

INTRODUCTION

MONEY, POLITICS, AND THE BUSINESS CYCLE

James A. Dorn

Erratic Monetary Policy

The double-digit inflation of the 1970s has given way to the moderate inflation of the 1980s, but monetary policy remains erratic. From early December 1985 through early March 1986, M1 grew at an annual rate of about 8 percent. Money growth then accelerated to nearly 20 percent by mid-June and has slowed only moderately in recent months. With M1 far above its target range, the Federal Reserve is in the disturbingly familiar position of having to choose between the prospects of accelerating inflation or, if money growth is sharply reduced, a probable recession.

Economists have long recognized the importance of monetary disturbances in generating or sustaining business cycles. As a medium of exchange, money enters all market transactions. An unstable value of the monetary unit can distort market prices and profits—altering their informational content—and misdirect resources away from higher-valued uses. Thus, monetary disequilibrium can alter the structure of prices and production and upset the smooth functioning of a market economy. It is this non-neutrality of money that is the characteristic feature of the monetary theory of the business cycle.

The excessive growth of money in the 1970s, which temporarily lowered the real rate of interest, distorted the true cost of capital and encouraged speculation in agricultural land, real estate, and energy. These misdirected investments are now being revealed in domestic bank failures, the impending bailout of the Federal Farm Credit System, and the continued international debt crisis, which was born in the shift from accelerating inflation to disinflation.

The search for stable money continues: there is still no anchor for the paper money regime; the Fed still has broad discretionary powers; and there is still great uncertainty about future monetary policy. Within this regime, the money-supply process can easily become politicized—especially in the face of mounting budget deficits, historically high trade deficits, and large pockets of unemployment in declining industries. Indeed, the cries for a new industrial policy and the rise of protectionist sentiment offer strong reasons for refocusing attention on the importance of stable money and on the need for a sound monetary constitution.

The articles in this volume explore the impact of erratic money on price-level stability and economic activity, the recent behavior of velocity, the institutional requirements for a sound monetary framework, and how meaningful monetary reform might be implemented in a democratic setting. Also discussed are the effects of financial deregulation on monetary control and the implications of alternative monetary and exchange rate regimes for economic stability. Particular attention is paid to the public choice aspects of monetary politics in a fiat money regime and to the necessity of a sound monetary constitution to ensure stable money and prosperity. In this sense, the present volume—based on the papers presented at the Cato Institute's **Fourth Annual Monetary Conference**¹—follows the research agenda laid out in earlier monetary conference volumes.

The linkage of monetary institutions, monetary politics, and business cycles has long been recognized. In a discretionary monetary regime, as opposed to a constitutional regime, short-term political considerations are likely to dominate the money-supply process. The papers in this volume offer further evidence of the distorting effects of a fiat money regime and the benefits of moving to a rules-based regime. Whether the rule is geared to a monetarist money growth rule, a gold standard, a tabular standard, or a Hayekian competitive currency standard with free banking is secondary to the importance of establishing a constitutionally grounded monetary standard. Without a constitutional anchor to stabilize the value of money, the current monetary regime is unlikely to gain credibility as it drifts according to the political winds.

The problem of moving from the current discretionary environment to one characterized by strict limitations on the monetary powers of government and the central bank is a difficult one. Within a majoritarian democracy, monetary policy can be used to "buy votes." Further, the resource drain from inflationary financing of government

¹"Money, Politics, and the Business Cycle," Washington, D.C., 16–17 January 1986.

deficits appears less costly to politicians than outright tax increases. Coupled with the Fed's inclination to conceal its true policy objectives and its reluctance to relinquish its discretionary authority, the implementation of a sound monetary constitution will be difficult at best. Nevertheless, history illustrates that monetary crises—and even moderate inflations—often provide the opportunity for adopting monetary institutions that protect the long-run value of money. With U.S. inflation at a relatively low level, the threat of a monetary crisis seems far removed. Yet, with the high rates of money growth over the past year and with considerable political pressure for continued monetary ease, it is perhaps an opportune time to reconsider the case for a monetary constitution. When the political landscape then becomes ripe for fundamental monetary reform, the intellectual groundwork will already have been laid for implementing a sound program for monetary stability.

Money and Business Fluctuations

In the opening paper, *Beryl Sprinkel* underscores the significance of stable money—that is, a noninflationary money growth path—for efficient markets and long-run prosperity. He argues against the futile exercise of trying to fine tune the economy via monetary and fiscal policy. The existence of various lags and the lack of detailed knowledge of the structure of the economy mean that attempts by policymakers to fine tune the macroeconomy are bound to be destabilizing. Although nonmonetary factors contribute to business fluctuations, says Sprinkel, the dominant force behind business cycles has been variations in the quantity of money. Thus, Sprinkel favors a policy of stable and moderate monetary growth. Such a policy would tend to avoid wide swings in the price level and set a framework for rational investment decisions and economic growth.

The role of money in rival theories of the business cycle is examined in the articles by *Leland Yeager*, *Gottfried Haberler*, and *Roger Garrison*. Yeager contrasts the “monetary disequilibrium hypothesis” with the Austrian theory of the business cycle and with the rational expectations (ratex) and “equilibrium always” models. Under the monetary disequilibrium theory, discrepancies in the demand for and supply of money at the prevailing price level set into motion an adjustment process during which real variables are influenced as the economy works its way toward a new equilibrium price level. Stickiness in price and wage adjustments, as well as other institutional rigidities—and the basic fact that money has no market of its own—mean that monetary disturbances can have a pervasive effect

on real economic activity during the transition process. This monetary disequilibrium hypothesis has a long history and is largely consistent with the available data, says Yeager.

In contrast to the monetary disequilibrium hypothesis, the Austrian theory of the business cycle, as developed by Ludwig von Mises and F. A. Hayek, assigns monetary contraction a secondary role in explaining business depression. Instead, the Austrian theory assumes that the seeds of the depression are already planted in a prior monetary expansion. Money is non-neutral, according to the proponents of this theory, because virtually any monetary expansion will have relative-price effects, cause the market rate of interest to diverge from its equilibrium level, and alter the structure of production. Yeager questions the Austrian business cycle theory in which money has specific injection effects. He finds no convincing evidence for this theory, especially its explanation of depression, and argues that its scenario is both incomplete and overly specific.

Yeager also is dissatisfied with the theoretical underpinnings of the *ratex* and equilibrium-always approaches to the business cycle; for they ignore the basic features of monetary disequilibrium. They disregard the sluggishness of price and wage adjustments during monetary disequilibrium, a sluggishness that is quite reasonable and understandable from the points of view of individual price-setters and wage negotiators. To rid the economy of the adverse effects of erratic money, Yeager proposes privatizing the supply of money, defining money in terms of the value of a commodity bundle, and separating the unit of account from the medium of exchange.

Gottfried Haberler and Roger Garrison offer further assessments of the Austrian business cycle theory, using Hayek's version as the basis for their critiques. Haberler, like Yeager, finds serious shortcomings with the Austrian theory, while Garrison sees the theory as offering important insights not found in rival theories of the business cycle.

Haberler's paper is of particular interest for the light it sheds on the development of Hayek's theory of the trade cycle in the 1930s, when Hayek was a young professor at the London School of Economics. Hayek's theory is essentially an overinvestment theory of the Great Depression based on "maladjustments in the structure of production" brought about by prior monetary expansion during the boom. Neither the Hayekian maladjustment hypothesis nor other maladjustment hypotheses are satisfactory to explain the Depression, says Haberler. The root cause of the Depression was the sharp contraction of the money stock; the maladjustments were of secondary importance. Haberler notes that even Hayek now concedes that the appro-

pritate policy to restore normal production and employment in the 1930s would have been to return money growth to a path consistent with price-level stability, rather than to wait for real wages to fall far enough to make it attractive to hire workers.

Hayek's use of the Ricardo effect to explain the upper turning point of the business cycle is disputed by Haberler. He also sees an inconsistency between Hayek's earlier call for a policy of zero money growth (to approximate the ideal of "neutral money") and his recent proposal for denationalizing money. A policy of noninflationary money growth is preferred by Haberler over Hayek's early proposal for a constant money supply rule, since such a rule could engender a depression. In his own approach to business cycle theory, Haberler takes a somewhat eclectic approach in which both monetary and real forces play a role.² As such, he sees some useful elements in the Hayekian theory of the trade cycle. Moreover, he reminds us that any shortcomings of Hayek's trade cycle theory are more than offset by his overall contributions to economics and related fields.

Roger Garrison finds many positive aspects to Hayek's business cycle theory and implies that a careful study of its component parts can be rewarding. In particular, Hayek's integration of monetary theory, price theory, and capital theory—and the emphasis he places on intertemporal coordination—distinguish his theory from rival theories of the business cycle. One comes away from Hayek's theory with a better understanding of the effects of monetary disturbances on relative prices and the structure of production, and the importance of the interest rate as an intertemporal allocation mechanism. The arguments that the Austrian/Hayekian theory of the business cycle is overly complex, lacks empirical support, and offers no convincing explanation for the Great Depression are questioned by Garrison. He argues that such criticisms miss the major thrust of Hayek's theory and misinterpret Austrian methodology. He finds the Austrian theory superior to alternative theories of the business cycle by virtue of its microeconomic approach, its ability to account for intertemporal discoordination, and its incorporation of the Hayekian knowledge problem. Consequently, Austrian theory avoids the pitfalls of focusing primarily on the nexus between money and the price level, as well as the unrealism of the New Classical school's *ratex* and equilibrium-always models.

The critics of monetarism are addressed by *Leif Olsen* in his article, "Is Monetarism Dead?" Olsen notes that monetarism—in the sense of constraining the Fed to noninflationary money growth over the

²See, in particular, Haberler's classic *Prosperity and Depression* (1937).

long run—has never been tried. Monetarism, therefore, can hardly be said to be dead from a substantive viewpoint. Critics of monetarism wage their attack on emotional rather than logical grounds. They urge a set of contradictory policy prescriptions such as expansionary monetary policy, low interest rates, and low inflation; and they would use the government to circumvent market forces. Thus, Olsen interprets the strong antimonetarist rhetoric—evident in academia as well as the popular press—more to a dislike of the monetarists' free market perspective and their opposition to discretionary policy, than to legitimate theoretical and empirical support for antimonetarist propositions. The fact that inflation is primarily a monetary phenomenon has not been disproven in Olsen's view, even though the relationship between changes in M1 and nominal GNP have weakened. Market participants would be foolish, therefore, to ignore the basic tenets of monetarism and be swayed by straw men to support inconsistent policies and government fine tuning.

Politics and the Choice of Sound Monetary Institutions

The papers by *Peter Bernholz*, *Richard Wagner*, *Alan Reynolds*, and *David Meiselman* all consider the interface between the political regime and the monetary regime. Bernholz argues that since 1914 the absence of any anchor for stabilizing the value of money—which prior to 1914 had been accomplished by either a gold or silver standard—has imparted an inflationary bias to the conduct of monetary policy. To eliminate this bias, it is necessary to limit the monetary powers of government by adopting a sound monetary constitution. Bernholz draws on public choice theory and his extensive knowledge of inflationary episodes to suggest how an effective monetary constitution could be implemented and maintained. He examines three cases in which political forces were at work to introduce or reintroduce a sound monetary constitution: (1) the case of hyperinflation; (2) the case of returning to a prewar parity after convertibility had been abandoned; and (3) the case of returning to a lower parity after a moderate bout of inflation.

In the first two cases there were strong political forces working to stabilize the value of money. In the third case, as the costs of moderate inflation became more widely perceived, the political cost-benefit calculus gradually favored stabilization. It is at this politically propitious moment, says Bernholz, that intellectual force must be applied to enact a monetary constitution and defeat those special interest groups that would gain from a reflation. Only by restricting the

discretionary power of government will there be any chance for achieving long-run price stability, argues Bernholz. To remove the influence of government from the monetary regime, he advocates abolishing the Federal Reserve, moving to a pure gold standard, and ushering in free banking.

A public choice perspective is also taken by Wagner in his examination of central banking and the Fed in particular. He argues that theories of market failure and public goods do not provide convincing justifications for central banking and that this institution is better explained by the theory of rent seeking. Moreover, because rent seeking is inefficient, wealth maximization would have been better served if free banking had been allowed to emerge. In his analysis, Wagner uses the economic theories of bureaucracy and legislation to "test" the public goods argument for the Fed. He shows why it is unlikely that a truly independent Fed would emerge within the framework of a majoritarian democracy. What his analysis suggests is that monetary reform without political reform is impossible. A sound monetary system, therefore, ultimately rests on taking a constitutional approach to democratic government as well as to the monetary regime itself.

Alan Reynolds ties the market for Fed watching to the existence of a fiat money regime in which the central bank follows no consistent policy rule. The uncertainty generated by this regime, including the secrecy of the Federal Open Market Committee (FOMC) meetings, offers the potential for profit by correctly anticipating changes in monetary policy. Failure in monetary policymaking, says Reynolds, typically generates additional scope for Federal Reserve discretion and enhances the market for Fed watching. In effect, the Fed thrives on uncertainty because it offers a rationale for an eclectic approach to monetary policy and maintains the Fed's bureaucracy. If the policy environment were more certain, as it would be under a monetary rule, there would be no need for an activist central bank. Reynolds notes that both quantity rules and price rules would limit central bank discretion; his preference, however, is for a price rule in the form of a gold standard or price-index rule.

The impact of elections on Fed policy and money growth is explored in Meiselman's paper. Faster money growth prior to an election should influence the election outcome if such a policy temporarily increases output and employment. But such a plan depends on *unanticipated* monetary shocks, not on systematic policy actions. Taking a twist on the rational expectations' presumption that the public learns, Meiselman observes that the Fed also learns. Indeed, it is the Fed's ability to be a moving target that keeps the public from correctly

anticipating monetary policy and allows the Fed to influence business conditions and financial markets. To play this game, says Meiselman, the Fed "must make strategic choices when and how to play." This aspect of policymaking implies that the Fed's success at influencing real variables will depend on uncertainty about monetary policy and strategy, and that it is in the Fed's perceived self-interest to create and maintain monetary policy uncertainty. One consequence is economic waste, partly reflecting general inability to forecast Fed actions and thereby business conditions, interest rates, and financial markets. Another consequence is increased difficulty finding statistical regularities in observed Fed behavior and the effects of monetary change, including evidence of a political monetary cycle itself. Meiselman does find some empirical support for a political monetary cycle: a systematic relationship between monetary policy and election strategy shows up for the 1960 presidential election, and, with the exception of the 1976 election, continues to hold through the 1980 election.

Banking and Business Conditions under Alternative Monetary Regimes

Theory and experience are both useful in selecting a new and improved monetary system. The articles by *Gerald O'Driscoll, Jr.*, *Hugh Rockoff*, *William Haraf*, and *Allan Meltzer* are instructive in this respect. O'Driscoll restates the legal restrictions theory (LRT) as five interrelated propositions and offers his critique. He questions the theory's methodology and its conclusion that non-interest bearing money is solely the product of regulation. In his discussion, O'Driscoll points to the tradition emphasizing money's nonpecuniary yield. He also questions whether economic fluctuations would entirely disappear in a fully deregulated financial system. Once the essential properties of money are recognized, argues O'Driscoll, the existence of unregulated banking is unlikely to see the production of interest-bearing base money. Although he points out the shortcomings of the LRT, O'Driscoll thinks it can offer valuable insights when merged with more traditional theories of money and banking.

Hugh Rockoff argues that the Scottish and American experiences with free banking offer evidence for the hypothesis that inconvertible private currencies are not inherently unstable. The institutional features of free banking that promoted stability were free entry and information flows about bank balance sheets. These characteristics put competitive pressures on banks to engage in sound banking practices and allowed the public to select banks and their notes with

greater confidence. According to Rockoff, regulations set up to protect free banking—such as unlimited liability in Scotland and the bond security system in the United States—often limited the flexibility of the banking system and were unnecessary for stable free banking.

The Scottish and American experiences, says Rockoff, do not provide us with any conclusive evidence for Hayek's denationalization of money scheme. Nevertheless, they do offer limited support for Henry Simons's proposal for a 100-percent reserve requirement and Milton Friedman's recent proposal for freezing the monetary base as ways toward monetary stability. Stable free banking is most likely to emerge, notes Rockoff, when the government leaves banking practices to the private sector. Whether the lender of last resort function can be dispensed with, however, is an open question.

The recent behavior of velocity and the case for a monetary rule are discussed in Haraf's article. He argues that uncertainty over the future course of monetary velocity does not diminish the value of limiting policymakers' discretion. Haraf finds that monetary velocity, nominal GNP, and the price level are not trend stationary—that is, they are subject to permanent shocks that make their future values increasingly uncertain as the forecast horizon lengthens. He therefore recommends adopting a monetary rule that would make some nominal variable trend stationary in order to reduce uncertainty about nominal values. Haraf favors targeting the price level directly. Under a price rule, argues Haraf, there would be increased certainty about future price levels that would improve the environment for nominal contracting. Such a rule would reduce the lag between changes in the monetary base and the speed at which the observed price level approaches the target level. As a result of this shorter lag, says Haraf, *a major objection to price-level targeting is removed.*

Although Haraf prefers a price rule, he is not opposed to targeting nominal GNP or domestic final demand (DFD) to reduce uncertainty about their future values. However, he notes that rules targeting these variables would not necessarily bring about price-level stability. Under either a nominal GNP or DFD rule, the price level would still be non-trend stationary. Even so, Haraf notes that these monetary rules are superior to the present discretionary regime in which *all* nominal variables are non-trend stationary.

In the final paper, Allan Meltzer compares the experience of Japan and the United States under fixed and fluctuating exchange rates. He finds that in Japan the switch to floating rates reduced the variability of forecast errors for prices and output, while the opposite occurred in the United States. And he attributes this difference to differences in monetary regimes in the two countries. Japan, after moving to

floating rates, adopted and enforced monetary targets that provided for a gradual reduction in money growth. As a result of this policy, Japan significantly lowered its rate of inflation without suffering a recession. At the same time, Japan introduced market-oriented policies, including financial deregulation, and reduced the budget deficit. The United States, on the other hand, chose to continue on the path of discretionary, stop-go monetary policy and experienced recession on its way to lower inflation. And unlike Japan, the United States never really attacked its budget deficit.

The greater credibility of Japanese monetary policy after the move to fluctuating exchange rates, argues Meltzer, helped reduce fluctuations in monetary velocity. In turn, this lowered uncertainty about future price levels and outputs and increased consumer welfare in Japan relative to the United States. Adopting and *enforcing* money growth targets in the United States that provide for long-run price stability, therefore, could be expected to generate results similar to those experienced in Japan.

Rhetoric and Reality in a Fiat Money Regime

Fed officials often assure us that they favor price-level stability, and there is no reason to doubt their sincerity. It is also generally recognized, however, that the institutional and incentive structure confronting Fed officials generate conflicting policy goals. The Fed has little incentive to pursue a single policy goal, such as price stability, if it can avoid being held accountable by pursuing diverse goals. In this way the Fed can maintain its discretionary power and can react to whatever problem seems most important at the moment. The current fiat money regime, therefore, fails to separate money and politics. As such, it is unlikely to reduce uncertainty about the future value of money compared to a rules-based regime.

Market participants react to this reality in making their long-run decisions, rather than to the rhetoric of central bankers and politicians. Without constitutional limitations on the discretionary powers of government and the central bank, political considerations will continue to impact on monetary policymaking—and monetary disturbances will continue to play an important role in business fluctuations. It appears that for monetary policy to gain credibility, the Fed will have to undergo a radical transformation. But since neither the Fed nor Congress has much incentive to bring about meaningful monetary reform, it may take a crisis to implement and maintain a sound monetary constitution. Yet, as Bernholz reminds us, history

does provide some hope that even a moderate inflation may present an opportunity for achieving long-run monetary stability.

The essays in this volume help lay the framework for understanding the principles of sound money that must guide the transition to a monetary constitution. Paul Volcker (1985, pp. 11–12) certainly has the *rhetoric* right in this regard:

The lessons of economic history suggest to me that our success or failure in approaching the practical problems will be dependent on the degree to which we respect some broad guiding principles. Their precise application in particular circumstances will always be debated. But they are important precisely because they provide some fixed points of reference for the technical debate. After all our experience, here and abroad, a sense of price stability surely must rank as one of those principles.

The *reality* of the present fiat money regime, however, is brought out in the following “Policy Statement” from the Shadow Open Market Committee (1985, pp. 1, 3–4):

The Federal Reserve concentrates on short-term policy decisions and lurches from excessive money growth to slow money growth and back to excessive money growth, with no long-term program to achieve non-inflationary money growth. . . . The responsibility of the monetary authorities is to maintain stable monetary conditions consistent with a return to full price stability. Unfortunately, confusion and uncertainty surround monetary policy. The Federal Reserve announces targets for monetary aggregates and, at the same time, urges more intervention in the exchange market. . . . Further, the Federal Reserve uses control procedures that increase the variability of money growth. As long as current procedures are used, interest rates, exchange rates and output will vary excessively.³

Whether it is sufficient to change current procedures or whether more fundamental measures are required to achieve monetary stability are issues of utmost importance. By focusing on the economics and politics of monetary reform—and the importance of stable money—this volume will help pave the way for less confusion and more certainty in the monetary regime.

³Milton Friedman (1985) makes a similar statement:

Insofar as U.S. policy can be said ever to have been monetarist, it was so solely in rhetoric, never in performance. Since the Fed adopted temporarily the rhetoric of monetarism in 1979, monetary growth has been more unstable than in any other postwar period of comparable length. That hardly constitutes a monetarist policy, and it has had the anticipated results: similar instability in interest rates, the economy, and exchange rates.

References

- Friedman, Milton. "The Fed's Monetarism Was Never Anything but Rhetoric." *Wall Street Journal* (18 December 1985): letter to the editor.
- Haberler, Gottfried. *Prosperity and Depression*. Geneva: League of Nations, 1937.
- Shadow Open Market Committee. *Policy Statement and Position Papers*. PPS-85-1. Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, 24–25 March 1985.
- Volcker, Paul A. Address before the Harvard University Alumni Association, Cambridge, Mass., 6 June 1985.