Monetary Reform in the Wake of Crisis

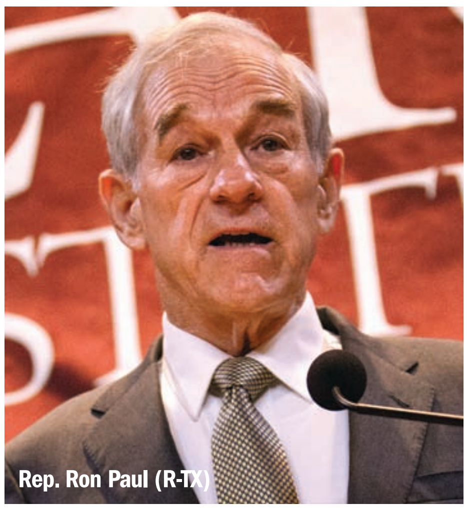
Over the past few years, the Federal Reserve has acquired an increasingly powerful position in both the U.S. and global economies, raising many critical questions. What is the best way to reform the global fiat money system? What monetary policies are needed to create a "free banking" regime? What are the limits of those policies? At the 29th Annual Monetary Conference, an all-day event held on November 16 in Washington, D.C., experts weighed in on these questions with their prescriptions for fundamental reform. Panelists offering various perspectives ranged from Austrian economists to the president of the World Bank.

REP. RON PAUL (R-TX): I've thought about the Federal Reserve for a long time now. I became fascinated with the monetary issue in the 1960s—having come across Ludwig von Mises and F. A. Hayek—and was very impressed when their predictions came true a decade later on August 15, 1971. I've always worked under the assumption that the regime that replaced the Bretton Woods system would be much worse. Well, the handwriting is on the wall.

We are currently dealing with a monetary system that is not viable—one that is little more than a deception. It's sort of like a drug—you get some benefits if you keep using it—you run up and monetize debt, run up inflation, and make a bigger bubble. But when the drug is taken away, you have to go through withdrawal. Ultimately, continuing to expand the Fed's balance sheet risks killing the patient—which in this case is the worldwide economy.

Confidence in the dollar is plummeting, confidence in the euro has been shattered by the European bond crisis, and beleaguered consumers and investors are slowly but surely awakening to the fact that government-issued currencies do not hold their value. The Federal Reserve is a facilitator of the current state of affairs—providing us with temporary benefits that are very detrimental in the long-term.

Politicians continue to fiddle around the edges as the country burns. We need to decide on the appropriate path forward, rather than continuing to paper over our monetary problems. I believe in a short period of time we will be forced into making those decisions.


Rep. Ron Paul (R-TX)

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I have supported a balanced approach to the Federal Reserve, even as far back as the 1980s Gold Commission. You can't close the Fed down in one day. Rather, I'd start by denationalizing money, taking the taxes off of silver and gold, legalizing competition in currencies, and allowing the free market to work in banking. This to me is the most important step we can take. But, at a higher level, we as a people ought to be asking a larger question: What role should government play in our society? Ultimately, if we defend the Constitution, restore the principles of liberty, and allow free markets to work, we would go a long way towards answering these fundamental issues.

BENN STEIL, Council on Foreign Relations: The financial crisis that began unfurling in 2008 has placed central banks at the forefront of the rescue and recovery effort. It is a fundamental postulate of today's dominant paradigm of Keynesian macroeconomics that all demand is created equal. Government spending is interchangeable with consumer spending, the logic goes—and this is itself interchangeable with business investment. I'd like to offer an analogy in response.

Imagine you get into the shower, turn on the water, and nothing comes out. You call the plumber. He tells you there's a hole in the pipes, and that it will cost you a thousand dollars to repair it. You tell him just to turn up the water pressure instead.

Sound sensible? Well, this is the logic behind the Fed's strategy of flooding the money pipes until credit starts flowing freely again from banks to businesses. You wouldn't expect this to work in your shower, and there's little reason to expect it to work in the commercial lending market.

The credit transmission mechanism in the United States has been seriously damaged since 2007. There is a hole in the pipes. Small- and medium-sized businesses in this country are dependent on small- and medium-sized banks for access to vital credit, yet too many of these banks remain the walking dead—they are unable to lend because their balance sheets are littered with bad commercial and real-estate loans made during the boom years. Whereas the Fed has driven its short-term lending rate down to zero, most banks will only lend on vastly greater collateral and at much higher real interest rates than before the bust. So the Fed plows on with the cheap and easy macroeconomic option: flood the pipes and see what comes out.

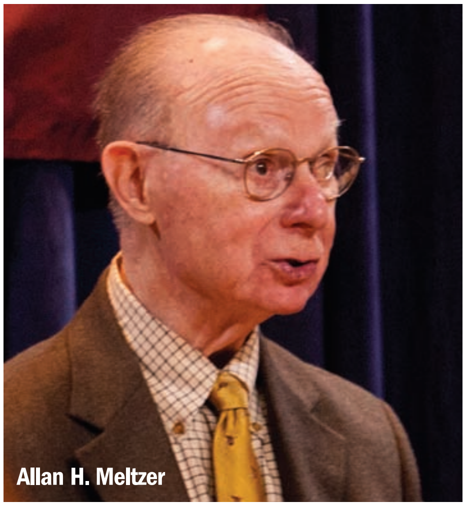
We've already seen the liquidity intended to boost domestic bank lending instead spill out through the cracks into markets as diverse as agricultural commodities, metals, and poor country debt. Those bubbles will burst, as they always do, but more will doubtless be created through the tried and troubled methods of modern central banking.

ALLAN H. MELTZER, Carnegie Mellon University: Over-response to short-run events and neglect of longer-term consequences of its actions is one of the main errors that the Federal Reserve makes repeatedly. The current recession offers many examples of actions that some characterize as bold and innovative. I regard many of these actions as inappropriate for an allegedly independent central bank because they involve credit allocation, fill the Fed's portfolio with an unprecedented volume of long-term assets, evade or neglect the dual mandate, and distort the credit markets.

Purchasing more than $1 trillion of long-term mortgages is credit allocation. How can the mortgage-related securities be sold later when inflation rises, while the housing market remains troubled? The Fed has no plan. Selling Treasury securities to finance mortgage or other purchases is a fiscal operation. Money doesn't change, and the purchase reduces the interest payment made to the Treasury. Selling two-year Treasuries to finance purchases of longer-term bonds also doesn't change reserves or money. It is debt management and should be left to the Treasury.

Bailing out Bear Stearns and accepting $30 billion of low-quality assets in March 2008 is high on the list of mistaken actions in this recession. That reminded financial markets that "too big to fail" (TBTF) not only remained part of operating policy, but that the policy now included non-banks and medium-sized financial firms. The bailout policy kept in place, and even extended support for, banks and others that earned high returns on risky assets but shifted many of the losses to taxpayers.

Without warning, the Fed and the Treasury changed TBTF policy in October, allowing Lehman Brothers to fail. That policy did not continue. Days later, the Fed bailed out American International Group by investing $180 billion in the failing company. These shifts in policy greatly increased uncertainty about what would happen next. Financial firms and others responded by greatly increasing the demand for cash. The Fed responded appropriately by acting as lender of last resort to financial markets at home and abroad by increasing the supply of cash assets.



Allan H. Meltzer

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What occurred next is a model of what a well-run central bank should not do. The Fed explained that the increase in cash assets was almost entirely short-term assets. These would decline over time and would be withdrawn. That didn't happen. The Fed replaced the short-term assets with longer-term assets and undertook credit allocation to stimulate the housing market by buying mortgage-related securities. It explained that these holdings would decline over time as borrowers paid interest and some principal. Again, that didn't happen. The Fed purchased long-dated Treasury securities to prevent its balance sheet from shrinking.

The most recent Fed action is the attempt to "twist the yield curve" by buying long-term debt and selling short-term. Reserves and money do not change. This is not a monetary action. The Fed is again engaging in debt management or credit-market policy that is the province of the Treasury. The Fed responded again to the financial-market soothsayers who warned of another recession. We know that was wildly wrong. The preliminary estimate of third quarter growth is 2.5 percent, double the second quarter rate. Of course, in advance of the Fed's announcement, the market again lowered bond yields, so some nimble speculators gained. How does that help the economy or the unemployed? It is a mistake that the current Fed keeps making.

LAWRENCE H. WHITE, George Mason University: Suppose for the sake of argument that we all agree to the following proposition: If we could change the monetary regime merely by snapping our fingers, we would prefer the United States to be on a standard different from the present fiat dollar. To be specific, let's suppose that we would prefer to be on a gold standard—a system in which gold defines the unit of account and serves as the ultimate medium of redemption. Currency notes, checks, and electronic funds transfers are all denominated in gold and are redeemable claims to gold. How do we get there from here? What would be the most cost-effective way for the United States to make the transition to this new standard?

Two paths suggest themselves. One path is to let a parallel gold standard grow up alongside the current fiat dollar. The more conventional path—as followed after the suspension of the gold standard during the Civil War—is to set a date after which the dollar would be defined as so many grams of pure gold. Today that implies converting the Federal Reserve System's dollar liabilities into gold-redeemable claims.

In the first scenario, the fiat dollar would lose little market share to gold so long as the Federal Reserve keeps its inflation rate low. However, the benefit from using gold-denominated money in a fiat dollar economy increases with the dollar's inflation rate and its uncertainty. Should the U.S. inflation rate return to double digits, consumers would find it very helpful to have an alternative currency network available. Potential competition might even help incentivize the Fed to keep inflation low.

As such, if an uncoordinated piecemeal switchover to a superior standard would not occur except during a painful period of high inflation, there is a strong case for avoiding that pain through a coordinated switchover.

Establishing a new gold definition for the U.S. dollar would require two steps. First, withdraw most of the $1.6 trillion in non-required reserves that banks have accumulated since September 2009. This would be achieved by eliminating interest on reserves and selling the mortgage-backed securities that the Fed acquired in QE1, plus enough Treasuries to bring total bank reserves down to the current value of the U.S. government gold stock. Second, redeem Federal Reserve liabilities with the U.S. government's gold at the then-current market price.

Because the nation's stock of money becomes endogenous, no monetary policy is needed under a gold standard. Retaining a central bank committee to "manage" the gold standard undermines its automatic operation and thus does more harm than good. A central bank inevitably faces political pressures to pursue monetary policies inconsistent with redemption for gold at a fixed rate, can endanger or suspend redemption with legal impunity, and faces no competitive pressure to maintain its reputation.

Going back to the gold standard by re-establishing a dollar-gold parity requires today what it has always required: first, a sufficient real gold stock, which the U.S. government has on hand; and second, the political will to do so. Developing a parallel gold standard, using present-day technologies for money transfer, is probably easier today than it has ever been.

GERALD P. O'DRISCOLL, JR., Cato Institute: I don't know what is politically possible, nor do most economists. There is nothing in the training of economists that provides that expertise. I do know that economic freedom and political freedom are systematically related. To maintain the classical liberal order requires the monetary arrangements congruent with that order. That system is the classical gold standard.

Robert Zoellick

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There are many moving parts in monetary reform. Ultimately, as many thinkers in the 1930s realized, monetary reform requires reform of the banking and financial system. But my argument is that monetary reform comes first. The classical gold standard has worked with a variety of different banking systems—though not equally well.

In Britain, the gold standard operated with a central bank. The Bank of England was founded in 1694 and the gold standard adopted only much later. The Bank of England dominated the system. There were many commercial banks in both England and Scotland, some of them substantial in size.

The United States adopted gold in the 1870s, but had no central bank until 1913. The banking system was highly fragmented with numerous small institutions. Branching was highly constrained if not forbidden. Nationally chartered banks issued notes.

In Canada, there emerged a system of a small number of nationally branched banks with some other financial institutions (such as trust companies). The banks issued the currency and there was no central bank until 1934.

My argument is not that the structure of the banking system does not matter. Quite the opposite. But adoption of the gold standard is a key for restoring monetary discipline and a free monetary order. Restoring a commodity standard is a necessary, but not a sufficient, condition for monetary reform.

The argument for gold is not that it is a perfect monetary system. There is no such thing. The most basic argument for a commodity standard is a public choice one: it constrains the ability of the fiscal authority to spend. If there is a central bank, it prevents the kind of wholesale monetization of government debt that is now occurring in developed countries.

A few intellectual efforts have been made toward restoration of the gold standard. It is unlikely to come about through international agreement, but it did not do so in the 19th century, either. Britain's adoption was a strong impetus to its gradual adoption by countries that saw it in their self-interest to do so. It emerged as a global monetary system in an unplanned fashion.

Simply put, the restoration of the gold commodity standard must be on the agenda for those wanting to restore a classical liberal order. Doing so undoubtedly requires greatly downsizing government—which, of course, is its own imperative. By constraining central banks, a gold standard would help limit the growth of government. It would also open up the possibility of a move toward some form of free banking.

ROBERT ZOELLICK, JR., World Bank: By and large, it's important for countries to have flexible exchange rates independent of central banks. As developed economies with sophisticated financial systems, the Group of 7 (G-7) countries should have a norm saying that you'll allow the exchange rates to adjust—but with an exception. If a situation occurs in which one country is out of sync, the G-7 would agree on some potential form of intervention.

With respect to emerging markets, the idea is that over time you want to move these countries towards flexible exchange rates independent of central banks as well. But you need to recognize that some of them are not quite ready yet.

I personally believe that the dollar will remain the principal reserve currency. But as the dollar loses some of its dominance in the face of economic reality, you could move to a multiple reserve currency system—though a lot of this depends on what happens with the euro in the future. Over time, if China moves to an open capital account, I think the yuan can play a role; and also the yen and the pound at a certain point.

How would countries manage such a system? My view is that the IMF could serve as a referee. It would be able to blow a whistle, but it wouldn't necessarily have a penalty to impose. In effect, they would at the very least be able to try to prod countries into recognizing the risks of certain policy actions.

In observing markets over the past several decades, I've noticed that the price of gold has started to reflect some lack of confidence in national policies and central bankers. I do not mean to suggest a gold standard—in reality, I'm talking about flexible exchange rates. Therefore, I believe that gold should be used as an indicator, an information tool. It shouldn't be considered a formal anchor, but as a way of being a check on the checkers.

Obviously, scholars have long pointed to the problems with the gold standard during the Great Depression. But sometimes they then overreact against the idea that gold could ever play a role. I'm being very pragmatic. What has my experience taught me? Sometimes scholars become captives to their own past analysis. They get so wedded to the beauty of their ideas that they ignore markets. I believe that is a mistake. ■