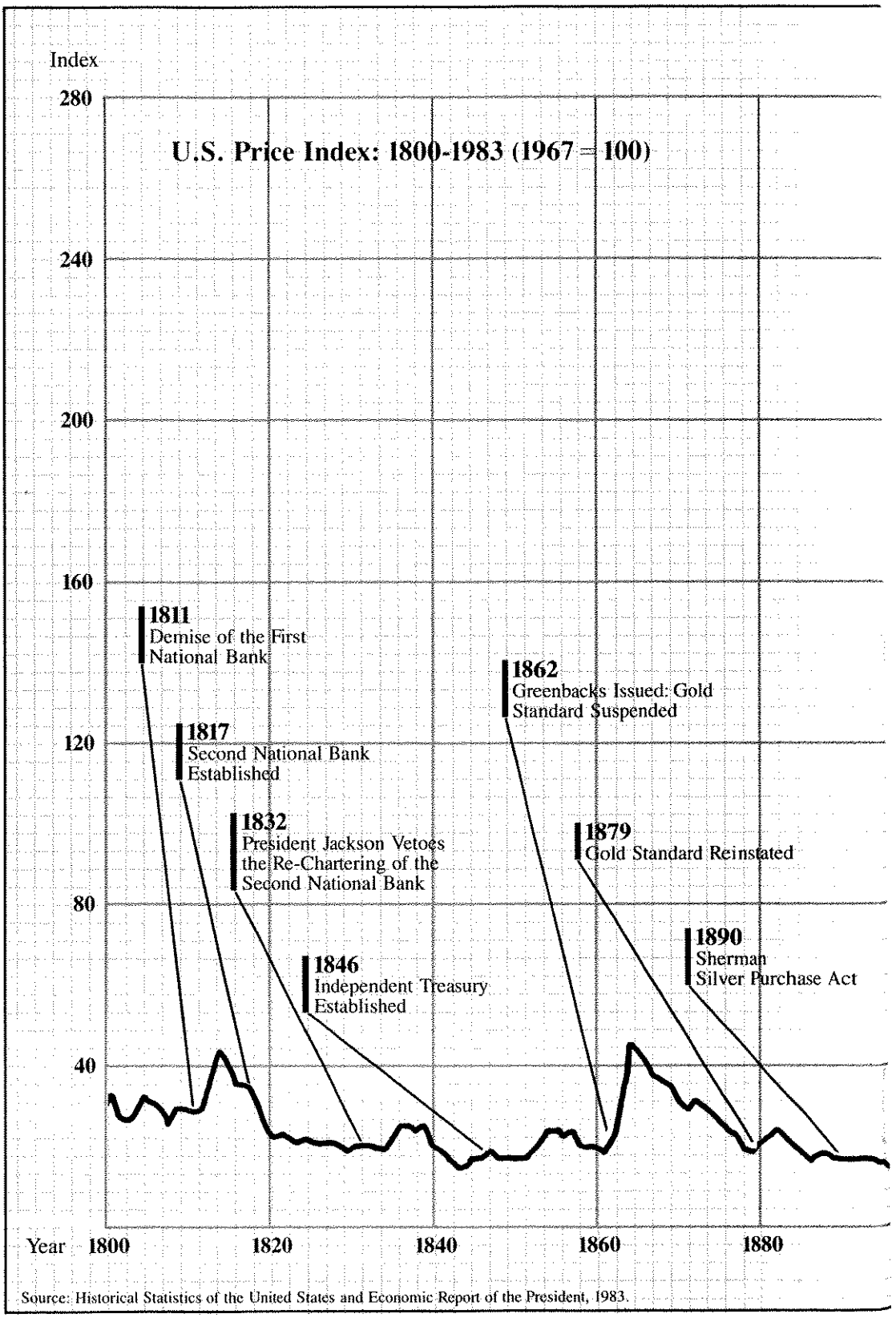
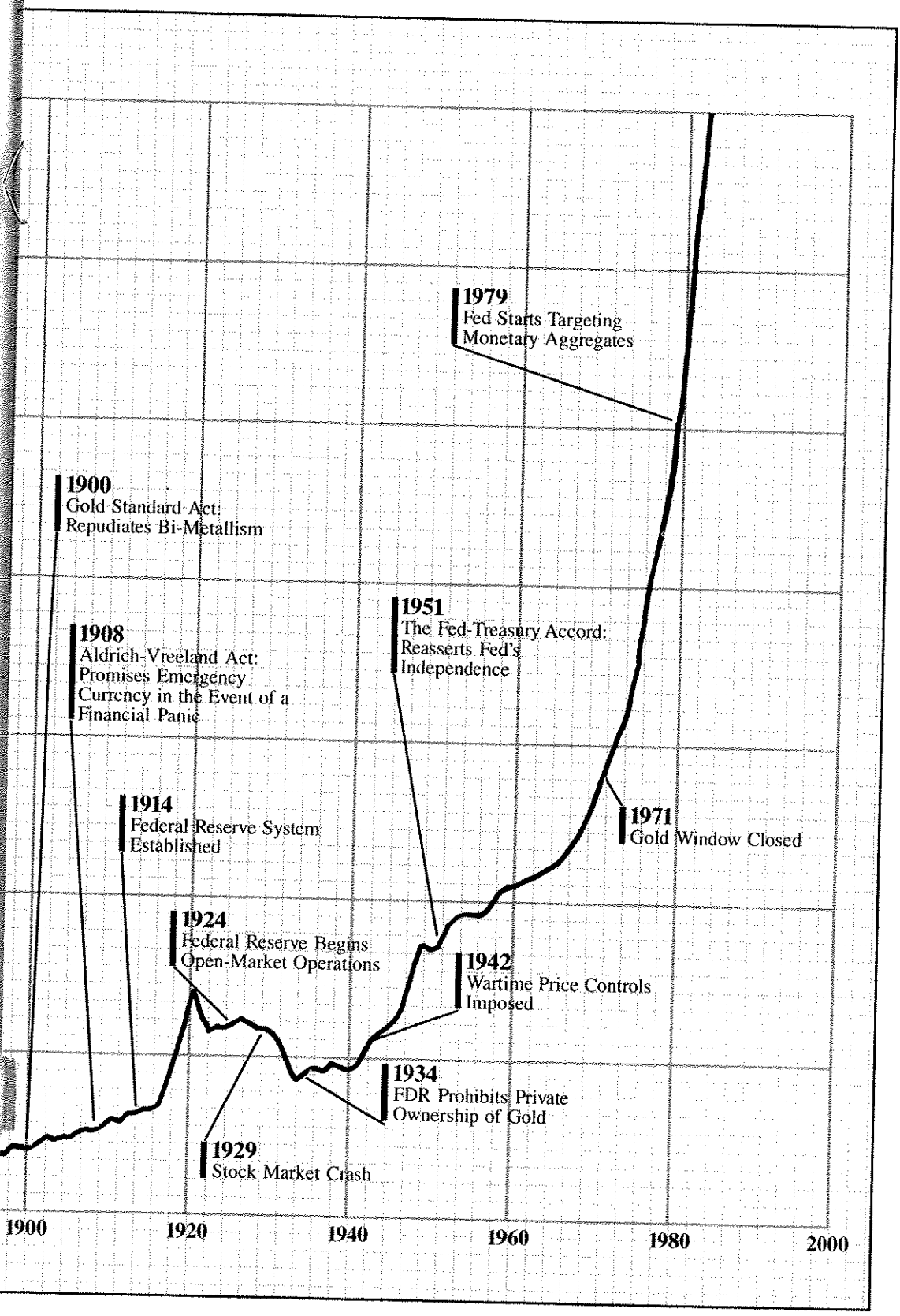


Source: Historical Statistics of the United States and Economic Report of the President, 1983.


1979
Fed Starts Targeting
Monetary Aggregates
1900
Gold Standard Act:
Repudiates Bi-Metallism
1951
The Fed-Treasury Accord:
Reasserts Fed's
Independence
1908
Aldrich-Vreeland Act:
Promises Emergency
Currency in the Event of a
Financial Panic
1914
Federal Reserve System
Established
1971
Gold Window Closed
1924
Federal Reserve Begins
Open-Market Operations
1942
Wartime Price Controls
Imposed
1934
FDR Prohibits Private
Ownership of Gold
1929
Stock Market Crash
1900
1920
1940
1960
1980
2000

The Denationalization of Money

by Andrew P. Clark

Until very recently, almost all analyses of monetary policy have presupposed a rather prominent role for the government. Various schools of thought have presented their particular proposals about how best to intervene in the monetary cycle, but very few intellectuals have challenged the notion of central banking itself. In the United States, this is particularly ironic in view of the fact that the Federal Reserve System has no basis in either the Constitution or the economic origins of our nation. But recently this has been changing: a new school of monetary thought is now beginning to question the very essence of the government money monopoly.

The most active of this group of economists developing proposals for fundamental monetary reform seek to allow competitive market forces, rather than government central banks, to shape monetary institutions. The Nobel Prize economist Friedrich A. Hayek became an early pathbreaker in this field when he published *Denationalisation of Money* (London: Institute for Economic Affairs, 1976). From all points of view, Hayek's work was an eye-opener. For the first time, here was a major attack by a prominent economist upon the entire system of governmental monetary control. Hayek, however, was not so radical as to demand an immediate abolition of the world's central banks. He called for a practical proposal in which countries would remove all restrictions on the international flow of currency. As Hayek himself pointed out, "What is so dangerous and ought to be done away with is not government's right to issue money but the *exclusive* right to do so and their power to force people to use it and accept it at a particular price."

Hayek's proposal is based upon the notion that if consumers and businesses have access to other forms of money (either foreign currencies or currencies privately issued by banks), it would be more difficult for a central bank to inflate the money supply—to put it simply, there would be another, more stable medium of exchange with which to store value. Many have argued that if banks were allowed to freely issue money, restricted only by the forces of competition, they would overexpand the money supply. Hayek reasoned, however, that if competing currencies were distinguished by brand names, the over-issued currencies would decline in value relative to more soundly managed currencies, and the over-issuing bank would lose customers. Banks, after all, earn their income from writing loans, and no one has any reason to borrow money which others will not accept in trade. Hayek thus concluded that competition between private issuers of money would lead to better money, just as competition in other markets leads to better products. Various other economists* have elaborated along these lines, clarifying the historical record on free banking, and providing theoretical justifications for alternative and competing currencies.

The idea of alternative monetary systems has coincided with a growing dissatisfaction with the Fed on the part of the business and intellectual community at large. This combination has had the favorable effect of getting financial practitioners to look more carefully at ideas that would otherwise have remained cloistered in the academic world. Murray Goldman, an economist in the office of Rep. Jerry Lewis (R; Calif.), believes that there is a "general long-term dissatisfaction with the policies and effects of the Federal Reserve System. Quite a large number of academics, businessmen, and politicians are unhappy with the way the Federal Reserve conducts monetary policy. This has led to a new wave of thinking in the intellectual/academic community that challenges the very essence of the Fed. For a long time, even free market economists believed that you could only have one producer of money--and that had to be the government. Now, you're having people question an idea that was once completely sacrosanct."

"A single monopolistic governmental agency can neither possess the information which should govern the supply of money nor would it, if it knew what it ought to do in the general interest, usually be in a position to act in that manner."

—Friedrich A. Hayek

What is clear is that certain forces are moving the financial community toward greater competitiveness and the development of alternative currencies. Given a world in which runaway inflation, rampantly fluctuating interest rates, and exacerbated business cycles are the norm, more and more of the financial community will strive to remove themselves from the control of the Federal Reserve in any way that they can. The process of financial innovation is one such response. It began in earnest with the great inflation of the 1970s, and has led to both de facto and de jure deregulation. As Mr. Goldman explains, "we're seeing more and more piecemeal financial deregulation. As more deregulation occurs, we're developing money substitutes that are coming closer and closer to money—and seeing that they work out fairly well."

Even the most established observers of the financial world agree that deregulation has made the Fed's task more complex. "I certainly believe that the creativity and the innovativeness of financial

markets has circumvented some of the Fed's control," says Norman Robertson, senior vice president and chief economist at the Mellon Bank. "I think also that it has made it difficult for the Fed to establish its various targets for the money supply and credit aggregates."

Despite these difficulties, there's a general optimism about the long-range prospects of deregulation. Thomas Huertas, vice president at Citibank, thinks that "financial deregulation is ultimately going to have a very positive effect." He argues that the widely discussed problems of Continental Illinois "were very much a product of the present regulatory system." And Thomas Humphrey, a research economist at the Federal Reserve Bank in Richmond, sees the Fed playing a strictly confined role: in his view, "the Central Bank should not be involved in regulation." Humphrey believes that with continued deregulation the growth of competitive currencies is a "definite possibility," although he noted that "if that situation ever comes to pass, then we'll see the death knell of central banking."

"Once the competing issuers had credibly demonstrated that they provided currencies more suitable to the needs of the public than government has ever provided, there would be no obstacle to their becoming generally accepted in preference to the governmental currencies—at least in countries in which government had removed all obstacles to their use."

—Freidrich A. Hayek

Another observer of the financial scene, Joe Cobb, a staff economist for the House Banking Committee in Congress, is even more confident of such a scenario. "We know that the trend is moving forward toward competitive currencies. The question is, how rapidly are these things evolving? Are we looking at a phenomenon that will have significance in five years or fifty years? Although we don't know how fast it will occur, we can identify those things that are slowing it down: banking regulation, tax laws, exchange controls; and we can also point to those things that are accelerating the process: uncertainty and instability in fiscal and monetary policy."

The monetary policy pursued by the Fed is something that has also come under stringent attack in recent years, and the reaction to that policy seems to be the other major factor (aside from continued financial innovation) moving us toward a less centralized banking system. Sanford Rose, the associate editor of *American Banker*, stated his opinion clearly: "I don't think we have a very soundly run monetary policy." Roger Shields, vice president at Chemical Bank, also doesn't "have a lot of confidence in the way monetary policy is handled." So widespread is the criticism that H. Erich Heinemann, vice president at Shearson/American Express, was moved to caution that "the long-range future of the Fed is at this stage, I think, extremely uncertain."

But if the future of central banking is in jeopardy, nothing could be more clear than that financial innovation and the transfer of information will continue to expand. Walter Wriston, chairman of Citibank, suggested recently that an "information standard" is rapidly becoming the coordinating mechanism of a single world financial market towards which we are moving closer and closer. "Clearly," he argues, "the information standard has replaced the gold standard and in its own way is just as severe." Given that "national governments in all countries have been debasing their currencies for more than 2,000 years," there is pressure for bankers and savers to invest in "alternative currencies" that are less subject to the bad policy decisions of chronically irresponsible governments.

Moreover, Murray Goldman, notes that this "information explosion allows people, under a system of competitive currencies, to immediately tell at what value a particular currency is trading." Joe Cobb likewise thinks that "all of this nascent innovation will become increasingly common as world markets are more thoroughly integrated." It allows room for financial entrepreneurs to make a profit in an increasingly competitive monetary environment.

As innovation spurs deregulation to new heights, and as more and more financial institutions attempt to escape from the extensive control of the central monetary authorities, the notion of alternative monetary systems will surely be more widely debated in the next few years. As M. Kathryn Eickhoff, executive vice president of Townsend, Greenspan & Co., Inc. noted, "Probably the ideal thing to be doing is to get yourself in a position where the Federal Reserve is not really that important to you." The confluence of these forces seems certain to make alternative, and even privately competing, currencies an important issue for the eighties. □

*See especially "The Competitive Supply of Money," by Benjamin Klein, *Journal of Money, Credit, and Banking* 6 (November 1974): 423-453; *Free Banking in Britain: Theory, Experience, and Debate, 1800-1845* by Lawrence White (Cambridge: Cambridge University Press, 1984).

The Future of Monetary Institutions: A Roundtable Discussion

Participants

Phillip Cagan, Professor and Chairman of the Department of Economics, Columbia University
Richard Hoey, Managing Director and Chief Economist, Becker Paribas, Inc.
William Poole, Member, President's Council of Economic Advisors
Alan Reynolds, Vice President and Chief Economist, Polyconomics, Inc.
Lawrence White, Assistant Professor of Economics, New York University

William Poole—I think we can all agree that no governmentally-run monetary authority is free from political influence. The question I would like to pose is whether the political incentives that policymakers face are necessarily bad.

Richard Hoey—I think there are two views out there. One view is that the Federal Reserve intentionally eases money growth around election time and that therefore the democratic system is being undermined by nonelected officials at the Fed who help incumbents get re-elected. The second view, which I feel is more accurate, is that the Fed, and central banks in general, place a high priority on holding down inflationary pressures over time. The Fed realizes it has no legitimate constitutional base in the American political system. All you need is 51 percent of the votes in the Senate, 51 percent of the votes in the House, and the signature of the President of the United States, and you can auction the Federal Reserve off at Sotheby's to the highest bidder. The Fed behaves like any other organization whose independence is threatened; it responds defensively in election years in order to preserve its flexibility. In off-election years, when it has running room, it essentially pursues disinflationary policies.

Poole—I think the Fed is very sensitive to political pressures. It tries to follow policies that are perceived to be politically neutral and because of this it often finds itself being attacked from both sides. In a way, that's to its advantage. When interest rates are rising, a lot of people criticize the Fed, especially if it's before an election, saying that the Fed is following policies that are not favorable to the incumbents. On the other hand, it is most often the case that interest rates are rising along with accelerating money growth. I think it's interesting to look at the last several Presidential elections from that point of view. In 1972, we had upward pressure on interest rates and high money growth; in 1976, it was the reverse; in 1980, the pressures were upward once again. So if you're a money watcher, the Fed followed an easy policy in 1972 and 1980, and a tight policy in 1976. If you're an interest-rate watcher, it was just the reverse. I think what the Fed tries to avoid is a situation where *all* the critics agree that it is following a policy that could be viewed as either favoring or harming political incumbents. If the Fed is perceived to be following a politically-motivated policy, its base of support for maintaining an independent position will be at great risk.

Lawrence White—I think there's a bigger question behind this. When you ask whether the political incentives which policymakers face are necessarily bad, it raises the issue of whether the democratic process should affect the supply of money at all. I think the answer is no. There are a lot of areas of economic life that should not be subject to the whims of the electorate. There are a lot of matters that are better to have either constrained by a Constitution or put in the private sector entirely.

Hoey—But that's an issue of delegation. The legitimacy of the system has to come from the elected structure. That's not to say that the elected structure can't legitimately delegate functions to the private sector or set the rules of the game a certain way. But the legitimacy of the system has to come from the democratic process.

White—You're opening a whole can of worms when you raise the question of whether the electorate gets what it wants. In something as technical as monetary policy, it's a difficult question to get very far on.

Phillip Cagan—Let me be more specific. We would be better off if the ultimate goal of monetary policy were one that said in the long-run we're going to stabilize the value of the currency. That's a clear and desirable goal for monetary policy to follow. Many would argue that if the public really understood all the reasons for such a goal they would support it. But I don't think that's true. I don't think the public does give a uniform answer in that direction. There is a lot of sentiment for discretionary control to deal with cyclical short-run problems. One of the problems that we have with monetary policy is the conflict between these two points of view which we've never been able to resolve.

Poole—Can we conceive of any automatic self-correcting institutions which could substitute for the policy judgments of a centralized monetary authority?

Hoey—Absolutely not. The financial institutional structure is constantly changing. You can't lay out any automatic self-correcting institution that can anticipate the changes in the institutional reality. The financial world is not just equations and aggregates. It is also a sum and total of very specific

"I think we can all agree that no governmentally-run monetary authority is free from political influence."
—William Poole

institutional arrangements. For one, I would prefer to have had Paul Volcker using his judgment in the summer of 1982 during the Mexican crisis than to have had any kind of a mathematical or automatic policy mechanism.

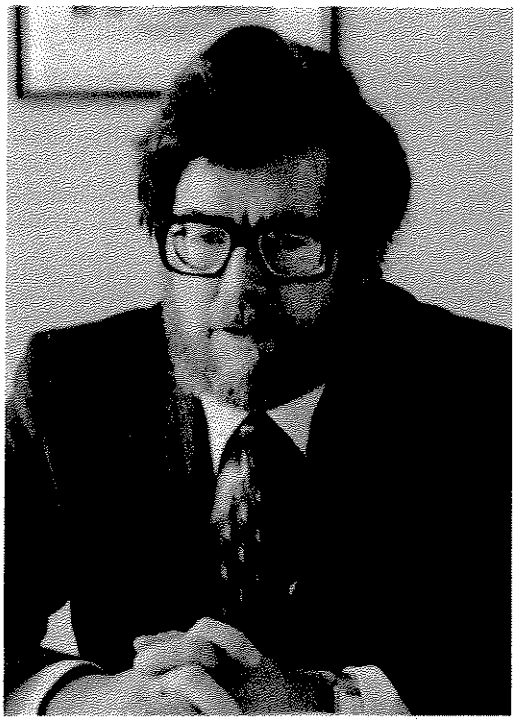
Poole—The question is not really what you would prefer but whether an automatic self-correcting institution is feasible. I think we should talk about whether such institutions are feasible before we talk about whether they are desirable or will produce better results than the institutions we now have.

Hoey—They're feasible in the same way as our current judgmental method is feasible, which is to say, if you put them into effect, they will continue until you have a disaster. If you have a disaster, then the people who decide the rules of the game will say —we don't like the way this game is being played; we want to change it. In a sense, judgmental monetary policy and automatic policy have the same problem—maintaining political support.

Cagan—It really depends on what private institutions do in response to any reforms in the system. In the early days before we had a central bank, the central city banks carried large reserves because they had to operate as a buffer for the system. If we were to implement a Friedman-type of rule, that is tell the Fed to put in so many reserves every week and then close its doors, fear of this in the market would be justified given our present institutions. The private market would have to adjust and create its own buffers to take account of the shocks that would then hit the system. It is possible that these private buffers wouldn't be entirely satisfactory.

Poole—It seems to me that it's really a straw man to say that we are talking about setting up institutions that we expect to last forever. Of course human institutions and constitutional provisions are subject to change. Nevertheless, there is an extraordinary difference between a system in which there is a constitutional constraint on monetary policy and the system that we have today. Monetary authorities used to be far more constrained by the broadly shared conviction in our society that it was improper to violate the gold standard. Now it's true that the gold standard was changed and suspended from time to time, but that's totally different from our current discretionary policy. I think that the operation of the gold standard is clear evidence that we can conceive of automatic, self-correcting mechanisms by which we can conduct monetary policy through some sort of monetary rule.

White—I would go a little further than your characterization of the gold standard as a rule. The gold standard didn't emerge as a rule to discipline a monetary authority. It emerged before there were monetary authorities. You can either think of systems for making monetary policy automatic, which is how you would characterize a Friedmanite K percent rule or some versions of the gold standard,



William Poole

where you have a central bank. But you can also conceive of doing away with monetary policy altogether. The automatic, self-correcting institution becomes a private institution.

Poole—There may be some administrative functions to perform within a stated policy. Money growth rules still require a central bank to do some things. The Central Bank has to conduct operations to achieve the specified rate of money growth. But it's essentially an administrative type of function rather than a policy function.

Hoey—They also need to have someone who can oversee a change in the rules of the game. Under an automatic system you have to have some delegated group of technically expert people who can make adjustments in the system. You have to have, in effect, some flexibility just as we have flexibility with regard to the Constitution. It's a huge barrier to get an amendment to the Constitution, but it is still open to reform if conditions change.

Cagan—But if you're worried about a possible change in the definition of M 1 , I don't think you want to go the constitutional route. That's one of the problems we face with any type of fixed rule. I don't have much confidence that we can frame such a rule and live by it. That's the basic problem. It raises an issue that I don't know the answer to: how you conduct monetary policy and get some of the advantages of a rule without politically committing yourself to a rule.

Poole—It's fundamentally a technical question

"The response of a judgmental decisionmaker in a crisis is likely to be faster than any automatic quantity rule running off statistics." —Richard Hoey

about whether you can design a rule that would do a better job than the arrangements we now have. We can conceive of such a mechanism. We've had one before. Lots of countries adhered to gold or silver standards. There are issues about whether, in this day and age, we can design a system that would be superior to what we now have.

Alan Reynolds—I think the system you're arguing for implies some kind of quantity rule, which I have problems with. In a deregulated environment, the definition of the aggregate you're shooting at will be changing constantly. You have to put a quantity rule up against the question that we're asking here. Can we conceive of any automatic, self-correcting institutions, other than the gold standard, which could substitute for our current judgmental Fed policy? I think a free banking system falls in that category. We saw it at work, and it had some useful properties. We can conceive of other variations on that theme, but we haven't seen a very successful example of a *quantity* rule in practice.

Cagan—Well, there are ways of doing it. We could follow a quantity rule of some previously defined monetary aggregate such that it would take into account what the velocity of the aggregate did over some recent period. There need be no discretion in it, and it would work out all right from decade to decade. But I don't think, given the sentiment for discretionary control, we could restrain ourselves from trying to correct whatever short-run inadequacies we found in that policy.

Hoey—Let's take a specific case. On March 14, 1980, the Fed announced that it was planning to place credit controls on the nation's economy. The result was the fastest rate of decline in the economy since 1932. The Fed, however, quickly reversed its policy, presumably driven by fear that things could get out of hand. Of course, as normally happens when they react aggressively, they ended up creating too much money. Would the kind of rule that you describe, with an adjustment for velocity changes, have given us the same swift reversal of policy that we obtained through the judgment of the Fed? The response of a judgmental decisionmaker in a crisis is likely to be faster than any automatic quantity rule running off statistics.

White—I think our discussion poses the question incorrectly when it assumes that there is a trade-off between long-run monetary stability under a non-discretionary system and more effective crisis management under a discretionary system. If you look over the history of the Fed, I think you'll see that the notion of the Fed as a crisis-preventing mechanism is rather naive. They certainly didn't prevent the crisis of the Great Depression. In fact they created it. If you look at the episode in 1980 which you just described, I would count the crisis-creating imposition of credit controls as part of a discretionary monetary policy.

Hoey—No, I would regard it as political interference with the monetary authorities. It was authorized by the White House. I have a sneaking suspicion that maybe the Fed knew what it was doing when it designed the credit controls so tightly that they didn't work. My sense is that the Fed has never really wanted to get into credit allocation—deciding who gets mortgages and who doesn't. The Fed could have easily stopped the inflation at that time with traditional methods. It was really the political structure telling the Fed—we are not going to let you raise interest rates even if it's necessary to cool off inflation. What we want you to do is put in credit controls. I interpret that as political interference.

Poole—I want to address the point that Larry White brought up, which has to do with the Fed's crisis management. I believe, too, that many of the crises that the Fed is perceived to have managed successfully, have been created in the first place by the Fed's own policy. We would not have had a crisis in 1970 with Penn Central and the commercial paper market had it not been for several years of inflationary policy and the maintenance of Regulation Q constraints on large time deposits. We would not have had the problems we experienced in 1974 if we had not had a big blowout of inflation as the result of monetary policies pursued in 1972.

Cagan—In spite of the Fed's shortcomings, I still think it is impossible to imagine us finding consensus for a system where there is no lender of last resort, which then raises all the problems we're trying to eliminate.

Poole—This might be a useful time to explore the possibilities for privatizing certain aspects of the monetary system.

White—I think a place we could start would be to privatize deposit insurance. It seems to me it's the only way to get deposit insurance correctly priced. There's an enormous moral hazard problem in insured banking which we've all become aware of recently. Private insurers do a lot of things to allay that problem, things which the FDIC has never thought of and has no incentive to think of.

The second thing to privatize would be reserve lending, that is, by letting the Fed funds market do it. This, of course, brings up the question of the lender of last resort. You may be right, Phil, that it's going to be difficult to get a consensus to operate a system without a lender of last resort, but there have historically been systems without a lender of last resort that didn't suffer from its absence.

Hoey—Which would that be?

White—My own research has been on the Scottish banking system before 1844. It was a gold standard system, and the large banks all held gold reserves and lent to one another if one bank had a liquidity problem.

Hoey—Was there ever a case where the core

reserve currency of the world capitalist system operated successfully without a lender of last resort?

White—I don't know when the Bank of England started to act as a lender of last resort, but I'm sure you can go back far enough to where the British pound served as the world's premier currency without a strong central bank. There has never been anybody who could print gold. Now, there have been institutions that have held large reserves and, therefore, were in a position to lend. But those institutions can be private as well as public.

Hoey—There's a tremendous social good in having a lender of last resort. It's a little bit like the gambler's dilemma. The gambler's dilemma is if you keep gambling long enough, you lose all your money. If you keep having a financial system without a lender of last resort, sooner or later you will have a devastating financial crisis that will cause tremendous economic devastation. You might have it anyway, even with a lender of last resort, but to me that's the one absolutely necessary function of central banking.

Poole—The lender of last resort and deposit insurance functions are closely related. The main purpose of deposit insurance is to prevent the runs that would bring the lender of last resort function into play. The problem I have with trying to privatize deposit insurance and the lender of last resort function is related to the economic incentives in fractional reserve banking. Once you have fractional reserve banking and you have a random chain of bank failures, the whole fractional reserve banking system can fall into a contractionary mode. Unless there is a way of putting additional liquidity into the system, the reserve multiplier runs toward one because it's in the interest of each individual depositor to take his money out and hold it in base money form. That's why I think that there's a public good function involved here that requires governmental intervention.

White—I don't think it's accurate to characterize it as a public good problem because it's certainly not something that involves non-rivalness in consumption. If a single bank has a liquidity problem, it can borrow from other banks. If a country as a whole has a problem, and it's part of an international monetary system, such as a gold standard, it can borrow gold reserves from abroad.

Poole—Let's talk about the world as a whole. Let's take all the countries that are on gold.

White—If there's a run on every bank in the world, even the lender of last resort function isn't going to help you, because nobody's in a position to print gold.

Poole—That may be one of the reasons why a system that is predicated on a base money that is completely inelastically supplied, such as gold, has a problem.

(l-r) Phillip Cagan, Lawrence White

White—I think there's generally a misapprehension of the historical record of the stability of banks under the gold standard. Particularly in the United States and England, there were laws that made banks a lot weaker and more unstable than they should have been. In England there were restrictions on the capitalization of banks. In the United States there was a ban on interstate branch banking and under the national banking system there were restrictions on the ability of banks to print currency, which people would have accepted in lieu of gold. When they couldn't get that, they ran for gold. So I think the need for a lender of last resort is in large part a manufactured problem.

Cagan—The question of lender of last resort is just an extreme case of the more general problem of a change in the amount of money which people wish to hold. Suppose there is a desire to shift from other financial assets into money. If everyone in the economy suddenly decides to hold more money, this produces deflationary pressures. This is a kind of externality that we look to the central bank to offset. This problem is similar to one under our fractional reserve banking where the money stock itself is reduced because of a desire to shift into currency. Both of these developments reduce the amount of aggregate spending.

The only reason we're more concerned with problems calling for a lender of last resort is that such disturbances can be larger and more serious than shifts in velocity. They're all part of a general externality problem which calls for the existence of a central bank to handle them.

Reynolds—I don't think you should dismiss the need to bring more competition into monetary operations. Right now we have a system in which the government has a monopoly on demand notes—

"I think the Federal Reserve Act was a mistake from day one." —Lawrence White

on currency notes. The FDIC has a monopoly on deposit insurance. If there's a run into currency out of deposits, obviously *they* have to be the lender of last resort. They're the only ones who can supply currency. If deposit insurance policies encourage imprudent lending, then obviously we're going to have these crises that require a lender of last resort. We've set up a system that encourages not only imprudence but error. We live in a world in which enormous instabilities of commodity prices are endemic to the system. At least that's been the experience since August of 1971. In that kind of environment, lenders are going to make a lot of mistakes.

Hoey—But that goes to Bill's point that the instability is not accidental.

Reynolds—Not as long as you have a discretionary policy that is totally unguided by any principles into which we can sink our teeth.

White—At this stage, I think I should clarify what I mean about privatizing reserves. Basically, I'm recommending that the Fed just close the discount window.

Hoey—Are you suggesting closing the discount window for other than lender of last resort purposes or closing it period?

White—Historically the lender of last resort is a lender to the market, not a lender to an individual bank. The Fed can certainly create reserves without going to the discount window.

Reynolds—I think if we're looking at privatization, regulation should be in there as well.

Poole—I agree. There's no earthly reason for the government to decide whether it's appropriate to have a bank on the southeast corner of Elm and Main as opposed to the northeast corner. At present we do these kinds of things, and I think they're totally inappropriate. Privatizing the lending of reserves is also feasible with regard to the federal funds market. The private market could surely run the Federal Reserve wire. You could have competing reserve lending just as easily as you have competing mail service.

This really leads us to the question of whether we can privatize the monetary system altogether. Can we get the government out of the money business?

White—I think the Federal Reserve Act was a mistake from day one. It was an attempt to deal with a genuine problem, the inelasticity of the currency, but it really misconceived the nature of the problem. The problem was that private banks couldn't issue currency when people wanted to switch between deposits and currency. The banks had to hold a particular kind of collateral against their notes. The proper solution to the problem would have been to eliminate the restriction that required them to have Federal bonds as collateral against their currency. If that had been done, most of the other problems would have been handled privately.

Federal Reserve, Washington, DC

To some extent they already were being handled by private clearinghouses.

Now, the question this doesn't answer is whether it's desirable to have a fiat currency rather than a commodity-based currency. I don't think that the role of an economist is to tell people what kind of products they ought to use. I don't see my role as saying that people ought to use a gold-based currency or a silver-based currency or a paper-based currency. My position is that people ought to be free to use whatever kind of currency they would like to use. Is it necessary to eliminate the Federal Reserve system as a player in that game? Some people have said to me—why do you talk about eliminating the Fed? Shouldn't they be allowed to compete in the market for currency? Well, it seems to me that allowing them to compete as an equal with a private firm means turning the Fed into a private firm. The same thing would be true of the post office. You're never going to get fair competition between the post office and private firms as long as the post office is a branch of the government.

What I would like to see is people not being forcibly subject to using the government's currency because the government has a monopoly. People should be free to use whatever kind of currency they find desirable.

Cagan—Government will never keep its hands off the monetary system. But even if some private institution arose to supply all the currency, we'd still have the same problems, because this institution would have a tremendous influence over aggregate demand.

White—I think you're confusing two things. I think there's a tendency to converge on a single monetary standard. That doesn't mean there has to be one firm supplying money any more than converging on

a single video cassette recorder standard implies a single cassette producer.

Cagan—True, yet once these various monies are fixed in terms of the unit of account, you're back to the same problem. A variety of suppliers does not alter the problem that the quantity and demand for these monies, assuming as I do that all will be fixed in terms of the unit of account, are going to influence aggregate demand. We will not be willing to let it fluctuate without control. We can discuss ways of improving the system. I can even imagine some new systems involving parallel currencies, which strike me as interesting, but I don't quite see us getting there. So we're right back to a single currency which we're not willing to leave uncontrolled.

Hoey—I think you have a situation where the government is already there with a superior product—superior because of the breadth of market acceptability of the dollar. Basically, it's accepted as a medium of exchange throughout the world. If we're going to privatize money, the dollar has a long head start in terms of acceptability. I'm not so sure that the opportunity to compete with an entrenched issuer of U.S. dollars is one that is likely to bring much venture capital forward.

Cagan—It depends on what you're offering. What if you offered an indexed dollar? Wouldn't that be attractive?

Reynolds—What if you offered a gold-backed dollar? Might not that beat out your indexed dollar? You don't know. Larry is basically saying, let them have at it. I think the problem we're having is that an awful lot of outstanding contracts are made in something called dollars, the meaning of which varies from day to day. Traditionally, the only constitutional role for government was to define the word dollar in terms of a unit of account, to anchor it to something real, notably gold or silver or both. Once you've defined the unit of account and guaranteed to redeem currency on demand in terms of gold, it really doesn't make any difference who issues it. With today's modern technology, a few would dominate that process. The main thing is that whoever issues demand notes has to guarantee redeemability. We have to stabilize the unit of account so that we make long-term contracts again—bonds, mortgages, and so on.

Hoey—We have the right in this country to make long-term contracts in other standards of value.

Reynolds—And the government has the right to violate them.

Hoey—I'm saying you can issue bonds convertible into silver. You can issue bonds convertible into gold. This has not been a tremendous growth industry.

Reynolds—That misses the point. Prices are still stated in dollars. Contracts are in dollars. The demand for a gold bond has a lot to do with Fed policy and its effects on the dollar. There was a flight from the dollar in 1978 and 1979 which drove gold to $800 an ounce. At that time you might say that gold bonds looked like a terrific deal. But then the Fed put the squeeze on pretty hard and drove gold down to $300. If you're making contracts in dollars and you ultimately want to convert that free market gold into dollars, you don't know which end you're going to get whipsawed on. In the long run it might be a good deal, but at the time of redemption it could be a bad deal.

Poole—Isn't this an argument saying that people now believe that the value of the dollar, in terms of goods, is more stable than the value of gold in terms of the same goods?

Reynolds—That's true because in the ratio of gold to dollars somebody has an awful lot of control over the denominator—namely the Federal Reserve. You're looking at this and saying—gold is terribly unstable in terms of dollars. That's because the Federal Reserve is controlling the value of money.

Poole—I'm not talking about gold in terms of dollars; I was talking about it in terms of goods. There's nothing that says that the variance of gold in terms of dollars determines the variance of gold in terms of goods.

White—There is no reason that *demonetized* gold should have a purchasing power that's any more stable than copper or silver, so that doesn't really speak to the question of whether it's desirable to monetize one of those assets.

Reynolds—Under our current system, gold is a hedge asset. We're talking about gold under two different monetary regimes, so we observe that gold has different properties. The value of the gold standard was that it had long-term properties. If there was a lot of inflation, you had every reason to expect that it wasn't going to last. The same for deflation. That was useful in terms of giving us long-term interest rates in the 4 to 6 percent range.

Hoey—Fiat money has long-term properties, too. They're just different.

Reynolds—Yes, it has a long-term inflation bias. There's also a deflation risk there, too. This system has a long-term inflation bias with periodic credit crunches that have become increasingly regular, almost annual. It's because our method of controlling the value of money has become intertwined with our financial intermediation. We use this tax on bank reserves, essentially reserve requirements, as our intervention mechanism. You basically have two options. You can try to fix the quantity of money and let the market determine its value. The question then arises, how do you value the outstanding stock of money? Suppose a Mitterand gets elected. That'll have an effect on the money stock regardless of the flow. It'll have an effect on the value of the money stock in terms of goods as well as everything else. An alternative system is to fix

"If deposit insurance policies encourage imprudent lending, then obviously we're going to have these crises that require a lender of last resort." —Alan Reynolds

the value of money and let the market determine the quantity. Under that system, I don't see the same problems arising. If there's an excess issue it will be redeemed. The beauty of convertibility is that people *do* convert.

Cagan—That will control the quantity of money but it won't control short-run fluctuations in aggregate demand.

Reynolds—I think that economists have been chasing the illusive goal of managing aggregate demand a little too long.

Poole—I'd like to get back to the issue of price rules which Alan raised. I regard the gold standard as having been fundamentally a quantity rule in that the quantity of monetary gold was quite inelastic. There were flows in and out of production and some use in industry and the arts, but the quantity of monetary gold was quite inelastic and didn't change much from one year to the next. The gold standard was a price rule in the sense of controlling the issue of paper money, because the authorities were supposed to redeem paper for gold in a certain ratio. It was a way of constraining how much paper money was issued, but fundamentally the properties of this system in the economy were those of an inelastically supplied quantity of gold—interacting with paper money and the effects of fractional reserve banking. Do you share that view?

Reynolds—I do not share that view. To say the gold standard was just another quantity rule is factually incorrect. Very often you had extremely large increases in the aggregate money stock, anywhere from 15 to 20 percent in a year. The system was extraordinarily elastic. Deposits were a claim on currency, and currency was the real claim on gold. The properties of inelasticity that were attributed to the gold standard had to do with problems in the banking system. One of them was the absence of deposit insurance, which I don't favor as a government monopoly, but which I think is useful on the private, competitive level.

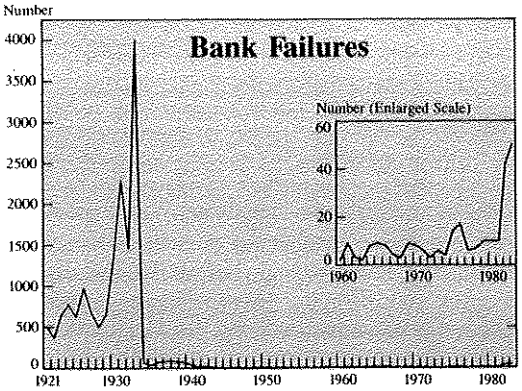
Basically, under a gold standard you're stating prices in units of gold, if it's working.

Poole—What I'm saying is that the key characteristic of the gold standard was that changes in the quantity of money were constrained by the quantity of gold.

Reynolds—In glacial and predictable ways.

Poole—I agree, in the sense that the gold stock was very large compared to the flow. Now, there is nothing in principle that differentiates that system from one where you have something called fiat money that grows slowly according to a specified rule.

Reynolds—It's a question of long-term confidence. Who's going to have long-term confidence in that fiat money? Nobody ever has. We've had historical episodes with good, firm quantity rules. France had one after World War I, up until the crisis of 1925.



Note: Data for 1983 estimated.
Sources: Comptroller of the Currency and Federal Deposit Insurance Corporation.

They had a legislative quantity rule where they couldn't issue notes past a certain amount; they also couldn't monetize the debt beyond certain limits. Of course, they violated the rule. But long before that, market participants anticipated that they would violate the rule and the velocity of the currency soared.

Cagan—I don't think we'd be satisfied with anything tied to gold. It's long-run value is uncertain and variable in terms of other goods. If we want to have some kind of a rule, we should fix our currency in terms of some broad-based index of prices. That's what people are looking for.

Reynolds—But you're imposing your tastes on the market. I don't think they agree with you. When that test has been put before them—the example of indexed bonds versus gold bonds, the gold bonds were far more popular.

Cagan—They have indexed bonds in Britain that seem to be doing very well. If I ask myself, what is it that people would want in terms of an asset, I should think it would be constant purchasing power in terms of the goods and services that they buy. I find it hard to believe that there'd be a preference for gold, though I grant that gold may be somehow more understandable to people.

Hoey—The critical question is long-term credibility. Some people take the view that we're doomed to hyperinflation. Others argue that we can have a constrained money supply with stable purchasing power. I regard it as a little bit like the Norse gods. They struggle manfully against the tremendous powers against them and survive for another day. That's my view of the Fed. I think it tries to do the right thing, but it's subject to powerful crosspressures and ends up doing an imperfect job. Overall, though, we don't have hyperinflation in the United States. We haven't had it since the collapse of the Continental currency. That's not too bad.

Reynolds—The issue isn't hyperinflation. The issue is a chronic inflationary drift, which is most evident in the problems with long-term bond issues.

"The problem now is that our financial markets are evolving in a way that could make monetary targeting more difficult."
—Phillip Cagan

Cagan—I see the problem differently. The credibility issue is one thing. I think we could develop a credible system of convertibility. We could have any number of circulating currencies which are convertible into the monetary base—which itself could be fixed in quantity. That would be equivalent to the gold standard. The real issue is what we do with these circulating currencies. Do we intervene in the monetary system to satisfy short-run discretionary objectives or are we willing to give up discretion? Whether we have a gold standard or not doesn't answer that question. We can have a lot of discretion under the gold standard as well.

Poole—At this stage, it might be useful for each of the panelists to sum up their positions.

White—I think Phil raised an important question: Is the electorate—or whoever decides such matters—going to muster the will to renounce discretionary policy? I think we *should* renounce discretionary policy. Then ultimately it becomes a question of convincing the public that they're losing more than they're gaining from the Fed's unlimited discretion. In the long run the future of central banking is going to depend on the ideas people have about what's desirable. I think we should make an effort to convince them that central banking is not desirable.

Cagan—Our monetary policy has gone through a number of distinct phases. Targeting monetary aggregates is the latest strategy to achieve long-term price stability while keeping the economy on an even keel in the short-term. The problem now is that our financial markets are evolving in a way that could make monetary targeting more difficult.

I don't see any satisfactory alternative to targeting monetary aggregates. Interest-rate targeting doesn't work well. I don't think we would be happy under the gold standard. Consequently we have some serious difficulties ahead of us.

Hoey—The one thing that we should push for is a clearer delegation of responsibility concerning both the Fed's goals and its priorities. The logical number one priority for the central bank should be to prevent financial collapse and depression; secondly, it should maintain a stable value for the currency. Stabilizing the normal business cycle should be very far down on the Fed's priority list, especially since the capability of the Federal Reserve to achieve a stabilization of the business cycle has not been proven by experience. I think that the current political instructions to the Fed, as embodied in Humphrey-Hawkins type of legislation, places too high a priority on stabilizing normal business fluctuations and not enough on stabilizing purchasing power. These priorities should be reversed.

Reynolds—When President Nixon "temporarily" suspended convertibility of the dollar into gold back on August 15, 1971, he did something that's been done many times before in history. His action was based on a presumption shared by many academics at the time—namely that a group of technical economic experts could and should decide how much of what kind of money people should hold. At times these experts would shift their strategy and try to set what they felt was the correct rate of interest. Neither of these strategies worked. Civilized countries almost never operate under fiat money any longer than we have. Inevitably they go back to some kind of gold convertibility.

I don't view the Federal Reserve as withering away in my lifetime. I think, like the IMF, that the Federal Reserve is an institution that will last long after it has any useful function, if it ever had one. So, will anything happen in the near future? Everything looks impossible until we do it. As for myself, I'm an activist in favor of nonactivist monetary policy, and proud of it. While other people are wringing their hands and crying that nothing will ever happen, I think we may yet be surprised.

(l-r) Richard Hoey, Alan Reynolds

Poole—It's pretty clear that the views of economists, particularly Keynesians, have moved economic policy in the direction of greater discretionary authority over the last fifty years. That movement towards greater discretion was based almost entirely on two theorems, both of which have proven to be incorrect. One theorem asserts widespread failure of private markets to function well. As Larry White has indicated, in the case of banking, these concerns have been greatly exaggerated.

The second theorem, largely unexamined, is that

government works well. What we have found instead is that government is not able to do much of what policy activists thought government would be able to do. The new field in economics, the study of Public Choice, is deepening our understanding of how governments behave. In time, I think we will be able to make use of that knowledge to find better ways of constraining government policy, and of limiting the discretion that has caused us so much trouble.

Limitation of governmental discretion is what the gold standard historically was all about. The gold standard was effectively enforced for many years not because of some academic understanding from the Public Choice literature, but because there was an intuitive distrust of the government's monetary powers and ample experience with depreciating paper money. We lost that distrust along the way. Now we're finding our way back to an understanding that we have to have constraints on the monetary powers of government.

There is no reason why the constraints on the monetary powers of government have to be of exactly the same kind as the historic gold standard. In my view the gold standard mechanism is an idea whose time has past, but the fundamental notion of constraining the monetary powers of government must be revived. I believe we can develop a viable system of constraints that will work in a satisfactory way. I am certainly not pessimistic about our chances of explaining these issues to the electorate, and believe that our institutions will evolve toward greater constraints on the government's monetary powers. □

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