A Private Committee for Monetary Reform: Process and Substance

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In this article, I propose establishing a private Committee for Monetary Reform (CMR), outline a process for advancing fundamental reform, and suggest what the substance of that reform might look like. Obviously, I cannot provide the exact details of the reform, or there would no point in having a process; the outcome would be preordained. The choice of a process is important, however, because the process will affect the outcome.

I first discuss how the process could work by drawing on the experience of the Shadow Open Market Committee (SOMC) founded in 1973 by Karl Brunner and Allan Meltzer. Second, I briefly review the case for monetary reform. Third, I propose some guiding principles for monetary reform. Fourth, I discuss the process in more detail.

The Shadow Open Market Committee

In August 1971, President Richard Nixon imposed wage-price controls in an attempt to dampen inflation, which was running at an annual rate of 4.4 percent (as reported at the time), as measured by the CPI. Arthur Burns, then chairman of the Federal Reserve, supported the controls to the dismay of Brunner and Meltzer, who, along with several other prominent economists, published an op-ed in the *Wall Street Journal* arguing that price controls distort market

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prices, and that the real cause of inflation is an excess growth of the money supply. But Meltzer (2000b: 2) recalled that although the op-ed attracted national attention, the process of getting the message out was "cumbersome, slow, and unsatisfactory." Thus, he and Brunner decided to establish the SOMC "to show that better policy choices were available and that inflation could be controlled at acceptable cost, if the Federal Reserve controlled money growth."

The SOMC met semi-annually over the years, and I attended several meetings as an observer in the mid- to late 1990s, when I worked in Washington, D.C. After Brunner's death in 1989, Meltzer alone chaired the group. Members of the SOMC prepared position papers on various aspects of monetary policy. The papers addressed both near-term policy and long-term issues. They were part of the process of improving policy discussion mentioned by Meltzer. A policy statement was prepared and committee members provided input into the statement's wording. The statement was modelled after that prepared at the meetings of the Federal Open Market Committee (FOMC). This all took place on a Sunday afternoon. The next day, the committee held a press conference.

The relevance of the SOMC to monetary reform today consists chiefly in its structure and focus. The membership of the committee did change gradually over time, but was relatively constant. There was continuity from meeting to meeting. Members certainly had different views on particular issues, and discussion was at times energetic. But all were committed to control of inflation through control of money growth. So there was a common purpose and broad agreement on theory. Consensus could be reached, typically driven by the chairman.

I propose incorporating these key features into a Committee for Monetary Reform. First, the committee must have a focus on fundamental monetary reform and not on current policy. Second, members should have a shared view of fundamental reform yet possess enough intellectual diversity to challenge each other on details. Third, discussions at meetings should build on prior discussions. The goal is to have a committee of semi-permanent membership and not a recurring seminar with an ever-changing set of participants. Meetings should take place on a regularly scheduled basis. Unlike the SOMC, the CMR should have a definite lifespan. Nothing facilitates agreement like a deadline.

Finally, and very importantly, there must a strong chairman to drive the committee to its goal. Anyone who has served on a committee, or been a senior staff member, can testify to the importance of a strong chairman.

Why Monetary Reform?

History does not repeat itself exactly. However, how leaders dealt with prior crises can provide lessons for dealing with new ones. The high inflation of the early 1970s generated a crisis of public policy: the imposition of wage-price controls. An ineffective, indeed, counterproductive economic policy was implemented to deal with a real problem. Meanwhile, the agency that could effectively control inflation was under a Fed chairman, Arthur Burns, who had an erroneous theory of inflation.[1] In Meltzer's account, the goal of forming the SOMC was to demonstrate that inflation could be controlled if the Federal Reserve controlled money growth.

Is there a crisis today? There is, in the sense that we are at a turning point for the Federal Reserve. There are multiple facets of the crisis.

Since the onset of the Great Recession and continuing into what is now more than six years of economic recovery and expansion, the Fed has greatly expanded its balance sheet and changed the composition of its assets. The average maturity of its portfolio has been lengthened, which means it has taken on much greater interest-rate risk, and its portfolio is concentrated in housing securities. Plosser (2014: 202) notes that this is a form of credit allocation that takes the central bank into the realm of fiscal policy, which deals with the size and composition of government spending. By lending to particular sectors at subsidized interest rates, the Fed is shifting resources toward favored sectors.

The Constitution intended that Congress make such decisions, if they are made at all, in a democratic fashion. Members are answerable to the electorate for their decisions. It is not always a pretty process to watch, but it imposes constraints not present when central bank policymakers make allocational decisions through the

[1]Burns also was busy putting the Federal Reserve in the service of the re-election of President Nixon (Ferrell 2010).

assets they purchase. If Congress wants to subsidize housing, the constitutional way to accomplish that goal is to appropriate funds for that purpose.

When a central bank strays into fiscal policy, it is at a minimum not a democratic process. It also threatens its independence and creates other political economy problems. As Plosser (2014: 208) emphasizes, "If the set of institutions having regular access to the Fed's credit facilities is expanded too far, it will create moral hazard and distort the market mechanism for allocating credit. This can end up undermining the very financial stability it is supposed to promote."

There is a crisis for the rule of law because the Fed is straying into fiscal policy. Thus, Plosser (2014: 208–09) advocates returning the Fed to a "Treasuries only" policy—that is, limit the central bank to purchasing only short-term T-bills—as an exit strategy from credit allocation. Other current and former Fed officials have made a similar recommendation (see, e.g., Lacker and Weinberg 2014). It is a proposal worthy of consideration by the proposed CMR.

The "Treasuries only" policy is not a panacea; it does not address the size of government, particularly its size relative to the private sector. It is government spending that takes resources away from the private sector, and thus affects resource allocation. When government appropriates resources for government purposes (e.g., war), those resources are no longer available to consumers and businesses.[2]

Government spending can be financed either through taxation or borrowing, which involves future taxation. In a Ricardian world, that choice does not affect resource allocation. As Ricardo recognized, however, we do not live in such a world (O'Driscoll 1977). So the choice can matter. If debt finance is chosen, and central banks are willing purchasers of Treasuries, then central banks can become enablers of government deficits. Nonetheless, the current "nontraditional" monetary policy strikes me as worse than "Treasuries only."

Central bank independence is a much-invoked value of central bankers. That valued independence, however, has been undercut by the Federal Reserve's low interest-rate policy. Jerry L. Jordan, a former president of the Federal Reserve Bank of Cleveland, notes, "In the 60-plus years since the Accord in 1951, the U.S. central bank has

[2]An increase in government spending also reallocates spending and incomes *within* the private sector. Firms and factors of production supplying services to the government gain at the expense of others.

gone full-circle from being a de facto bureau of the U.S. Treasury, to an 'independent' monetary authority, and back to a bureau of the Treasury. Of course, the long period of 'even-keeling' demonstrated that the Fed's independence was always more in rhetoric than reality" (Jordan 2014: 214).[3]

The policy from which the Fed sought to extricate itself in 1951, and which made it dependent on the Treasury, was one of interest-rate pegging or support of Treasury bond prices. The Accord ended that requirement, and liberated the Fed to act against inflation by raising short-term interest rates. Regardless of one's views of how truly independent the Fed ever was, in recent years it has effectively put itself back under the Treasury's thumb. Quantitative easing (i.e., large-scale asset purchases by the Fed) has a number of aspects, but it has functioned as a price-support program for Treasury securities. Consequently, the Fed surrendered its putative independence. That surrender is a crisis for supporters of central bank independence.

Through its aggressive lending during the height of the financial crisis, and its bailouts of some financial institutions, the Fed increased moral hazard. It socialized losses of financial firms while keeping the profits privatized. The Fed's "too big to fail" policy has been accompanied by a policy of "too politically well-connected to supervise" (Jordan 2014: 214). Cronyism among bankers and government officials is an epidemic in America and a crisis. It must be tackled in financial services as elsewhere.

The Fed began paying interest on bank reserves in October 2008, which roughly coincided with the beginning of the great expansion of the Fed's balance sheet. Each asset purchase added to the reserve balances of commercial banks at the Fed.[4] The interest being paid was low, 25 basis points, but lending opportunities were not attractive given the enhanced economic risk. Thus, banks built up their excess reserves at the Fed. That practice has continued and excess reserves are now around $2.6 trillion.

The volume of fed funds traded dried up in mid-2011. So the target fed funds rate has lost its meaning. A price has a meaning when

[3]Cargill and O'Driscoll (2013) provide a detailed discussion of Fed independence and argue that, indeed, it is more myth than reality.

[4]That is true whether the Fed purchases the asset directly from a bank or from its customers.

there are transactions at that price. The fed funds rate is now just a number.[5] Additionally, as the Federal Reserve expanded its balance sheet, it substituted long-dated assets for short-term Treasury bills. It now has no Treasury bills and thus nothing to sell to raise the fed funds rate at some future date (Jordan 2014: 220). This is a serious problem that deserves more attention (Melloan 2014). Fed watchers constantly ask, "When will the Fed raise interest rates? They should be asking, "*How* will it raise interest rates?

The Federal Reserve Bank of New York has established a reverse repurchase facility that enables the Fed to sell assets to financial firms for repurchase at a later date.[6] It puts the Fed in the position of being a borrower rather than a creditor. The facility could theoretically be used to set short-term interest rates, but it would need to be expanded to do so as a practical matter. James Bullard, president of the Federal Reserve Bank of St. Louis, believes the Fed would need to borrow "several hundred billion" dollars to raise short-term interest rates (Boesler 2014). There are about $250 billion of reverse repos outstanding in the Federal Reserve facility, so perhaps the system is close to where the Fed could attempt to effect monetary policy through use of reverse repos. But monetary policy is clearly in unchartered waters, and monetary experimentation may deepen the crisis.[7]

Additionally, the Fed has established the Term-Deposit Facility to help drain reserves.[8] It appears to be another exercise in monetary experimentation.

The major argument for monetary reform is the Fed's 100-year policy record. Selgin, Lastrapes, and White (2012) examined that record and cast serious doubt on the Fed's performance. Jordan (2014: 226) succinctly summarized the record: "The Fed's century-long track record includes the Great Depression of the 1930s;

[5]There is presently a limited amount of borrowing, mainly by foreign banks, and a limited amount of lending, principally by Federal Home Loan Banks. My thanks to Jerry Jordan for this analysis.

[6]In a reverse repo, the Fed borrows cash overnight from money market mutual funds and others using its securities as collateral. The counterparties return the securities the next day and receive their cash plus interest (Boesler 2014).

[7]As this is written, discussion of the risks associated with the new policy tool is occurring within and outside the Federal Reserve (Derby and Hilsenrath 2014).

[8]For an explanation of this facility, see www.federalreserve.gov/monetarypolicy/tdf.htm.

the Great Inflation of the 1970s; episodes of bubbles, panics, and crises; and an average inflation that left today's dollar worth a small fraction of the 1913 dollar. The challenge is to establish institutional arrangements that prevent the next hundred years from being simply more of the same."

Substance

Almost every proposal for monetary reform involves adopting a rule.[9] The nature of the rule varies with the reform proposal. All such proposals contrast with the current system, which is one of pure discretion. David Fand (1989: 323) succinctly described the current system. "The only rule governing [the Federal Open Market Committee's decisionmaking process] is that, at each point in time, those who are responsible for monetary policy choose the convenient and expedient thing to do." I suggest that this situation motivates many reform proposals. Almost any rule would add predictability compared to monetary policy today.[10]

A rule can specify a target for an economic variable. Examples are prices (price index), interest rates, nominal GDP, exchange rates, or an unemployment rate. The unemployment rate stands out as a real variable, while the others are nominal variables. I will return to this point.

A rule can specify a policy instrument to control, usually with a target in mind. An example is control of a monetary aggregate with the goal of zero inflation. The growth rate of the aggregate, say the monetary base, consistent with zero inflation must be estimated. The monetary rule then consists in a statement about the growth rate of the monetary base rather than prices. The reason is that the monetary base can be controlled directly by the central bank while prices cannot, but zero inflation or "price stability" is the ultimate policy goal.

[9]I am using rule in a broad sense, such as "the rule of law," and not narrowly as in "a monetary rule," which suggests a formula for the growth of a monetary aggregate.

[10]Under the leadership of Ben Bernanke and now Janet Yellen, the Fed has attempted to create more market certainty through better communication of their intentions ("forward guidance"). However, what matters to markets are actions, not intentions. Unlike discretion, rules restrict actions and inherently provide their own forward guidance.

My example is an old-style monetarist rule. It is essentially the rule the SOMC followed for its early history (Meltzer 2000b). Monetarist rules of this kind have fallen out of favor because of the inability of researchers to establish a stable or predictable relationship between a monetary aggregate and price inflation.[11] In the wake of the financial crisis, that problem has worsened. The connection between base growth and the growth of bank money appears to have been largely severed.

At this point, I only want to establish that monetary reform will involve choosing a rule of some kind. It may be expressed in terms of policy goals or policy instruments. Or, the rule might be that competitive banks responding to market signals determine the quantity of bank money ("free banking"). The debate over monetary reform will be over which rule to choose. I think it fair to say that there is no consensus among reformers of which rule to choose.

Just to sample from the alternatives, some advocate a commodity standard (gold, silver, or other); some advocate nominal GDP targeting, but there is no consensus on what type; some advocate competitive money production (free banking); some support nonbank private money production, like bitcoin; and so on. As long as there is reform cacophony, there will be no progress.

I now suggest a few principles of selection. First, rules aimed at controlling real economic variables should be excluded from consideration. The shared goal of reform advocates is taking a long-run view of monetary policy. That is what rules accomplish, or at least good rules. There is no long-run relationship between money, a nominal variable, and real variables. If monetary policy aims at influencing real variables, it almost inherently becomes focused on the short run. That is true because relationship between money and real variables is a short-run economic relationship.

My first principle is correct, but also controversial. The dual mandate for the Federal Reserve instructs it to set policy to promote maximum employment. I would not be the first to suggest that the policy could be interpreted as a long-run policy. In that case, a monetary policy of zero inflation could also promote maximum employment in the long run and moderate long-term interest rates.

[11]Not all researchers have given up on finding such a relationship.

But taking the long view is not what Fed policymakers have typically done. The Fed has in practice focused on fluctuations in the unemployment rate. That is nowhere more apparent than at the 2014 Jackson Hole conference ("Re-Evaluating Labor Market Dynamics"), and most notably in Janet Yellen's presentation (Yellen 2014). Fed employment policy makes my case that pursuit of a real variable leads to short-term policies.

Would the first principle exclude the Taylor Rule? At first blush, it appears to do so. That rule proposes adjusting the policy interest rate (i.e., the fed funds target rate) to deviations in the inflation rate from a target rate, and deviations of output from its long-run trend ("the output gap"). So the Taylor rule separately targets a nominal variable and a real variable. By contrast, nominal GDP targeting looks only at the product of prices and real output.

Some analysts interpret the Taylor Rule as aimed at targeting nominal GDP. Why then not target NGDP directly, as Hummel (2014) suggests? Some defenders of the Taylor Rule suggest that it is merely taking account of the Fed's dual mandate, which is the law of the land. That line of argumentation suggests a second principle, one that is a corollary of the first: the Fed's dual mandate should be ended. I leave to further discussion how to assess the Taylor Rule.[12]

My third suggested principle is not to allow the best to be the enemy of the good. There is no perfect monetary system. The path to monetary reform will involve a series of tradeoffs. That is especially true were the ultimate goal a competitive or private monetary system. O'Driscoll (2014) points out the subservience of a central bank to fiscal authorities. When governments run very large deficits, as a practical matter they require central banks to finance them. If the banking system consists of private banks, the financing requirements will threaten the solvency of the banks. That is what occurred with the Bank of England during the Napoleonic wars, and with other banking systems (Smith 1990). Private banks were given monopoly powers and privileges (e.g., limited liability and exclusive rights to note issue) as compensation for the requirement to lend to their governments. As the monopoly privileges accumulated, the heretofore private banks evolved into central banks as we know them today.

[12]Dorn (2014) argues that the Taylor rule would improve monetary policy but what is needed is fundamental reform.

A modern system of competitive or free banking would end similarly in a world of large fiscal deficits. That suggests that those advocating competitive banking face a complex task. They need to evolve a monetary rule for a transition period. And they would need to evolve a fiscal rule consistent with the long-run goal of free banking. Indeed, for any monetary rule to be durable, fiscal deficits likely must be tamed (Buchanan and Wagner 1977, Sargent and Wallace 1981, Cochrane 2001).[13]

But there is a silver lining in this complexity. In the medium run, advocates of competitive banking share common cause with a wide range of reformers who want a limited central bank. For example, free bankers might find common cause with advocates of NGDP targeting. Whether my speculation can be realized remains the outcome of discussion and debate on the proposed committee. So, I turn now to the process.

Process

At Cato's 31st Annual Monetary Conference in November 2013, I briefly outlined the idea for a reform process (O'Driscoll 2014: 403). The idea was received favorably in some quarters. Implementation has been made easier by the creation of Cato's Center for Monetary and Financial Alternatives. The Center could provide institutional support and sponsorship. Cato staffing in money and finance is expanding. The Center has an academic advisory board. So there is a natural population from which to draw members of a committee for monetary reform. Experts from other institutions would presumably also join the committee.

To clarify, I am proposing a *private* Committee for Monetary Reform. There are precedents for private efforts (Friedman and Schwartz 1963: 117–19). As explained below, the output of a private committee can influence legislation and then policymaking.

On the size of that committee, I suggest 6 to 12 members. The SOMC started with 12 members to mimic the number of voting members on the FOMC. It eventually migrated down to 6. Today it

[13]There can be reverse causation between monetary and fiscal rules. The existence of the gold standard helped ensure budget balance over the long run (White 2012: 420).

stands at 7. The Meltzer Commission (see below) had 11 members, and operated efficiently and effectively with that number. A range of 6 to 12 members makes for a good working committee. A smaller number may not produce enough diversity, and a larger number starts to become unworkable. Large boards are notoriously ineffective, and leave real decisionmaking to the chairman.

Other events make such a committee very timely. Congressman Kevin Brady (R-TX) has called for the creation of a "Centennial Monetary Commission" (H.R. 1176) to examine the Fed's performance and consider alternative monetary regimes. Brady was inspired by the National Monetary Commission, whose deliberations culminated in the Federal Reserve Act. His bill proposes that the Commission examine six possible monetary regimes, including the status quo.[14] The regimes encompass most categories of monetary reform. I would omit the status quo, since I am proposing a Committee for Monetary Reform and not the status quo.

Congress often creates commissions when there is agreement on the need for reform and legislation in an area, but no consensus on exactly what to do. When the area is highly technical, like monetary policy, there is added reason to move deliberations out of the normal legislative process. There is also a hope that a commission will be less partisan than is Congress.

When I proposed the idea of forming monetary reform group, Congressman Brady saw that its recommendations could feed into the Centennial Monetary Commission. He reacted favorably to my idea.

In July 2014, the "Federal Reserve Accountability and Transparency Act of 2014" was introduced into Congress (H.R. 5018). It requires that the Federal Reserve adopt a rules-based policy. The act specifies a "Reference Policy Rule," which is the Taylor Rule. The legislation does not require the Federal Reserve to follow the Taylor Rule, but the central bank must describe how its rule would differ. But it must follow a rule.

These two pieces of legislation and other developments create a politically teachable moment. The time is ripe for discussion, debate

[14]Rep. Brady introduced his bill, the Centennial Monetary Commission Act of 2013, in the 113th Congress. It did not pass, but he is expected to reintroduce it in the 114th Congress.

and action. A Committee for Monetary Reform could help shape the outcome of the reform process.

Substance merges with process. I have argued for continuity of members, regular meetings, and a fixed lifespan of the committee. I was staff director for the Meltzer Commission. By legal necessity, we held all our meetings and issued a report within a six-month deadline. In that period, there were meetings on 12 days and then public hearings on 3 additional days (Meltzer 2000a: 2). The report was written in real time as all that was going on. It is not a pace that I would recommend. I think a one-year time frame would work best. Here is why.

First, to be effective, the CMR should act in a timely fashion so as to influence the policy debate and have an influence on legislation. The timing is right. Second, there is no shortage of ideas on monetary reform. It is time to implement some of those ideas. The proposal for a committee is intended to produce an action plan. Third, it can be done logistically in a year. Maybe there would not be enough time to get a report in print. These days putting a document on a website is publication, however.

I would envision a series of meetings among the committee members. Other experts could submit papers and briefs to the committee. There could be hearings with testimony. All of that would ensure that a broad range of ideas for reform would be heard. The hearings at the Meltzer Commission were very important in shaping the committee report.

To reiterate, I am proposing the creation of a private Committee for Monetary Reform. It would not be subject to the rules and regulations applying to an official government commission. Some might think that a private committee would be less authoritative and influential than an official commission. My response would be that the stature of CMR members can offset that effect.

The committee's report would be its product. It would presumably summarize its deliberations, the material submitted to it, and the outcome of the hearings. It could recommend a series of reforms, which taken together would constitute a monetary regime. Or, it might choose to present one or more alternative regimes. The report would be the basis for legislation, not a piece of legislation. As previously suggested, its findings could feed into the deliberations of the Centennial Monetary Commission. The report would constitute public policy recommendations for consideration by Congress and the executive branch.

I reference once more the Meltzer Commission as illustrating what a commission report looks like. That commission was charged with examining a group of international financial institutions: the International Monetary Fund, the World Bank plus three other regional development banks, the World Trade Organization, and Bank for International Settlements. The commission made recommendations for each institution, more for some and fewer for others. To cite one case, for the development banks it was recommended that they change from lending institutions to grant-making institutions for poverty relief. That would transform them from being banks into something more akin to foundations. That is regime change.

Unfortunately, the World Bank mostly ignored the commission's recommendations. It mainly still lends to countries with easy access to capital markets. For very poor countries, some grants are being made. It is unclear what the rationale is for the World Bank's continued existence.[15]

The lesson for the CMR is that entrenched organizations oppose organizational reform. That reality must be incorporated into the plan of the CMR.

Conclusion

I have not covered all issues of design and implementation for a Committee on Monetary Reform. Some of that would be done by the committee itself. I trust, however, that I have outlined a process that can expedite a concrete plan for fundamental monetary reform.

In the wake of the financial crisis, the Federal Reserve has greatly expanded its balance sheet, expanded the kind and duration of assets that it holds, and made significant loans to the shadow banking sector—and even to arms of industrial companies like auto manufacturers. In doing so, it has taken on more and new types of risks that ultimately fall on taxpayers. As argued in this article, the Fed has surrendered what independence it possessed to the Treasury.[16] In

[15]My thanks to Adam Lerrick, formerly special advisor to the Chairman of the Meltzer Commission, for the analysis of the World Bank's recent operations. I also thank Allan Meltzer for his analysis.

[16]It has done so at the same time as it accuses its critics of jeopardizing its independence.

short, the Fed has expanded its size and scope, while de facto changing its institutional structure.

These events call for public reconsideration and reform. The intellectual climate is receptive to ideas for change. It is time to turn ideas into actions.

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