SHOULD WE SELL THE FED?

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Few topics in economics generate more disagreement than the question of monetary policy. No consensus appears to be emerging as more and more theories and proposals appear. Economists disagree over what monetary policy can do and what it should do. Indeed, the debate over monetary policy is often cited by noneconomists as evidence of the confused state of contemporary economics.

We suggest a way out of the confusion. We propose letting the market settle the issue of the proper monetary policy. The government should sell the Federal Reserve System and its power to make monetary policy to the highest bidder. Monetary policy would then be determined through market purchases and sales. Before we explain the details of our proposal, we will discuss some leading current proposals for the conduct of monetary policy.

Some Current Proposals

Discretionary Monetary Policy

Many economists have argued that the Federal Reserve should attempt to moderate the effects of business cycles by engaging in countercyclical monetary policy. The ideal policy response would differ according to circumstances, but it could be expected to be expansionary during recessions and contractionary during inflationary booms. The success of discretionary policy could be judged according to one or more criteria, including the rate of unemployment, the standard deviation of the growth rate of real output, the

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rate of interest, or the rate of inflation. The actual policy target itself can be subject to the discretion of the monetary authorities, changing as circumstances change. For example, depending on the situation, the Federal Reserve might switch from a monetary target to an interest rate target (Poole 1970).

A Monetary Rule

Milton Friedman (1968) put forth the most famous proposal for a monetary rule: the quantity of money (however defined) should be allowed to grow at a constant rate (say 3 to 5 percent) year in and year out. Under this plan, the Federal Reserve Board could be replaced by a computer. The constant growth rule, it should be noted, does embody an automatic countercyclical response. When economic growth is sluggish, the monetary expansion will be more rapid than economic growth, pulling up growth rates. When economic growth is rapid, the expansion of the economy is greater than the monetary growth rate, and monetary policy dampens things a bit. Although Friedman's constant growth rate is the most famous example of a monetary rule, there are others. For example, in a simple rational expectations model (Sargent and Wallace 1976) all known monetary rules are equally effective in reducing the variance of real output caused by unanticipated policy. The advantage of such rules is that they are known to all and are automatic; the rule replaces the discretion of authorities. Although the rule will not eliminate all macroeconomic problems, supporters argue that the rules perform better than the misguided interventions of authorities. The superiority of rules arises because of authorities' ignorance of the short-term timing and magnitude of the effects of monetary policy or because policymakers face incentives to follow inconsistent policies (Kydland and Prescott 1977).

A Gold or Other Commodity Standard

Many economists believe that the basic problem may be fiat money itself. With fiat money, only the authorities have the ability to limit the growth of the money supply. Rules can always be changed. With a paper currency tied to gold, an excessive monetary expansion will cause holders of paper to convert it into gold. The gold drain will force the government to slow down the rate of monetary expansion in order to restore the value of the currency and stem the outflow. The gold (or some other) standard thus provides the discipline to prevent wide swings in the value of the currency. A mild countercyclical response would perhaps exist with such a policy; its main

advantage is that authorities do not have the power to destabilize the economy under a commodity standard.[1]

Denationalization of Money

One proposal that appears to be gaining strength in Hayek's (1978) argument that money should be denationalized. The proposal amounts to ending the government's legal monopoly of currency issue and allowing free competition. If, for example, private banks begin to issue their own money, competition will force the banks to maintain its value. The force of competition, then, will automatically impart stability to the economy. There is some debate over the specifics of free banking. Greenfield and Yeager (1983) proposed severing the tie between the unit of account and the means of exchange in a free banking system. Whatever the specifics, the common element in proposals for denationalization is the belief that competition outperforms government-sponsored monopoly.

Current Federal Reserve Policy

The Federal Reserve sets policy targets in light of the current and expected future states of the economy. But the decisions made that guide policy and the actual policy are not easy to fathom. Since October 1979, the Fed has officially based monetary policy on targets for monetary aggregates. In recent years, the Fed appears to have abandoned the target approach with respect to M1; the growth of M1 is often well above or below the target range. Policy now appears to be some (occasionally erratic) combination of setting targets for the monetary aggregates, M2 and M3, and influencing interest rates.

Although our list of major proposals and actual policies is not exhaustive, it should be sufficient to demonstrate that numerous proposals for the proper conduct of monetary policy vie for support in political and intellectual marketplaces. Moreover, the proposals are so dissimilar as to create the impression among laymen that economists do little more than argue. The differences in policy proposals, however, do not for the most part reflect differences in goals. All of the proposals aim at increasing economic stability, which in turn should increase consumer welfare and may increase long-run economic growth. Welfare, stability, and growth, then, are the goals. It should be possible, therefore, to eventually find the optimal policy through trial and error. Accumulated historical experience ought to be moving policy in the right direction, as mistaken policies are tried

[1]For a recent proposal to return to the gold standard, see Mundell (1981).

and then abandoned. Such a belief, however, neglects the problem of incentives.

The Problem of Incentives

In a remarkable article, Milton Friedman (1986, p. 2) confessed that the time he has spent attempting "to persuade the Federal Reserve System that it was doing the wrong thing and that it ought to adopt a different policy . . . was time ill-spent." Friedman was not abandoning his belief that a monetary rule would work better than alternative monetary policies. He was acknowledging that, as the public choice theorists argue, public officials are like other people: They operate in their own self-interest. The chairman of the Federal Reserve Board has been called the second most powerful man in America, the adoption of Friedman's monetary rule—or, for that matter, *any* rule—would strip the chairman of discretionary power. It would be difficult for any public official to accept the proposition that some automatic system or computer could do a better job than he is doing. That tendency, mingled with the natural desire for power, militates against any member of the Federal Reserve Board choosing rules over discretion.

The problem with current policy is that the system's incentives are such that only those who believe in an activist policy are likely to end up on the Federal Reserve Board. Anyone qualified to serve on the board could earn far more in the private sector, and most board members take substantial cuts in pay when they join the board. If income is not the reward, then it must be the power, prestige, and influence attached to the position. Furthermore, the men and women attracted to the job are those who place a relatively high value on power and prestige. A banker whose principal goal is to maximize personal income is not likely to be interested in serving on the Federal Reserve Board. The current system, then, is biased toward activism because only activists will be attracted to the job.

It might appear that the bias toward activism would be no problem if activism were always the correct policy. But even granting the necessity for some activist policy, a problem still exists. Many different activist policies compete for public support and the Board's adoption, and choosing the correct policy might be made more difficult if questions of power influence the choice. The degree of activism that is optimal for the economy may differ from the degree of activism that is optimal for the monetary authorities. These conflicts will not always be resolved in favor of the economy.

It would be a gross misstatement to say that the performance of the economy does not matter to the monetary authorities. It obviously matters a great deal. No Federal Reserve official would willingly plunge the economy into recession in order to increase his or her power or prestige. Moreover, such temptations are not likely to exist, because poor economic performance tends to reduce the prestige of the Fed and bring about calls for a reduction in its power. The Fed, then, does not have unlimited, arbitrary power. Its general policies must not be too harmful to the economy; this constraint forces a certain amount of conservatism on the system. At the margin, however, there remain many choices to be made, and there is no mechanism to ensure that these choices are generally correct. The incentive structure may work to reduce the probability of disastrous missteps, but monetary policy may always limp along at something less than optimal. Recessions might be a little deeper or a little more frequent than they would be if those who made monetary policy bore the full consequence of their mistakes. As things stand, neither the chairman nor the board members can be removed. Although the president who appoints the members of an unsuccessful Federal Reserve Board might face political consequences, this check operates with a long and uncertain lag.

Current incentives, then, probably prevent disastrous mistakes while allowing or perhaps even encouraging small mistakes in monetary policy. If, as Friedman concluded, persuasion is largely a waste of time, what is to be done?

Selling the Fed

We suggest a remedy that forces the public and private interests to coincide. Specifically, we propose to sever the tie between the federal government and the Federal Reserve System by selling the Fed in the open market. The new Fed, however, would not be run as a typical profit-maximizing private bank. Rather, the profits of the private Fed are to be in the form of payments from the federal government. The payments in turn would be tied to the nation's economic performance. If the economy performed well, the Fed would receive a large payment from the Treasury; if the economy performed poorly, the Fed would receive a small payment from the Treasury. The owners of the Fed would have a direct financial incentive to find and adopt policies that lead to optimal macroeconomic performance.

We propose that the Fed and its power to control monetary policy be sold to the general public as a stock issue. The stock could be sold

through one of the major investment bankers or issued directly to all or part of the citizenry. The certificates could be re-sold at any time. Whatever the methods of original stock issue, the final outcome should be the same. In the end, the Federal Reserve will belong to those who are willing to pay the most for it. The method of original issue could have budgetary and distributional effects, but it should not have a significant effect on the final pattern of ownership.

The payments to the now-private Fed would be financed by tax revenues. They could be contingent on the economy reaching a certain level of performance and will always be directly related to performance, increasing as performance improves. The transfers from the Treasury to the Fed, therefore, would not represent a net revenue drain but would be part of the surplus generated by proper monetary policy.

The attraction of our plan stems from the change in the location of the debates over monetary policy. Debates would be moved away from academic journals, newspapers, and congressional hearings and into the market. Instead of vying for academic honors and political influence, proponents of alternative views will be forced to subject their views to the market test. If an economist has a better method of conducting monetary policy, then a corporation could gain profits by buying a controlling share in the Fed and instituting the policy. For example, suppose a monetary rule is in effect. If successful, the payments by the Treasury to the corporation increase and the price of stock in the Fed rises. Suppose, however, that the policy does not prove successful. If revenues earned by the Fed fall and the stock price falls, then the Fed is fair game for a corporate takeover.[2] Advocates of the gold standard could mount a takeover bid and institute their policy. If successful, the price of stock will rise and the policy will stay in place. If unsuccessful, the stock will fall in price and another takeover (and policy change) will become likely. Under this system, no unsuccessful policy can survive. Furthermore, as new knowledge leads to new ideas in policy, the market mechanism creates a relatively efficient way for new policies to be adopted. The long march from academic idea to popular approval to governmental adoption can be replaced by the quick implementation of new ideas by corporations seeking profits.

Current institutional constraints on the Fed's behavior would be removed under our proposal. The private Fed would have complete control over monetary policy. If the Fed chose to stop printing money and allow competitive monies, it could do so. The Fed could also

[2]Our plan would not allow anti-takeover measures, such as poison pills.

continue to issue money and allow private monies as well, with Federal Reserve notes serving as the unit of account. All three current policy instruments—the reserve ratio, the discount rate, and open-market operations—could be used in any way the Fed chose.

Our plan does not prevent the Fed from continuing to operate as it does today. The purchasers of the Fed could retain Alan Greenspan as chairman and tell him to carry on as before. Our plan also makes greater political control of the Fed possible. Nothing prevents supporters of the president from purchasing the Fed and operating it according to the president's directions. Those who believe that the president should have this power could purchase control of the Fed and subject their belief to the market test. Someone could even purchase the Fed and subject it to the control of Congress.

The possible sources of the Fed's policy, of course, would not be limited to politicians. Indeed, the battle for control of stock in the Fed might evolve into a battle of competing economists. A corporation could be formed to buy the Fed and implement the policies prescribed by, say, Milton Friedman; another corporation might espouse the theories of James Tobin. It is possible that a corporation could be formed to try the policies of some economist from the past, such as John Maynard Keynes. The debate between supporters of various economists could thus be settled by the market.

Many other differences could emerge in the competitive bidding for control of monetary policy. Whatever the debate, the market will settle it. Success or failure will be registered in the rise or fall of the price of stock in the Fed. What the Fed can and cannot do will also be reflected in the price of its stock. This reflection leads us to a major problem we have yet to confront. What is the basis to be for the payments to the Fed? In other words, what will constitute a successful policy?

The Problem of Success Criteria

Our proposal calls for the new Fed to be compensated according to the economic performance of the economy. The problem is to choose the proper criteria for measuring the success of monetary policy. Some economists believe that monetary policy can affect real output in both the short and the long run. Others believe that money can affect real variables in the short run only. Yet another group believes that anticipated monetary policies have neither short-run nor long-run effects on real variables.

More agreement is to be found when economists discuss the relationship between money and inflation. Practically all American econ-

omists believe that the rate of growth of the money supply has *some* effect on the rate of inflation. To some economists, inflation is always a monetary phenomenon. To others, money is merely one—and perhaps not the most important—of a host of factors that can cause inflation.

The same disagreements over the effects of monetary policy on real output and the price level arise with other performance criteria, such as the rate of interest. Such disagreements mean that no single criterion can be adopted as our measure of the success or failure of monetary policy. If, for example, the payoff to the owners of the Fed were based on its ability to raise the growth rate of real output above its long-run average, those who believe that monetary policy cannot accomplish such a feat would not bid for the Fed. Similarly, those who believe that money has little effect on the price level would bid very little for the Fed if the payoff to the owners was based entirely on the rate of inflation.

It is highly desirable that groups holding different beliefs about monetary policy should have an incentive to bid for the Fed, and the bidding itself should reveal the strength of these beliefs. In order to encourage those with differing perspectives on macroeconomic policy to bid for the Fed, we suggest multiple performance criteria. The payoff to the owners of the Fed could be based on a weighted average of the following: (1) growth rate of real GNP; (2) rate of inflation; (3) standard deviation of the growth rate of real GNP; and (4) nominal rate of interest.

The numerical measures of success or failure can be determined empirically, perhaps by considering the historical performance of the economy. Although we are not wedded to the four criteria listed above, either this or a similar alternative list is necessary to ensure that a variety of beliefs will be represented in the market for control of monetary policy. Factors other than monetary policy will obviously affect the economy and the resulting payoff to the Fed. The purchase price of the Fed should reflect the degree of anticipated control over economic growth, inflation, stability, and rates of interest (see our discussion of fiscal policy in the next section).

The payoff to the owners of the Fed could be based on the following formula: Payoff = Operating cost + β $(X - \bar{X})$, where X is the performance index and $\bar{X}$ is the historical average of the performance index. For the growth rate of GNP, the payoff coefficient would be positive. The payoff coefficient would be negative for inflation, the nominal rate of interest, and fluctuations in the growth rate of GNP. The allowance for operating costs is to ensure that the payoff will cover costs (and bids for the Fed will be made). If the cost allowance

is set too high, the purchase price of the Fed should rise to eliminate potential rents.

Once the payoff criteria have been set, modifications should be made only with the greatest of care. Otherwise, the owners of monetary policy would have substantial incentives to lobby for changes in the payoff matrix that would increase revenue. If the lobbying were successful, the owners would reap windfall gains. Similarly, politicians trying to earn political capital have incentives to periodically change the rules of the game, creating windfall gains or losses for the Fed's stockholders. The solution that suggests itself is that the criteria and the monetary payoffs for meeting these criteria should be established on a permanent basis, perhaps in the form of a constitutional amendment. Such a law would allow some limited flexibility for changing circumstances but would substantially increase the difficulty and costs of constant tinkering. The law would also protect owners of the Fed from capricious rule changes by Congress. That is, Congress, preferably through a constitutional amendment, must still set the goals of monetary policy. Our proposal is aimed at creating incentives so that the private goals of the policy-makers at the Federal Reserve will coincide with the public goals in choosing the best possible technical means of meeting those goals.

Possible Objections to the Proposal

Many objections will be raised against the proposal to sell the Fed and the conduct of monetary policy, so we will attempt to anticipate some of them.

1. *Monetary policy could be purchased by some wealthy crank who will then destroy the economy with crackpot policies.* The check against such an occurrence is that the payoff to a successful policy will be high enough to preclude purchase by any individual. The present value of the returns to successful monetary policy will be in the billions. For example, payment for an average level of performance could be set in the neighborhood of $1 billion per year (with substantially higher payments for above average performance). If the Fed were capitalized at 10 percent, its stock would be worth $10 billion.[3] This necessitates a large number of investors and prevents any single individual from having sufficient wealth to purchase the Fed outright.

[3]One billion dollars a year, or $3 billion, or even $10 billion in a $3 trillion economy seems a small cost to create an incentive structure that would produce the monetary policy generating the greatest possible levels of stability and growth.

There is the possibility of a large number of investors banding together to support some crank. The market, however, provides a quick check. A truly bizarre monetary policy would cause the price of stock to plunge, quickly leading to a takeover by investors who backed a more credible policy. The check on cranks, then, comes from the same market forces that prevent someone's buying IBM and converting its plants to manufacture electronic toothbrushes.

One problem remains. If a crank or group of cranks purchases the Fed and conducts a disastrous monetary policy, the damage to the economy could be enormous and would probably dwarf the private losses of the Fed's owners. We admit this possibility, but a crank could also be inadvertently appointed under the current system. Moreover, a political appointee may be more difficult to remove than a private manager.

2. *The price of stock in the Federal Reserve could be excessively volatile.* Some financial economists (Schiller 1981) hold that stock prices are excessively volatile relative to the stream of earnings. In other words, small changes in performances as measured by earnings often lead to extremely large swings in stock prices. The relevance of excessive volatility to our proposal is that small declines in performance might cause large declines in the price of Fed stock. A management change could then occur as the result of a takeover that was not justified on grounds of poor performance. The excess volatility of stock prices, then, could lead to excess volatility in monetary policy.

There are two counter-arguments to this argument. First, Flavin (1983) has argued that stock prices are not excessively volatile, so the issue remains in doubt. Second, even if stocks are excessively volatile with respect to the "underlying fundamentals," stock volatility is probably no greater than political volatility. Continuity and stability have not been the hallmarks of the history of monetary policy. The political swings of the electorate will produce changes in monetary policy under the current system. The stock price of the Fed could be excessively volatile in the short run, but will reflect performance in the long run. No such guarantee exists under the political control of monetary policy.

3. *A foreign power could purchase monetary policy and purposely use it to cripple the American economy.* Such an occurrence is unlikely for many reasons. First, a foreign power would find the acquisition to be quite expensive, particularly because it would have to be arranged through a third party (assuming that foreign governments would not be allowed to purchase stock directly). Second, it is not clear that crippling the American economy is in the best interest of any foreign

powers. Third, the danger is only slightly greater than under current conditions. Purchasing one or more leading corporations today and deliberately mismanaging them could cause severe damage to the economy. Whatever checks prevent hostile foreign purchases today—e.g., SEC and FTC rules—would continue to operate for the protection of a Federal Reserve, whose stock could be freely purchased and sold in the market.

Although we believe these checks would be sufficient to prevent hostile ownership of the Fed, some commentators are less sanguine. As an additional safeguard, we are not averse to giving the SEC (or some other agency) the power to void any sale of Fed stock that may jeopardize national security.

If we ignore for the moment the problem of overtly hostile foreign purchase, it is not clear that a private Fed should exclude foreign ownership. If the Fed performs better under foreign ownership, then the American economy benefits. Moreover, if one takes a broader view, it is possible that the optimal organization of the Fed is as a multinational corporation. Foreign subsidiaries would be responsible for foreign money supplies. Coordination of world monetary policies could lead to gains for all nations represented in the corporation. A multinational Fed could solve such vexing problems as the determination of optimum currency areas and the relative merits of fixed and floating exchange rates. The market price of the shares of the multinational Fed would reflect the success or failure of various international monetary policies. Consideration of these and other international issues, however, is beyond our scope here.

4. *Monetary policy is not effective without a responsible fiscal policy.* If economic performance is affected by monetary policy, fiscal policy, and regulations, then the payoff to the Fed will be affected by something it cannot control: the tax and expenditure policies of the federal government. Moreover, the necessities of financing the federal debt and continuing deficits could greatly reduce the degrees of freedom allowed the Fed in operating monetary policy.

This objection is important, but it does not reduce the attractiveness of the proposal. If the performance of the economy is lowered by irresponsible fiscal policy—in spite of responsible monetary policy—the price of Fed stock will reflect the Fed's limited powers. At the lower price, investors will have an incentive to purchase monetary policy and use it to improve the performance of the economy. Even if events are dominated by fiscal policy, good monetary policy is preferable to bad monetary policy.

The importance of fiscal policy suggests other counter-arguments. For example, if fiscal and monetary policy cannot be effective inde-

pendently, then perhaps the Fed should purchase them both. We see no inherent reason why both monetary and fiscal policy should not be sold. Indeed, selling both would be a way to determine if control of both is necessary to affect economic performance. If monetary and fiscal policy must work together to be effective, then stock in a corporation that controlled both would be worth more than the sum of the stock of two different corporations that controlled them separately. In such circumstances, a single corporation would end up controlling both. If monetary and fiscal policy can be operated effectively and independently, then comparative advantage is likely to lead to control of each by a separate corporation. Indeed, if fiscal and monetary policy are partly related and partly independent, a working relationship between the two could be worked out by the two corporations, e.g., some joint ventures or perhaps a jointly owned subsidiary. In sum, the market can answer the question of the relationship between monetary and fiscal policy and create firms that take account of that relationship, whatever it is.[4]

5. *The purchaser of the Fed could set monetary policy for some goal other than that selected by the political process.* For example, a financial institution with large bond holdings could purchase the Fed and use monetary policy to affect bond prices. In some instances, the goals of the firm will coincide with the public interest; in others they will not. The possibility arises, then, that a firm will purchase the Fed and use monetary policy for private benefit but public harm.

We do not believe that this problem could arise. For one thing, the firm must pay for poor macroeconomic results. The gain on its portfolio must be very large to offset this loss—particularly since we envision large payoffs to the successful management of the Fed. Also, portfolio gains are one-time in nature, but gains from successful operation of the Fed are continuous. The firm that intended to use the Fed to effect a one-time increase in the value of its portfolio would be bidding against firms seeking to purchase a lucrative perpetuity. The firms seeking the perpetuity would surely out-bid other firms most, if not all, of the time. Those rare cases where the firm seeking portfolio-enhancement won would be short-lived, because such firms would be ripe for takeovers.

The fact that Fed policy could be controlled by the president or Congress raises the possibility of political business cycles. A group of investors who are political supporters of the president could pur-

[4]We are not, however, advocating any particular approach to fiscal policy. Other proposals for changes in fiscal policy could be compatible with our proposal for monetary policy.

chase the Fed and use monetary policy in an attempt to initiate a cyclical boom on the eve of an election. Opponents of the president could purchase monetary policy in order to initiate a recession on the eve of an election. Either policy is unlikely under our proposal. It would be extraordinarily expensive to the new shareholders if the policy did in fact prove harmful to the economy.[5] Even more important, the adoption of our proposal would cut the political link between the effects of monetary policy and the president. Why would the president be praised or blamed for the effects of monetary policy if it is well-known that the office of the president has no control over monetary policy? Furthermore, the public does not have to wait for an election to change the control of monetary policy. If monetary policy is unsatisfactory, the price of stock in the Fed will drop, leading to a takeover. If the president or his supporters should purchase control of the Fed, the performance of the economy would still be judged in the market, not at the polls. Any attempt by the president to manipulate the economy for political advantage would cause the value of stock in the Fed to fall, quickly ending presidential control over monetary policy. Presidents, in common with other potential owners, must design monetary policy so as to maximize the long-run performance of the economy or else lose the Fed to new ownership. The political business cycle, therefore, is far less likely under our proposal than under the current system.

6. *Proper incentives could be created if we simply provide incentive pay to current members of the Federal Reserve Board.* For example, Morgan Reynolds (1980) has suggested that the Board of Governors be paid on a sliding scale, depending on the level of inflation. This plan addresses the problem of incentives, but it has two shortcomings. First, current members of the Board (who have 12-year terms) have generally been attracted to the job more for power and prestige than for income. Hence, they may be less responsive to these types of incentives than others who would seek the job of determining monetary policy. Second, the plan does not allow for takeovers by groups who think they can do a better job and are ready to subject their efforts and ideas to the market test.

Conclusion

We have presented a proposal to allow the market to choose the proper monetary policy. Although we do not explicitly favor a partic-

[5]Although presidential elections themselves are expensive, costing several hundred million dollars, the value of Fed stock under our proposal would be far more expensive—up to many billions of dollars.

ular policy, by leaving the question up to the market we implicitly adopt the view that markets work. The range of policies that could be adopted under the regime we propose is thus only a subset of all possible policies, due to the exclusion of policies based on nonmarket criteria of success. We note the limit our market orientation imposes on policy choices.

We also recognize that our proposal will not win immediate acceptance. In conversations with other economists, we have found our proposal labeled "crazy" or "too wild." Yet, as we have demonstrated, we have not found any compelling objections to our proposal. Once the novelty wears off, the simple logic of the market solution becomes clear. By putting forth our proposal we hope to introduce a new option into the debate over monetary policy, an option that may not be adopted today but at least will be available for some tomorrow when political and economic conditions make it possible.

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