

PROSPECTS FOR FUNDAMENTAL MONETARY REFORM

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The intellectual climate has never been more open to a critical analysis of existing monetary institutions both here and abroad. When the Germans agreed to a monetary union, they were promised that they would keep the Bundesbank; only the name would be changed to the European Central Bank. Instead, Germans with whom I have spoken now think they got the Banca d'Italia. In the United States, before the financial crisis, the Federal Reserve was held in high regard by the public. Now, at least in some circles, "the Fed" has become a term of opprobrium, not unlike "the IRS."

Since the financial crisis, the entire monetary and financial system has come under increased scrutiny and criticism.¹ That includes not only central banks but also the private banking system, which is part of the money-creation process. Central banks are at the heart of the monetary and financial system, however, and they will be my focus.

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¹In November 2013, the Mercatus Center at George Mason University hosted a conference titled "Instead of the Fed: Past and Present Alternatives to the Federal Reserve System." That conference critically examined the historical performance of the Fed, prospects for improving that performance, and possibilities for fundamental reform. Also in November, *Cato Unbound* featured four essays on "The Federal Reserve at 100" (O'Driscoll Jr. et al. 2013).

I do not want to exaggerate the degree of criticism of central banks. Among academic economists at large and in much of the financial system, the Federal Reserve is still generally held in high regard. The latter is easy to understand, since the Federal Reserve bails them out and supplies them with nearly free money. The affection for the Federal Reserve among academics was best analyzed a number of years ago by Milton Friedman (in Fetting 1993) and detailed by Larry White (2005). They noted that a large percentage of monetary economists are employed by the central bank. Many others are consultants and invited to Federal Reserve conferences. People do not bite the hand that feeds them.

Relative even to the recent past, however, the prospects for serious discussion of monetary reform are bright. The work done over the years by scholars, many of whom have spoken at Cato's Annual Monetary Conference, contributed to these improved prospects.

In this article, I make a case for fundamental monetary reform, explain the critical problems that call for monetary reform, examine reform alternatives, and discuss prospects for reform. I also propose a strategy to improve the prospects for fundamental reform.

U. S. Monetary Commissions and Reform

National monetary commissions, like the Centennial Monetary Commission proposed by Rep. Kevin Brady (R-TX), have a long history in the United States. They signify that the demand for fundamental reform has caught the attention of the political system, but that the consensus required for legislation has not yet emerged. Congressman Brady and his colleagues have heard the call for change, but the nature of the preferred change is not yet clear. Further, the monetary system is a highly technical issue and one not readily addressed in the normal legislative process. A commission report can not only provide a path to reform but also provide political cover to make difficult choices.

These factors are evident in the structure of the Centennial Monetary Commission Act of 2013 (H.R. 1176). First, there are 13 "findings" that establish a need to consider reform. Then there is a call to "evaluate operational regimes," of which 6 are listed. The Commission is charged with recommending a course for monetary policy. Then there are the details on membership and reporting. The Act envisions that a Commission Report, which would delve

into the technicalities of monetary reform, could form the basis of legislation.

The Act notes that “following the financial crisis known as the Panic of 1907, Congress established the National Monetary Commission to provide recommendations for the reform of the financial and monetary systems of the United States.” Those recommendations became the basis for the 1913 legislation creating the Federal Reserve System.

The National Monetary Commission was created by the Aldrich-Vreeland Act of 1908. Republican Senator Nelson Aldrich of Rhode Island was its chairman. At a secret conference of bankers on Jekyll Island, Georgia, in November 1910, a plan for what became the Federal Reserve System was hatched. That plan, dubbed the “Aldrich Plan,” was eventually submitted to Congress (Bruner and Carr 2007: 145).

The Aldrich Plan was viewed correctly as a (big) bankers’ plan. In 1910 the Democrats took control of Congress, and in 1912 Woodrow Wilson was elected president. Progressives, now in control of Congress and the presidency, were (incorrectly) viewed as hostile to big banks (Kolko 1963). Carter Glass was the chief congressional sponsor of the Federal Reserve Act and naturally did all he could to disguise the Act’s origins in the Aldrich Plan. Paul M. Warburg, the true author of the Aldrich Plan, later detailed “the near-identity of the two” (Friedman and Schwartz 1963: 171, n. 59).

Long before the National Monetary Commission, there were earlier efforts at reform. There were alliances, political movements, and even political parties (the People’s or Populist Party) formed to effect monetary reforms. In 1897, a group of bankers and businessmen in Indianapolis established their own monetary commission. There was a plan for an asset-backed currency, the “Baltimore Plan,” put forward by the American Bankers Association at its convention in October 1894 (Friedman and Schwartz 1963: 117–18). For one reason or another, these early efforts never bore fruit. Some, such as the Baltimore Plan, would likely have avoided the Panic of 1907 if it had been in place.

If history is a guide, money matters must get worse before they can get better. Discussions, analysis, and a plan can mean that when crisis hits, there will be a way forward. The trick is to get the plan right so that we are really moving forward and not down a policy dead end.

Alternative Reform Proposals

The most basic distinction between monetary regimes is between a regime of discretionary monetary policy and one governed by rules. It is difficult to conceive of a regime of pure discretion in which the monetary authority followed no rules or regularities in their actions. It would be a regime of pure randomness.

R. S. Peters (1958: 5), in *The Concept of Motivation*, observed:

Man is a rule-following animal. His actions are not simply directed towards ends; they also conform to social standards and conventions, and unlike a calculating machine he acts because of his knowledge of rules and objectives. For instance, we ascribe to people *traits* of character like honesty, punctuality, considerateness and meanness. Such terms do not, like ambition, or hunger, or social desire, indicate the sort of goals that a man tends to pursue; rather they indicate the type of regulations that he imposes on his conduct whatever his goals may be.

Peters' analysis suggests that central bankers will evolve some kind of rule even if there are no rules with which to work initially. Three decades ago, Axel Leijonhufvud (1984: 23) proposed viewing the modern fiat money regime as "a random-walk monetary standard." David Fand (1989: 23), elaborating on Leijonhufvud's standard, noted that "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." It is a minimalist concept of rule-following behavior, and it is not unreasonable to designate such a regime as one of discretion.

The 100-year history of Federal Reserve policy is not an attractive one.² Most studies of it start by writing off the Great Depression. The two wartime experiences are treated as exceptional periods (with justification). Periods of monetary stability get down to a relatively few years in the 1920s, the post-Accord period in the 1950s, and the Great Moderation in the mid-1980s to the mid-2000s. In each period, the Fed was rule-bound though the rules differed: in the

²My historical sketch is heavily influenced by Allan Meltzer's verbal summaries of the results of his 3-volume *History of the Federal Reserve*. Friedman and Schwartz (1963) is also relevant.

1920s, the Fed was governed by the modified gold standard; in the 1950s, there was a fiscal rule of balanced budgets (after the Korean War), imposed by President Dwight Eisenhower, a deficit hawk; and in the Great Moderation, the Fed appeared to be following what is now called the Taylor Rule—a self-chosen and self-enforced rule.

In the monetary literature, the Federal Reserve's good performance is attributed to the Treasury Accord of 1951 and the central bank's newly achieved independence. Cargill and O'Driscoll (2013: 419–20) argue that the decade of the 1950s does not provide evidence that the Federal was independent, or that independent central banks provide superior inflation performance. Any central banker would have had a relatively easy job with the “Eisenhower Rule.” Once Eisenhower left office, the long-time Federal Reserve chairman of that era, William McChesney Martin, was willing to accommodate Kennedy-Johnson fiscal activism and inflation ensued.

The brief periods of superior Federal Reserve performance buttress the findings of rule-based models. Moreover, the three episodes suggest that there may be a variety of rules consistent with monetary stability: a gold or commodity standard, a fiscal rule, and a modified monetarist rule. What is important is that a viable rule was in place that constrained central bank policymakers.

As to the fiscal rule specifically, I suspect one must be in place for any monetary rule to work well. The Great Moderation was overall a period of fiscal balance, or at least an improving fiscal outlook, and ended, coincidentally or not, when fiscal deficits began growing again. A commodity standard requires and facilitates balanced budgets. As Lawrence H. White notes (2012: 420), “A gold standard does help to ensure budget balance in the desirable present-value or long-run sense, by requiring a government that wants to sell its bonds to stay on a fiscal path consistent with full repayment in gold.”

Classical fiscal theory evolved against the background of a commodity standard. From 1789 into the 1950s, a budgetary pattern emerged. “Deficits emerged primarily during periods of war; budgets normally produced surpluses during peacetime; and these surpluses were used to retire debt created during war emergencies” (Buchanan and Wagner 1977: 12). The constraints of a commodity standard helped promote balanced budgets over time. Classical fiscal theory emerged to rationalize practice.

Once Keynesian ideas gained political currency in America, ideas of fiscal prudence changed. If peacetime deficits can be monetized,

it is difficult to conceive how adherence to balanced budgets could be permanently reinstated. They were briefly in the 1990s with divided government. The Republicans gained control of the House of Representatives in part by promising a balanced budget. President Clinton was being advised by Treasury Secretary Rubin to balance his budget. Political forces aligned on that question. President George W. Bush had no such commitment. Instead, he implemented a new entitlement program (Medicare, Part D) and engaged in costly wars. There was no external constraint, such as that provided by a commodity standard, to keep fiscal discipline in place. History indicates that a durable commitment to balanced budgets requires some type of commodity standard. At least that is what has worked in the past.

Preconditions for Reform

Public choice considerations must be factored into any discussion of monetary policy generally and monetary rules specifically. To work as designed, a monetary rule must be incentive-compatible—that is, it must be consistent with the interests of monetary policymakers and the political powers to which they must respond. In the United States, that consists of politically appointed members of the Board of Governors, the presidents of Reserve Banks, members of Congress (especially the committees of jurisdiction over the central bank), and, realistically, the president. This mix produces the monetary “rule” of convenience and expediency identified by Fand.

More concretely, the Federal Reserve has focused on employment and only incidentally on prices. I speak here of deeds not words. Concern over prices appears in the speeches of every Federal Reserve official. The inflation record reveals that such concerns are not generally salient. Only when inflation hits high levels and produces political discontent does the Federal Reserve act against inflation. The Volcker Fed of the 1980s was an inflation-fighting Fed because high inflation changed the political calculus. Fighting inflation gained political support. The changed political calculus helped elect Ronald Reagan president, and he backed Paul Volcker’s continued anti-inflation policy. That policy had begun under President Carter.

The Federal Reserve will be buffeted by shifting political winds and respond in expedient ways so long as it is not rule-bound. It is the

existence of a monetary rule that enables it to resist political pressures to stimulate employment, or, as it now does, to supply credit to favored sectors like housing. The requirements of even the modified gold standard enabled the 1920s Federal Reserve to resist calls to stabilize agricultural prices. Low budget deficits in the 1950s kept pressure off the Federal Reserve to engage in expansionary monetary policy. History repeated itself in the 1990s as budget balance was restored and the Fed's following a Taylor Rule produced the Great Moderation.

Rules enable central banks to operate in a way that may be described as independent. As Adam Smith and the classical economists observed, it is the natural tendency of governments to spend in excess of revenues. Good rules help a central bank resist political pressures to inflate to pay for spending. Absence of a rule does not enhance, but rather erodes central bank independence (Cargill and O'Driscoll 2013).

Monetary policymakers must be rule-bound for the same reason that ordinary government officials must be bound by the rule of law. As the Founding Fathers well understood, preserving liberty depends on having institutions in which even bad men can do little harm. Public institutions designed to allow good men to do great things give too much power to fallible human beings.

Public choice arguments are complemented by informational arguments. These were at the heart of Milton Friedman's monetarism and Hayek's work earlier. They both argued that there are ineluctable informational problems that render discretionary monetary policy impossible. Neither suggested that monetary policy actions had no effects. Quite the opposite. Both men believed that money had powerful impacts on the economy. But both argued we do not have sufficient information about the structure of the economy and agents' expectations to improve economic outcomes in a *systematic* way. Friedman (1961,1968) summarized these arguments most cogently. A brief quotation from an early monetary work of Hayek anticipates Friedman's later, more thorough statement of the information problem. According to Hayek (1933: 23), "The one thing of which we must be painfully aware at the present time . . . is how little we really know of the forces which we are trying to influence by deliberate management; so little indeed that it must remain an open question whether we would try if we knew more."

Once one states a preference for a rule-bound monetary regime, the obvious questions are (1) which rule? and (2) where does the rule come from? In the monetary literature today, we have rule conflict. The failure of monetary economists to agree on a rule helps perpetuate monetary discretion.

I submit the second question has priority because, in answering it, we narrow or expand the choices. Most advocates of rules derive them as propositions of models. I propose instead that we choose from what has worked historically. The two procedures are not necessarily at loggerheads. Models can help us understand what worked. I have identified three different rules in effect during the relatively brief periods of monetary stability under the Fed: the modified gold standard of the 1920s, the fiscal rule of the 1950s, and the Taylor Rule accompanying a new fiscal discipline.

I would add an obvious fourth rule: the classical gold standard of the 19th century. In the United Kingdom, it was in effect from the end of the Napoleonic Wars until World War I. In the United States, it was in effect from the end of the Greenback period in 1879 until World War I.³ Before the Civil War, the United States was on a bimetallic standard.

The United Kingdom had the longer historical experience under the gold standard. From roughly the end of the Napoleonic Wars until the eve of World War I, the price level was essentially unchanged. Prices fluctuated in between, but inflationary episodes were chiefly associated with wars. The same was true in the United States. Other countries adopted the gold standard at different points in the 19th century. The UK experience was a gold standard with a central bank. The U.S. experience was a gold standard without a central bank. There was only the brief period from the Federal Reserve's creation at the end of 1913 to the beginning of World War I that the Federal Reserve was operating within the classical international gold standard.

A Note on Free Banking

Free banking, in its simplest terms, is a system of banking without a central bank. More important, it is a system of monetary freedom and competitive issuance of currency. Under a free banking regime,

³From a legal or de jure perspective, the classical gold standard didn't come into play until passage of the Gold Standard Act of 1900.

the monetary and banking systems are the product of market forces; the rules that emerge meet the market test. They are the product of the same evolutionary process that develops for all other goods in a market economy. That process addresses directly my second question: from whence does the monetary rule come? To the greatest extent possible, rules in money and finance should be market-generated.

Any move toward monetary freedom requires the end of legal restrictions—such as legal tender laws and anti-private coinage statutes—on competitive money. Moreover, as we have seen recently, anti-money laundering statutes can be used to suppress competitive money issuance (White 2014).

A Strategy for Fundamental Reform

I now turn to strategic issues. For 31 years, Cato's Annual Monetary Conference under the direction of Jim Dorn has become an indispensable intellectual assembly for all those interested in ideas and analysis of monetary issues. Jim has been catholic in his choice of topics, particularly when viewed over the course of three decades. He has provided intellectual diversity in monetary debates available nowhere else.

The question is how to get from a discussion of issues to a reform plan. How do we get from talk to action? The competition of ideas at Cato has made the conference a success. What I propose is taking up some of those ideas and moving forward with them. I see the Brady Bill proposing a Centennial Monetary Commission as a step in the right direction—toward mutually reinforcing monetary and fiscal rules.

To get from talk to action, I propose that those committed to actual monetary reform plan to meet regularly, along the lines of the Shadow Open Market Committee. They would meet not to discuss current policy but to devise a concrete plan for monetary reform.

We are not at the point where the goal can be accomplished in one grand event, like Jekyll Island, but only in a series of meetings with a core group of stable participants. Again, my model is the SOMC. The meetings should be under the auspices of an institution like Cato. These meetings would complement other monetary events. The meetings could also provide useful background research for the Centennial Monetary Commission. Then we could move from discussion, to a plan, and finally to its implementation in legislation.

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