

EDITOR'S NOTE

Part 2 of *Restoring Global Financial Stability*, based on the Cato Institute's 27th Annual Monetary Conference, held in Washington, D.C., on November 19, 2009, contrasts the current discretionary government fiat money regime with alternatives designed to improve global financial stability.¹ Those alternatives range from constraining the power of central banks by imposing some type of monetary rule to replacing them with private competing currencies convertible into one or more commodities. Even if it is unlikely that the Federal Reserve and other central banks would be abolished any time soon, it is useful to consider the properties of private, rule-based, market-friendly monetary regimes.

Financial stability rests squarely on monetary stability and predictability. Today the dollar has no defined value, as it did under the gold standard, and there is no monetary rule of law to reduce uncertainty about the dollar's future value. The Federal Reserve is tasked with meeting two objectives—full employment and price stability—but the Fed cannot alter employment and other real variables in the long run by manipulating the monetary base. Having two targets, therefore, detracts from what it can do—control currency and bank reserves to influence the path of money, credit, and prices.

Under current law, no official is penalized if the Fed fails to achieve long-run price stability; but if inflation occurs, citizens suffer a loss of value in their cash holdings. There is nothing to anchor the value of the dollar in a fiat money world except a belief in the U.S. government's promise to protect the value of money. With no link to gold and no monetary rule, that promise was broken long ago—and with record deficits and debt, the dollar's future value is even less certain.

The challenge, as *Lawrence H. White* notes, is not to make the Fed independent but to limit its discretion. Financial and monetary stability require limits on the quantity of money and credit. Under the gold standard, market forces brought the supply of money in line with the demand

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for real balances, and the long-run value of money was relatively stable. That predictability is absent today.

If there is no consensus to adopt a convertibility principle and institute a real gold standard, then at least the discretionary nature of monetary policy should be limited by adopting a monetary rule to reduce uncertainty. One can debate the merits of various rules, but the objective should be to achieve monetary stability and safeguard the value of money so that what Clark Warburton called “erratic money” will not distort market prices.

Leland Yeager has long argued for privatizing money to eliminate monetary instability. His work with Robert Greenfield explains the advantages of defining the dollar by a broad basket of goods and services and allowing issue of private notes and deposits indirectly convertible into this standard unit. The Yeager-Greenfield system would eliminate monetary policy, base money, monetary disequilibrium, contagious bank runs, and bailouts. The public’s demand for money would determine the actual quantity. Central bankers managing a fiat money system could never do as well in matching money supply to demand.

Bennett McCallum thinks a privatized monetary system could work if the underlying legal structure created the right incentives. He views the behavior of the Fed during the financial crisis as appalling, to the extent that the Fed engaged in credit allocation and fiscal policy, rather than pure monetary policy to offset the sharp decline in nominal income. He favors a rule-based monetary policy to stabilize the growth of nominal income and achieve long-run price stability. Although he would support a real gold standard, he thinks governments would not adhere to the rules required for such a self-adjusting system to work. A commodity basket system would improve on a gold standard but also face political hurdles regarding convertibility.

George Selgin, like White, argues for the rule of law in monetary affairs versus the rule of central bankers. As a first step toward monetary freedom, both Selgin and White would allow private issuers to supply the currency component of the monetary base. A simple monetary base rule could then be used to control the quantity of money. But they go further and argue that by replacing central banking with free banking, presumably with private currencies convertible into one or more commodities, there would be monetary and financial harmony—not chaos.

Under a private system, there would still be bankruptcies but not bailouts. Asset bubbles could occur, but the natural limits on the growth of money and credit would mitigate the monetary origins of bubbles. As White notes, “Free banking allows us to implement the ultimate restraint

on central banking—namely, doing without a central bank. . . . A gold or silver standard, without a government central bank to loosen its constraints, will stop the banking system from following a path that inflates a bubble in asset prices.”

During the financial crisis, the Fed vastly expanded the monetary base and radically altered its portfolio to include billions of dollars in mortgage-backed securities and other toxic assets. Using emergency powers under section 13 (3) of the Federal Reserve Act, the Fed has become a de facto branch of the Treasury. The danger is that the Fed will cave in to demands to monetize the growing U.S. debt.

James Grant argues that managed exchange rates and low inflation, as measured by conventional price indexes, are examples of “apparent stability.” In reality, the Greenspan Fed engaged in excessive money and credit growth, which showed up in highly leveraged balance sheets of financial institutions and the housing bubble. There is no permanent anchor for the paper dollar: “The dollar is a piece of paper exchangeable into nothing except small change.” Manipulating interest rates in the search for the optimum quantity of fiat money is a futile exercise. “The underlying problem,” writes Grant, “is not that the Fed sometimes fixes the wrong rate but that it arrogates to itself the knowledge and judgment to fix any rate.” He welcomes “honest turmoil,” which is always present in a dynamic market system. What he doesn’t welcome is the delusion that the dollar can be as good as gold.

Judy Shelton shares Grant’s desire to return to a true international monetary system based on a gold-backed dollar. The International Monetary Fund might have a role in such a system, but the Fund clearly has no role in the current non-system. Without a link to gold, the dollar is adrift and the IMF has wandered into foreign territory unrelated to its original purpose. The Fund has failed to call for a return to convertibility and, in fact, prohibits its members from pegging their currencies to gold.

Miranda Xafa, a former IMF official, thinks that the Fund does have an important role to play in terms of giving technical advice and providing an early warning system that could help avoid financial crises. But she is less sanguine about the IMF’s ability to detect “fundamentally misaligned” exchange rates.

Swaminathan Aiyar emphasizes that the IMF is ill prepared to forecast financial crises: The IMF, like private forecasters, has no model to predict the future with certainty and, in fact, completely missed the 2008 financial crisis. Moreover, unlike private forecasters, the IMF has a built-in political bias and will be influenced by its members.

Richard Rahn likes the idea of a single global currency, but he wants it to be a private currency, not the IMF's special drawing right. As a step in that direction, he advocates creating a "constant unit of account," which would consist of a bundle of major currencies weighted by their relative shares in global trade, adjusted for inflation and exchange-rate movements.

Luigi Zingales advocates the use of market discipline to stem debt/financial crises. He seeks to solve the too-big-to-fail problem by timely breakups of large banks that are deemed insolvent. To do so, he would rely on the prices of credit default swaps on long-term junior debt. Moreover, he would require the regulatory body to hold a portion of that debt if the troubled institution was deemed systemically safe by a stress test. With moral hazard less of a problem, the long-run health of the financial system would improve.

Those who think the global financial crisis was due to "market failure" will find compelling arguments to the contrary in this issue of the *Cato Journal*. They will also find a framework for future reforms that could reduce the probability of crises and improve financial harmony.

—J. A. Dorn