SPECIAL CONFERENCE ISSUE

POLICY REPORT

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The Search For Stable Money

Despite the recent decline in the inflation rate, the economic uncertainty of the past decade is still with us. Unemployment and interest rates remain high, the price of gold is volatile, and many observers warn of another round of inflation. While the Administration boasts that inflation has been halted, Americans still lack confidence in the stability of the dollar. With this in mind, the Cato Institute held a conference in January to consider "The Search for Stable Money." Distinguished advocates of such alternatives as monetarism, the gold standard, and free-market currency presented papers. This issue of Policy Report *contains excerpts from a number of papers. Complete papers will appear in the Spring 1983 issue of the* Cato Journal, *available for $5.00 from the Cato Institute.*

Joseph T. Salerno addresses more than 200 participants at conference on monetary reform.

Staying the Course at the Fed

by Henry C. Wallich

Easing is urged on the Federal Reserve, particularly as a "quid pro quo" for budget tightening. It is generally recognized that the large structural component in our huge budget deficit, now on the order of $70 billion or more and in danger of going much higher if nothing is done, is at the root of many of our problems, including high real interest rates. A reduction in the deficit is urgently needed, to become effective at a time when the economy no longer needs the stimulus in order to recover. But would it make sense to ease monetary policy to compensate for the reduction in purchasing power resulting from a lower deficit? Reducing the deficit will contribute greatly to the reduction of real interest rates, as the government's demands on the national supply of savings diminish. Accelerating the money supply for an extended period would mean temporarily lower interest rates but more inflation and higher interest rates eventually, relative to the results of a stable money supply policy. There is a lasting benefit to be gained from a lower budget deficit but not from combining it with greater monetary ease. Trying to change the fiscal-monetary mix in the direction of greater fiscal tightness and

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Henry C. Wallich is a governor of the Federal Reserve System.

GUEST EDITORIAL

Falling Prices Are No Problem

by Tom G. Palmer

Even cartels made up of governments break up under the impact of market forces, as OPEC member-states are discovering. As this issue of *Policy Report* goes to press, the official OPEC benchmark price for crude oil remains at $34, but spot market prices are hovering around $28, non-OPEC producers are cutting prices, and OPEC member-states like Nigeria, Libya, and Iran are offering significant "discounts" to circumvent the cartel price. An official OPEC price cut of major proportions is just around the corner.

Deregulation of domestic prices is partly responsible for this falling price level, along with price-induced conservation measures and a world recession that have diminished the demand for oil. The doomsayers of the past 10 years, with their tales of "a new era of limits," the need for "sacrifice," and an end to prosperity and consumer capitalism — all brought about by OPEC and rising energy costs — have been proven wrong. Now many of these same people are bemoaning the *demise* of OPEC and *declining* oil prices, but they will be proven wrong again. Even government cartels cannot last forever or force their will on consumers in relatively free markets. The breakup of OPEC and simultaneously declining oil prices are in fact a welcome tonic for an economy in recession.

Following the logic of the anti-change gurus, support is brewing in some quarters for import surcharges on oil in order to maintain domestic energy prices above market levels. Proponents of this approach present two arguments, neither of which is compelling (although the law itself would be). The first is pure economic sophism: Domestic oil producers face declining revenues and declining profits, which will mean their demand for capital goods will decline; and banks that made investments or extended credit in the expectation of ever-rising oil prices will fail as they reap the consequences of their entrepreneurial error. This will lead to a ripple effect of unemployment and idle capacity that will plunge our society into an economic nightmare with no hope of escape. Of course, the same specious argument could be advanced every time a hot dog vendor in Times Square goes out of business, with the same logic leading eventually to economic collapse. In a dynamic market economy, as scarce capital is withdrawn from one activity, it is reinvested in others. The process of investment and production is merely diverted by market signals into other more profitable channels.

While some will lose from their incorrect anticipation of the future, many others will gain. Airlines and other fuel-consuming industries can expect to reap substantial benefits, along with industries sensitive to demand for consumer goods (average annual home heating costs, for example, may decline by $100 or more per household, meaning more money in the hands of consumers). Also, banks with investments in or loans outstanding to import-dependent developing nations or governments (like Brazil) can expect to do quite well. Some will be harmed, but others — the vast majority of us — will benefit immeasurably.

The other argument for an import surcharge is that a drop in oil prices will mean declining government revenues. The Morgan Guaranty Survey predicts that a $5-per-barrel price drop will result in a $19 billion drop in revenues for domestic oil producers. Of that amount however, some 70% will be offset by lower severance, windfall profit, and income taxes. Thus, federal, state, and local governments will be the biggest losers ($13 billion) from declining oil prices. Decades of conservative anti-deficit rhetoric have provided the rationale for tax hikes every time government spending exceeds revenues (and that means all the time). Since few have the courage to propose spending cuts, and liberals have taken up the conservative anti-deficit rhetoric, the pressure will increase to raise new taxes to replace the lost government revenues.

There are also those that contend that consumers would not be harmed because the price would merely remain the same, rather than go up. This is another sophism commonly advanced on behalf of state intervention: The benefits that consumers *would* have reaped but aren't allowed to are of no account because they aren't noticed. This may be astute political thinking, but it is as specious as it is vicious.

Price-propping oil import surcharges would bail out domestic oil producers and their backers, generate tariff revenues for government, and maintain revenue from other taxes, all at the expense of consumers and fuel-dependent industries. Oil import surcharges would deny consumers and industry the benefit of lower prices at the same time they would interfere with the downward price flexibility that is essential for the economy to extricate itself from recession.

Free-price movements are vital to a dynamic and prosperous economy. Efforts to artificially prop up prices through coercive government interventions will only impede the ability of the economic system to advance consumer welfare. ■

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Stable Money (Cont. from p. 1)

greater monetary ease is not a meaningful policy for more than a short period. All the lasting benefits come from the reduction in the deficit. That should be our major objective in the fiscal-monetary area. It is fiscal policy, not monetary policy, that can have a lasting effect on real interest rates.

The best contribution that monetary policy can make is to continue to bring down inflation. That is entirely consistent with a moderate rate of economic growth and a decline in unemployment to less unacceptable levels. Only if economic growth becomes very rapid, which does not seem likely at this time, would the inflation-reducing effects of high excess capacity and, unfortunately, high unemployment, be nullified and perhaps reversed. The best way in which the Federal Reserve could contribute to this continued reduction in inflation would be to continue its discipline on the growth of money and credit.

The Need for Rules

by Robert E. Weintraub

Recent history shows why constant monetary discipline will work and is needed. After 1948 unions stopped bargaining for annual wage increases large enough to force us to choose between unemployment and inflation and remained moderate in their demands until the late 1960s. They did so because during this period it was clear that the Federal Reserve would not underwrite the inflation that was needed to prevent unemployment from increasing as a result of excessive wage increases. And during this period, business cartels such as may have existed were essentially inactive. In the late 1960s, however, the Johnson administration gave the green light to unions and business cartels to increase wage demands and prices more aggressively. The Johnson administration abandoned monetary discipline in 1968 in favor of seeking to hold down interest rates. As President Johnson saw it, "the cost of monetary restraint is high and unfair, imposed on a single industry — homebuilding."

Whether to help housing or for other reasons, monetary policy concentrated on keeping interest rates down from 1968 to late 1979, except for Nixon's first and last years in office and Ford's brief time as President. As a result, money growth (Ml basis) was accelerated sharply after 1968 and grew on average more than 4 percentage points faster per year between 1968 and 1979 than in the 1956-1967 period. In association, after 1968, unions and cartels became increasingly aggressive and both inflation and unemployment increased secularly. Ironically (except for monetarists), interest rates also increased after 1968.

Reinstatement of monetary discipline in late 1979 brought sharp decreases in wage demands and price boosts beginning late in 1981 and continuing until now. Price and wage flexibility have returned in major measure. This development assures the ultimate restoration of normal real GNP growth and full employment, provided that we have the patience and courage to endure. Lately, however, there have been signs that monetary policy is again focusing on interest rates. This, in my opinion, bodes badly for future wage and price flexibility and economic stability. Beginning at the end of 1984, or early in 1985, inflation will be high enough for most to understand it was rekindled. And sometime around 1986 or 1987, we will again have to choose between galloping infla-

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tion and another recession.

In short, institutions with power to set wages and prices benefit from loose, undisciplined, easy-money policies. Their powers erode, however, and wage and price flexibility increase with monetary discipline. That is the lesson of history. It also is good economics. Strong, aggressive unions and cartels cannot thrive or even long survive in the presence of sustained monetary discipline. Consumption and investment patterns shift against unionized and cartelized industries in economies characterized by strong, aggressive unions and cartels under disciplined monetary policy regimes. Those who run unions and manage cartels know this, or learn it quickly, and they adjust their wage demands and pricing behavior accordingly.

History suggests that discretionary monetary powers will often be misused. Lloyd Mints put it this way in 1950, "About all that can be said in defense of the [Federal Reserve] Board is that any other group of men clothed with discretionary monetary powers might have done as badly." That observation also holds for the period from 1950 until now.

We should accept, at long last, that in monetary policy "rules" are preferable to "authorities." And at this time, the preferred rule would appear to be one that fixes the growth of M1 so as to rid our economy of inflation permanently. And doing that will promote price and wage flexibility and the return to full employment that all of us desire.

Alvin Rabushka of the Hoover Institution talks with Rep. Ron Paul after his address to the conference.

Anna Schwartz talks with Karl Brunner of the University of Rochester, banquet speaker at the conference.

Monetarism Hasn't Been Tried

by Michael D. Bordo and Anna J. Schwartz

Theory and evidence are convincing that a systematic monetary rule is superior to discretion. A fixed rule, with no feedback from the current situation to policy instruments, a rule that is simple and preannounced, is the most favorable condition for stabilizing the economy. Any feedback rule that involves government manipulation of the private sector's forecast errors is doomed to failure. There is no information available to authorities that is not also available to the private sector.

A fixed, simple, preannounced rule can take a number of forms. For some who are opposed to discretionary policy, the systematic rule is the gold standard rule; for others, an interest rate or price rule. We do not examine the reason such rules have won support. The rule we favor is a constant monetary growth rule. It satisfies the requirement for a systematic, preannounced policy or regime that economic agents can incorporate in their expectations. It is a rule which can easily be implemented. The case for it, as stated initially by Friedman, is that economists lack adequate knowledge to conduct discretionary policy successfully. A monetary growth rule would obviate monetary policy mistakes. When physicians take the Hippocratic oath, they pledge not to do harm to their patients. Economists should take a similar oath with respect to the instruments that they may be in a position to administer.

Some observers predict that the banking deregulation process now underway will obscure the quality of moneyness of assets and hence render control by the central bank problematical. We regard this apocalyptic view as unduly alarmist. Not so long ago, it was commonly argued that payment of interest on demand deposits would mean the end of their use as transactions balances. That has not happened, and we do not foresee radical changes on the horizon in the operation of the payments system. The alternatives are not the creation *de novo* of a set of monetary arrangements or the preservation unchanged of the existing set. For all the talk of the adoption of monetarism by central banks, their performance gives little indication that they

in fact have been influenced by the central message of the doctrine — monetary instability is a potent source of unstable economic performance. Note the wide swings that have been observed even in a smoothed, two-quarter moving average of the U.S. money growth rate since 1980 — 1.9% in the second quarter, 5.8% in the third quarter, followed by 13.2 % in the fourth quarter; in the four quarters of 1981, 8.1, 7.1, 4.9, 3.0%; and in the first three quarters of 1982, 8.3, 7.1, and 3.4%, with the fourth quarter figure a likely high multiple of the third quarter figure. Is this monetarism?

A legislated rule has never been tried. It is a modest step toward restraining monetary authorities, but both theory and evidence suggest that it could be a giant step toward achieving economic stability.

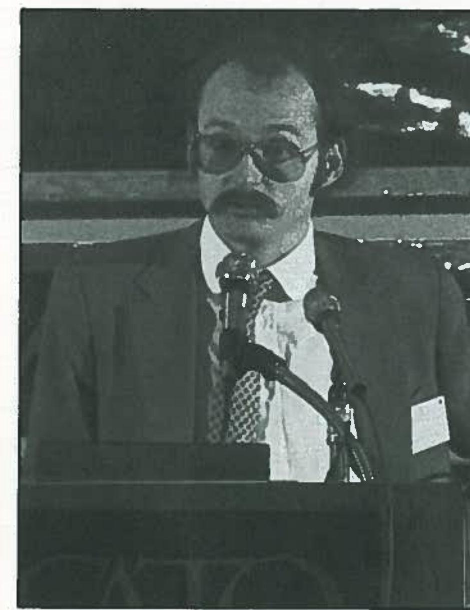
Michael D. Bordo is professor of economics at the University of South Carolina and a research associate of the National Bureau of Economic Research. Anna J. Schwartz is a research associate of the NBER.

Two Kinds of Monetary Distortion

by Don C. Lavoie

It is important to recognize that there are at least two different sources of monetary disturbance of the operation of the market. Monetarists have generally focused on what could be called the *price-level source:* Excessive monetary expansion tends to bring about a rise (either anticipated or unanticipated) in the overall price level, which implies that the value of the monetary unit, in terms of which prices are calculated, changes. This has obvious deleterious effects on intertemporal contracts, acts as a tax on money balances, and leads to various other misallocations of resources. The dangers from this source of monetary disturbance are real and have been analyzed at great length in the economics literature.

But there is another, quite different source of damage to the market from the side of money which might be called the *injection source:* Any monetary expansion brings about a temporary rise in prices near the point of injection of new money relative to prices that are more remote from that point. This occurs as long as there is *any* lag between the insertion of new money and the consequent adjustment of prices to a higher level, and monetarists themselves have estimated this lag to be as long as one to two years. The injection source of market disturbance induces wealth effects which confer special benefits to those participants in the competitive process who happen to be "near" (in an economic rather than geographical sense) to the



point of injection. Their input into the multidirectional tugs of the market process tends to pull the allocation of resources into particular avenues of investment, which would not be sustainable by the direct and indirect influence of consumer expenditure but which can only survive by virtue of further monetary injections. The strength of bidding power of these injection beneficiaries is not due to any superior foresight about consumer tastes or technological conditions but rather reflects mere luck (or conceivably the political foresight of certain competitors concerning what precisely the Fed or the Treasury Department is about to do next, although this seems to have been rather unpredictable in the past). Because the economic system is undergoing continuous change, the pathways through which the injected money works its way through the intricate latticework of market relationships will be forever changing, even if its entry points — say, the federal reserve banks — remain the same. But this implies that, unlike price level effects, injection effects are inherently impossible to anticipate (beyond the first few exchanges in the process).

Indeed the central thesis of Mises' and Hayek's work in monetary theory has been that the serious periodic recessions that have plagued the world's economies have been largely due to this injection source of monetary disturbance. Resources are temporarily drawn into capital investments which are inappropriate for the satisfaction of the consumers' desires and are eventually rendered unprofitable as consumer expenditures reveal this fact. Thus in the earlier (boom) phase of a monetary expansion, before the price level has fully adjusted, entrepreneurs are catering to the demands of the early recipients of the newly injected money and ignoring the implications of consumer preferences. However, as we approach the later (recession) phase of the expansion, and the money has had the chance to circulate fairly evenly throughout the system, the consumers become able to re-exert their influence, causing the misdirected investments to fail. If this theory is correct, then of the two sources of monetary disturbance, the one which is generally ignored may in fact be the most serious.

Don C. Lavoie is assistant professor of economics at George Mason University.

A World Central Bank

by Robert Mundell

One purpose of creating a world central bank is to provide a global money when it does not exist and it is desirable to create one. There are many others — to provide a source of international money when it is unduly scarce, and to curb its growth when it is excessive; to act as risk-bearing intermediary between surplus and deficit countries; to reduce, if not eliminate, unnecessary and undesirable fluctuations in exchange rates; to provide an intermediary between debtor

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and creditor countries for rescheduling or funding debt service commitments when ordinary channels and bilateral solutions no longer work. These functions are already partially filled by existing institutions such as the IMF, the IBRD, the BIS, and various regional banks, national agencies, and private consortia. But the prevalence of arbitrary international reserve growth, undisciplined debt growth, the insecurity of the international commercial banking community, the invasion of private fields by international institutions, not to mention the debt crisis, clearly reveals the gaps in the international structure. Crisis was narrowly averted in 1982, but there is no guarantee that a solution has been found for the rest of the decade and after.

I shall suggest below a plan for establishing a trillion-dollar World Central Bank. The Bank would be empowered to accept among its assets gold, foreign exchange, and debt obligations of the member countries. It could accept deposits of national currencies or selected debt instruments and, in exchange, open accounts for the member governments denominated in the World Reserve Unit, cheques on which would be accepted by other members up to multiples of its quota, which would be established by initial agreement among the participating countries. The Bank would extend credit at bank rate under specified conditions that would reflect market conditions. Its activities would be coordinated with, and help coordinate, the activities of the IMF and IBRD.

The new bank could play a role in the gold market, in the event that the major countries wanted to establish the new gold standard or re-establish the gold convertible-dollar standard. This could be effected through the use of existing SDRs as the new currency unit or by creating a new currency unit.

The World Central Bank could take the lead in accepting gold from national central banks that desire more central bank liquidity or in selling gold to those central banks which wish to reduce their holdings of the world reserve currency. The actual transactions could be carried out between the Bank and a member, or through one of the national central banks operating as an agent for the Bank.

A country would then have the option of stabilizing its currency in terms of the world currency, which would be convertible into gold, or of buying and selling gold directly. New credit lines opened up to countries by the Bank would earn an interest rate related to market (say, Eurodollar rate or Libor) while liquid deposits at the Bank would earn a lower interest rate.

The existence of such an institution would go far toward alleviating the current difficulties of debt rescheduling — or worse — and also mitigate the gigantic swings up and down of the dollar exchange rates when diversification takes place, or its opposite. It would also prevent the destabilizing fluctuations of international reserves caused by fluctuating gold prices.

Although some of these functions would be carried out in the absence of such a bank, they would not be carried out as efficiently or at an equivalent multilateral level of risk-spreading. The difficulties of establishing such a bank are considerable, but no more insurmountable than the difficulties of setting up the Bank of England or the Federal Reserve System. The path has already been laid by the comparatively successful establishment of the IMF and IBRD at Bretton Woods. After 40 years, these institutions are thriving, the more so as the debt crisis deepens. But the pace of financial development over these 40 years has been so phenomenal that a framework is needed to cope with the foreseeable difficulties of the next few decades. Gold alone cannot be the solution, with prices of gold likely to be negotiable. And dollar liabilities cannot continue to accelerate without undermining the U.S. currency. Eventually, we will have to face the fact that we need a new multilateral World Central Bank.

Returning to Gold

by Alan Reynolds

The current period is by no means the first time that a major nation has attempted to maintain the value of the unit of account by regulating the volume of some media of exchange. The United States was on such a system from 1776 to 1792, for example, and again from 1860 to 1878. Britain used managed money from 1797 until 1821. France tried it before Napoleon and again after World War I.

During the U.S. Greenback era, William Graham Sumner wrote:

> Nearly every nation which has ever used paper money has fixed its amount, and set limits which it has solemnly promised again and again not to pass, but such promises are in vain. A man might as well jump off a precipice intending to stop half way down . . . . In its more general effects, the paper currency with a fixed limit produces a steady advance in the rate of interest, and also a reduction in prices . . . . If we had a currency of specie value, we should get just as much as we need, and then we should know how much that is, but then, too, we should no longer care.

Alan Reynolds is vice president and chief economist of Polyconomics, Inc.

I have elsewhere prepared a detailed history of five past periods of chronic monetary instability, and the forces that very gradually led back to restoration of a metallic standard. Periods of fiat money — those that stopped short of runaway hyperinflation — had several features in common:

- A return to gold was always initiated during the deflationary aftermath of a relatively modern inflation.
- Government budgets were an acute concern, usually with a combination of deficits, growing interest expense, and tax resistance.
- There had already been many years of experience in trying to regulate or limit the quantity of money.
- Interest rates were always historically high, particularly in real terms.

The immediate results of returning to gold were also similar:

- Real output always expanded very rapidly for at least four years, thus solving the budgetary problems.
- The money supply grew even more rapidly, usually at annual rates exceeding 10%.
- There was no sustained inflation or deflation.
- Interest rates were always reduced, stock markets always rallied, and long-term rates never exceeded 5-6%.

The practical answer to the question "why gold?" is that it always works, while nothing else ever has. The burden of proof is not on gold.

The more abstract case for gold rests on the need to link the word "dollar" to something real, something of reasonably predictable value. Doing so reduces information costs, lengthens time horizons, and strengthens property rights.

The case for gold is not simply a way of depressing some price index — an ordinary credit crunch can do that, for awhile. Instead, the purpose of a firm monetary standard is to utilize money's potential for facilitating economic progress. The case for gold is the case for growth.

Gold vs. Central Banking

by Roger W. Garrison

Some reformers see gold as an instrument that can help the central bank do a better job. Gold, perhaps, can help the Fed behave as if it had both will and ability. I think that this view involves a fundamental misdiagnosis of the problem. Using gold as a monetary base, for instance, would improve neither of these characteristics. Technically speaking, the Fed has the ability now to keep its monetary base within a more narrow tolerance than would be exhibited by a gold base. Also, the Fed's will would be no stronger than its promise that monetary policy would be constrained by the amount of gold in its possession. The *implicit* promise that the central bank would be so constrained *used* to be effective when breaking that promise would have triggered a public uprising, but that was another day.

Today the Fed cannot stabilize the money supply until it regains some credibility; it cannot regain credibility until it demonstrates that it can maintain monetary stability. In a phrase, the Fed has crossed back over to the primeval side of the chicken and the egg problem. No marginal adjustment in the design or use of its monetary tools is capable of extricating the Fed from this predicament. A more drastic measure is required. Monetary reformers must force this institution, which is now utterly lacking in credibility, to perform an act that is *inherently* credible. The imagery that comes to mind here is the final scenes of the old western movies in which the posse is closing in on the bandits. When they finally come face to face, the bandits are not ordered "promise not to shoot"; the order instead is "throw down your guns." Monetary reformers must not be so naive as to confront the central bank and order "promise not to inflate"; the order instead must be "throw down your monetary tools." This is to say that only when the central bank's instruments of inflation are dismantled will it become credible that the bank will cease to be the engine of inflation.

It is with this understanding that the gold standard is put in the most favorable perspective. Gold is not the material with which we patch up a faltering central bank. It is a monetary commodity that can ensure confidence and hence stability in the *absence* of a central bank. Nature limits the size of the monetary base; competition and prudence govern the amount of money that the gold base will support. Under such a system there is nothing left in the way of monetary policy that the central bank needs to do or can do. Thus, I urge the supporters of gold to offer the gold standard as an alternative to central banking and not as an essential element of central banking.

Roger W. Garrison is assistant professor of economics at Auburn University.

Gold and Money

by Joseph T. Salerno

In sharp contrast to the proponents of a genuine gold standard, who seek to put an end to government monetary policy by completely denationalizing the money-supply process, it is the intent of the advocates of a gold price rule to integrate gold into existing fiat-money arrangements in such a way as to improve

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the conduct of government monetary policy.

For example, economist Alan Reynolds, a staunch supporter of a monetary policy based on a gold price rule, argues: "The purpose of the gold standard is to improve the efficiency and predictability of monetary policy by providing a flexible signal and mechanism for balancing the supply of money with the demand for money at stable prices. Elsewhere Reynolds writes: "The central issue, however, is whether monetary policy is to be judged by clumsy tools, like Ml, or by results. When sensitive prices [e.g., the price of gold] are falling, money is too tight; when prices are rising, money is too loose."

What is of overriding significance in these passages is the explicit or implicit characterization of the gold standard as a "mechanism" deliberately designed to implement specified policy goals, such as a "stable price level," that are aimed at by the government money managers. It is the underlying conception of the nature and role of money, which is implied in this portrayal of the gold standard, that ultimately and irreparably divides the modern from the traditional advocates of a gold-based monetary regime.

By using the gold price as a proxy for the general price level, the advocates of a price-rule regime thus hope to stabilize the purchasing power of the fiat dollar. While some of its supporters have made vague references to the desirability of getting gold coin into circulation, it is clear that the gold price rule is not meant to provide a genuine gold money.

From this brief overview of the gold price rule, it is evident that its proponents accept the currently prevailing view of money as a "tool" of government policy. According to this view, the monetary system is or ought to be deliberately and rationally constructed so as to promote, as efficiently as possible, the attainment of the various macropolicy goals sought by government planners. These policy goals are formulated and ranked in accordance with criteria that are developed independently of, and oftentimes in conflict with, the valuations and choices of market participants as these are expressed in the pattern of prices and quantities that spontaneously emerge in the free-market economy. From this standpoint, the degree to which a particular monetary policy is judged to be "optimal" depends on the extent to which it succeeds in altering the spontaneous microeconomic processes of the economy to yield macro-statistical outcomes that are consistent with the planners' chosen policy goals.

In short, the arguments of the policy-oriented advocates of gold are founded upon a presumption regarding the phenomenon of money which they share in common with their anti-gold opponents and which, as I shall argue, is emphatically rejected by hard-money advocates. This presumption is that money is a mechanism consciously designed and constructed to serve certain known purposes. These purposes are those of a small group of individuals acting in concert, namely government planners, and are therefore limited in number, subject to a unitary and consistent ranking, and capable of being readily communicated to those undertaking the design of the monetary system. Following Hayek, the attitude toward monetary institutions to which this presumption gives rise may be designated "constructivism."

In light of the Mengerian explanation of the origin of money, the answer to the question of how a good money is to be discovered and implemented becomes quite obvious. The money which emerges on the market is precisely the money that is best suited to perform the social coordinating function of a general medium of exchange, because it is the product of the natural selection process of the market, a process which brings to bear the experiences and knowledge of literally millions of human minds. To argue that such a market-chosen money can and should be improved on involves the heroic assumption that the myriads of individual transactors, whose decisions and actions over the ages ultimately conditioned the market's choice of a money, consistently and repeatedly erred in assessing the relative benefits and costs of alternative media of exchange. Furthermore, as Menger notes, the recurring formation of market prices is like the origination of money in that they both result from the anonymous individual strivings of countless individuals that constitute the market process. Therefore, if the market process can be counted on to repeatedly discover and converge on the "right" prices for an almost infinite array of goods, this same process surely can be relied on to find and institute the "right" medium of exchange and to continually and correctly adapt this institution to changes in economic conditions.

Allan Meltzer of Carnegie-Mellon University makes a point as Robert Greenfield (Fairleigh Dickinson University), Warren Coats (International Monetary Fund), and Carl Christ (Johns Hopkins University) listen.

Free-Market Money

by Leland B. Yeager

On reflection, our existing monetary system must seem preposterous. It is not difficult to understand how individually plausible steps over time have brought us to where we now are, but the cumulative result remains preposterous nevertheless. Our unit of account — our pervasively used measure of value analogous to units of weight and length — is whatever value supply and demand fleetingly accorded to the dollar of fiat money.

I used to favor the familiar monetarist quantity rule, but lately doubts have been plaguing me. Recent and ongoing financial innovations (money-market funds, sweep accounts, overnight RPs, overnight Eurodollars, highly marketable credit instruments, cash management devices, and all the rest) are hopelessly blurring the very concept of money and making velocity of whatever constitutes money hopelessly unstable and unpredictable. So, anyway, goes a view that I cannot confidently dismiss.

Realistically, a private money must mean money that is *predominantly* so. The government would still be involved — in repressing force and fraud and in enforcing contracts.

As a libertarian, I favor allowing free banking — the competitive private issue of notes and deposits redeemable, presumably, in gold. Notes and deposits would be backed by merely fractional reserves, since efforts to enforce 100% banking in the face of contrary incentives and private ingenuity would require an unacceptably high level of government interference.

Robert Greenfield and I have elsewhere described in detail the reform that I currently prefer, provisionally calling it the "BFH system" (because it is based in part on the ideas of Fischer Black, Eugene Fama, and Robert Hall). Like the reform proposed by Hayek, it would almost completely depoliticize money and banking. By the manner of its withdrawal from its current domination of our system, the government would give a noncoercive nudge in favor of the new system. It would help launch a stable unit of account free of the absurdity of being the supply-and-demand-determined value of the unit of the medium of exchange. The government would define the new unit, just as it defines units of weights and measures. It would be defined in terms of a bundle of commodities so comprehensive that the unit's value would remain nearly stable against goods and services in general. The government would conduct its own accounting and transactions in the new unit. Thanks to this governmental nudge, the public-goods, or who-goes-first, problem of getting a new unit adopted would largely be sidestepped. The government would be barred from issuing money. Private enterprise — probably in the form of institutions that combine the features of today's banks, money-market funds, and stock mutual funds — would offer convenient media of exchange. Separation of a unit of account of defined purchasing power from the medium — or rather *media* — of exchange, whose quantity would be appropriately determined largely on the demand side, would go far toward avoiding macroeconomic disorders and facilitating stable prosperity. Lacking any base money, whether gold or government-issued money, on which ordinary money would by pyramided on a fractional-reserve basis, the BFH system would not share the precariousness and vulnerability of ordinary monetary systems.

Although I do not have the space for a full description of the BFH system here, I would like to forestall a few misconceptions that, as experience shows, are likely to arise. The BFH system is not a variant of the often proposed composite-commodity or commodity-reserve system of government money. It is not a variant of the tabular standard (widespread indexing). Questions about whether the BFH system involves convertible or inconvertible money — questions presupposing some familiar answer — are inapplicable. The definition of its unit of account does not require "implementation" through convertibility of any familiar sort, any more than does maintenance of the defined length of the meter. (Of course, ordinary business practice would force people to make and receive payments for current purchases and sales of goods and services and in settlement of debts in property actually worth the specified number of units of account. Whether this counts as "convertibility" is merely a question of terminology.)

The BFH system would lack money as we now know it. People would probably make payments by writing checks — checks denominated in the defined unit of account — on their holdings of shares of stock in institutions combining the

(Cont. on p. 11)

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How the U.S. Blocks Free Trade

Toward a More Open Trade Policy, *by Murray L. Weidenbaum with Michael C. Munger and Ronald J. Penoyer. Center for the Study of American Business, St. Louis, 1983. 50 pp. $1.30.*

Former Council of Economic Advisers chair Murray Weidenbaum and two of his associates have produced a timely and readable analysis of present international trade practices, incorporating revealing data and insightful analysis with a persuasive call for trade liberalization.

The booklet opens with a current account of trade policies, data on the balance of payments with Japan and Western Europe, pressures for protectionism, and expected changes in the laws governing foreign trade. The second section includes a useful survey of foreign obstacles to U.S. exports, noting the myriad and ingenious non-tariff barriers to the importation of American-made goods. The nations surveyed include Canada, Japan, West Germany, the United Kingdom, France, and Italy.

Perhaps the most useful section is the third, "U.S. Obstacles to International Trade," those numerous tariff and non-tariff trade barriers so often ignored in public debate over free trade vs. protectionism. To cite just a few, the U.S. government limits agricultural imports if such goods interfere with domestic price support programs and requires that federal agencies pay up to 6% differential for domestically produced commodities. (Many states also have "Buy American" or even "Buy State" laws.) Also, U.S. flag vessels must be used to transport 50% of the gross tonnage of all commodities produced with U.S foreign aid funds, and all ocean shipments from one American port to another must be shipped in U.S. flag vessels. The U.S. imposes selective high tariffs on textiles, dairy products, chemicals and many other products, as well as coercive "standards" that, by coincidence, only U.S. manufactured goods meet. "Orderly Marketing Agreements" and "voluntary" quotas restrict the importation of many foreign goods.

Also included is a discussion of U.S. obstacles to exports, which seriously limit the ability of American firms to compete in foreign markets. Among these are thousands of regulatory burdens, export controls, restrictions on East-West trade, anti-boycott laws, and the Foreign Corrupt Practices Act of 1977, which imposes corporate fines of up to $1 million and individual penalties of up to five years in prison and a $10,000 fine. The Act has excluded American firms from markets where "commissions" are a regular and accepted part of doing business and, through its sweeping, intimidating, and ambiguous language, has forced firms to forgo lucrative opportunities and adopt conservative marketing strategies. Many of the impediments to American competitiveness in international markets originate in Washington, D.C., not Tokyo, Paris, or Seoul.

Policy Report Reviews

In the last two sections the authors make a compelling case for across-the-board liberalization of trade policies, warning of the dangers of using "reciprocity" as an excuse for imposing greater barriers to trade.

The major disadvantage faced by free-trade advocates is clearly stated: "One of the great difficulties in public policy discussions involving protectionist measures is that the beneficiaries are usually few in number, but each has a large individual stake in the outcome. Moreover, they have little concern about the likelihood of retaliation by foreign governments on other American industries. . . . Although the benefits of open trade may far exceed the costs, those benefits — such as lower prices to consumers — are widely diffused among 50 states and 225 million residents. Any consumer's stake in the outcome is quite small."

The authors conclude with a comprehensive eight-point program of reforms in trade policy designed to offset pressures for protectionism through free-trade initiatives.

Reaganomics: A Midterm Report, *edited by William Craig Stubblebine and Thomas D. Willett. Institute for Contemporary Studies Press, San Francisco, 1983. 232 pp. $14.95.*

The editors of this volume see "strong prospects" for long-term economic recovery under the Reagan administration's program, and insist that we must not "equate absence of immediate success with failure of the total program."

They acknowledge that the administration promised a "supply-side miracle" which did not occur. But, they say, "behind the administration's supply-side rhetoric has actually been a quite traditional mix of restrictive fiscal and monetary policies," which they contend will eventually prove right. While perhaps the most successful aspect of the current economic situation is the reduction in inflation brought about by somewhat tighter monetary policies, Stubblebine and Willett question whether "the initial slowdown in the rate of monetary growth may have been too great."

Other authors in the volume examine specific aspects of the Reagan program. Happily, the book generally avoids such overblown rhetoric as "the Reagan revolution," a myth adopted by both liberals and conservatives early in the Reagan term. Richard Rahn offers a useful defense of the supply-side thesis and acknowledges that very little of the supply-side program has been implemented. Attiat F. Ott makes some good points (sometimes inadvertently) in her discussion of government spending. She refers to a "dramatic reduction" in entitlement spending under Reagan, but her figures clearly show only a reduction in the rate of increase. William A. Niskanen, of the Council of Economic Advisers, in a brief comment, boasts that the rate of increase of federal spending was down to 11% in 1982, but acknowledges that the federal share of national output is up.

Thomas Gale Moore has a valuable assessment of the Reagan regulatory effort. He sees a "bias toward benefiting business, especially big business" in the Reagan administration rather than a bias toward "fostering competition." The administration's worst regulatory performance is in transportation, the great success story of the Carter administration. Reagan has moved toward more regulation in the maritime, airline, and surface transportation industries. Moore also has an interesting commentary on the problems with cost-benefit analysis, citing a case where two different administration studies produced benefit figures that varied by 8,000%.

Unfortunately, this volume is a largely superficial analysis of the Reagan economic program. The authors skirt such difficult issues as defense spending's impact on the economy, the rising government claim on GNP, and the lack of a real tax cut.

Bailing Out a Bankrupt World, *by Christopher Weber. Investment Insights Publishing Co., Vancouver, B.C., 1983. 164 pp. $16.95.*

In a bottom-line, no-nonsense fashion, Weber explains the international debt situation. Written for a general audience, the book investigates, nation by nation, the size of the debts, with sovereign bankruptcy making repayment impossible. Having made the financial nightmare clear, Weber explains how the situation developed as a result of the practices of the Western lending institutions, focusing primarily on the International Monetary Fund, the World Bank, and the American banking system. Weber speculates that eventually governments will bail out the creditors, generating a rapid inflation. Since it will require a strong currency and a strong nation to bear this burden, Weber predicts that the U.S. citizen will pay for the catastrophe. *Bailing Out a Bankrupt World* is not a policy-oriented book; it makes no recommendations. One can easily conclude, though, that the problem lies in state interventionism: government financial institutions and government regulation of the banking industry.

Weber estimates that of the $540 billion currently owed to Western banks by foreign nations, there is $300 billion in bad debts. When the loans come due and the nation cannot pay, all the creditor can do is postpone the payment deadline, hoping that the bankrupt nation will find some means of payment (usually more borrowing) in the future. This "rescheduling" of the debt, as it is called, is now common practice. In 1982 a total of $39.4 billion was rescheduled, more than the total of the preceding 26 years. It has become obvious now, Weber says, that "banks can count it a major triumph just to continue receiving the interest payments."

Why have banks so grossly overextended themselves? Weber cites several reasons. The McFadden Act, passed during the New Deal, prohibits banks from opening branches across state lines. Banks can and do, however, operate in other countries, where more business opportunities are available. Another reason billions were lent in the 1960s was to prevent nations from "going communist" (although later in the '70s billions more were lent to communist nations). The banks went along with this plan because of political pressures and, as Weber puts it, "all believed at bottom that if they ever got into real trouble, either the International Monetary Fund would take it out of the foreign countries' peoples' hides or Washington — or Moscow — would directly bail them out."

In Weber's view, the current crisis won't end in default. Western governments are tied too closely to their banks. The banks would be devastated by widespread defaults, ending in a major domestic crash. Instead, Weber expects a government bailout in typical inflationary fashion. The IMF and the World Bank are too poor to provide substantial bailouts. (He spends a chapter on these two institutions.) In the end, central banks will take up the slack. "While Germany and Japan will help out, there is really only one country rich and powerful enough to shoulder the burden: the United States." The Fed will buy the debt of bankrupt governments and monetize this debt in the same manner that it monetizes the U.S. debt. Weber predicts that this will result in tremendous inflation, greatly enervating the American economy. ■

Stable Money (Cont. from p. 9)

features of mutual funds and banks. (These shares would have market-determined flexible prices.) These practices would not entail the textbook inconveniences of barter. The advantages of having a single definite unit of account and convenient methods of payment would be retained and enhanced. The absurdities of linking the unit of account and medium of exchange in the manner now familiar to us would be avoided.

Unlike the monetarism we are familiar with, which requires an accurate adjustment of the quantity of money to the demand for it and must therefore be suspicious of innovations that alter the supply-demand relation and even blur the concept of money, the BFH system can positively welcome deregulation and financial innovation. The government can take just as much a laissez-faire stance toward the financial system, once it has offered and promoted a particular definition of the unit of account, as it can take toward ordinary businesses that happen to employ a defined unit of length in their operations. ■

Social Security: Continuing Crisis or Real Reform

A Cato Institute conference featuring Paul Craig Roberts, Norman Ture, Peter G. Peterson, Peter Ferrara, A. Haeworth Robertson, and Rep. William Archer, to be held June 6-7 in Washington, D.C. For information write Kristina Herbert, Cato Institute, 224 Second St. SE, Washington, D.C. 20003.

"To be governed . . ."

A freeze means letting taxes and spending rise

What we need to do is freeze the budget to thaw the economy . . . .

• A Tax Freeze. Freezing tax rates would mean deferring the 10 percent personal tax cut scheduled for July and canceling the indexing of tax rates for the near term . . . .

• A Defense Freeze. Freezing defense spending means holding ourselves to 3 percent real growth.

—Sen. Ernest Hollings in the *New York Times*, Feb. 6, 1983

Getting the voters off his back

Mayor Marion Barry refused yesterday to identify the city programs and services that he is cutting back this year to try to avert a projected $110 million deficit because, he said, the public would be confused by all the budget numbers.

—*Washington Post*, Feb. 18, 1983

Social Security's cousins

The pension bill adopted [by the Maryland legislature] in 1979 was called one of the state's most significant reforms, one that its proponents swore would pull Maryland from the edge of "fiscal ruin" and future bankruptcy caused by a costly, uncontrolled employee-retirement system.

But four years after the passage of the controversial legislation that was supposed to have ended Maryland's pension problems forever, the trouble remains. Far from leveling off as expected when the bill passed, pension costs have continued to skyrocket. In the last two years, the debt for future retirement costs has nearly doubled, from $2.9 billion to $5 billion. That figure is also nearly $2 billion more than experts had predicted in 1979.

—*Washington Post*, Feb. 6, 1983

A third alternative

Reaganism of the Week: The President, to the same convention: "Has anyone stopped to consider that the best way to balance the federal budget is not by taxing people into the poorhouse and it's not by cutting spending to the bone, but rather it's by all of us simply trying to live up to the Ten Commandments and the Golden Rule?"

—*Washington Post*, Feb. 7, 1983

Charity begins at home

The Washington region continued to claim a large portion of the federal dollar last year, as the District of Columbia led all jurisdictions in federal spending per person and Virginia and Maryland ranked second and fifty respectively among the states.

—*Washington Post*, Feb. 6, 1983

Tweedledee and Tweedledum

In Iowa, for example, conservative Republican Terry Branstad, 36, spent a year campaigning fiercely against higher taxes. After his election, Branstad . . . on his ninth day in office proposed the first increase in Iowa's sales tax since 1967. . . .

In Massachusetts, Gov. Michael Dukakis [a Democrat] has kept his campaign promise not to raise taxes . . . but has agreed to raise the gas tax.

—*Newsweek*, Feb. 28, 1983

Why we shouldn't hate Washington

Well, pardon me and excuse my English and remember, if you can, that I am educated beyond reason, but lump it America — Washington has won. Yes, the city you've learned to hate, the city of faceless bureaucrats and pointy-headed intellectuals has won the NFC championship. . . .

Maybe it was not the same as ceasing to pick on government workers or acknowledging that real people live here, but it will do for now. The bureaucrats won. They beat that most American of all cities: Dallas. . . .

Lump it, America. We won.

—Richard Cohen in the *Washington Post*, Jan. 23, 1983

Just let us compete

If President Reagan agrees to impose tariffs or quotas [on Japanese motorcycles], [Harley-Davidson chairman Vaughn] Beals said, "We will be in a position to compete head-to-head with the Japanese without any further protection."

—*Washington Post*, Jan. 20, 1983

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