Honest Money

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This article addresses some of the recent proposals for the conduct of monetary policies in the post-bubble environment. Advocacy of higher inflation targets is analyzed, and the challenge of maintaining monetary discipline in the face of massive fiscal deficits and mounting government debts is presented. Proposals for reforms of monetary arrangements must be based on consensus regarding the objectives of such reforms. The article concludes with some suggestions for near- and intermediate-term changes to present arrangements, as well as ideas for longer-term reforms.

The Psychology of Money

For several years now I have been seeking to change the conversation we have about money—not to something new, but to something old. John Stuart Mill ([1848] 1987: 488) wrote,

> There cannot . . . be intrinsically a more insignificant thing, in the economy of society, than money; except in the character of a contrivance for sparing time and labour. It is a machine for doing quickly and commodiously, what would be done, though less quickly and commodiously, without it: and like many other kinds of machinery, it only exerts a distinct and independent influence of its own when it gets out of order.

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I welcome very much James Buchanan's recent remarks that "members of the public, all of whom are transactors in money values, must come to trust the value of money as iconically sacrosanct. The whole psychology of money in modern times must become different" (Buchanan 2010: 257–58).

As we continue to debate the issue of asset bubbles and monetary policy, we should keep in mind the importance of honest money and "not waste this set of crises by exclusive recourse to jerry-built efforts to patch up the failed monetary anarchy we have witnessed" (Buchanan 2010: 288).

Unfortunately, in my view, too much of the conversation about monetary policy has been about the strategies and tactics for the formulation and implementation of discretionary monetary policy, and not near enough on reforms of monetary arrangements that might assure a constant monetary yardstick. To be fruitful, a dialogue about possible reforms must be preceded by development of a consensus about the objectives of constitutional monetary arrangements.

I will first comment on some of the proposals for conducting discretionary monetary policy, and then turn to my views on what should be the objectives of monetary reform and how we might realize those objectives.

Misguided Policy Prescriptions

In the wake of the 2008–09 financial crisis, there have been numerous proposals for enhancing the effectiveness of monetary and fiscal policies. Most of these proposals have dealt with reducing the "pain of hangovers." They prescribe greater policy activism and, thus, even more discretion for policymakers to address the aftermath of bursting bubbles. This approach is in sharp contrast to F. A. Hayek's idea that the best way to avoid the pain of recession is to prevent monetary distortions in the first place.

The most dangerous suggestion with regard to monetary policy is that central banks should target higher inflation by allowing prices to rise, on average, by more than the conventionally accepted 2 percent. Inflation "doves" acknowledge that debasing the currency is a form of taxation, yet they defend higher inflation by saying that it is no worse than other forms of taxation.

Economists who advocate inflation—as a way out of recession—assume that monetary policy works solely, or at least primarily,

through interest rates, and they fret about the "zero boundary problem." The argument is that since nominal interest rates can't go below zero, the Federal Reserve should target inflation at more than 2 percent to ensure that nominal rates include an inflationary premium and are at a level that would allow the Fed to cut rates when necessary.

The central idea is that if aggregate nominal demand for output declines for any reason, a judicious reduction of interest rates by monetary authorities will spur consumers and businesses to spend more, thus sowing the seeds of recovery. The claim is that if the crisis is severe it takes larger cuts in interest rates to reverse the contraction in aggregate demand, so higher interest rates to begin with—the result of higher inflation—give the policymakers a bigger weapon.

In the case of the Great Recession of 2008–09, this policy prescription is misguided; it is the result of a faulty diagnosis. The error stems from having concluded that the trigger for the crisis was a contraction in the financial sector—credit availability shrank, so household and business demand for output fell. Policy activists want more powerful monetary and fiscal tools to address such conditions.

That diagnosis fails to consider that what has been characterized as a "housing bubble" was not sufficient to cause the economic damage we have seen. Neither the dot-com bubble of the 1990s nor the rapid increases of house prices in Canada or other countries were followed by widespread declines in output and employment as well as banking failures. The key to the differences is what was happening on the other side of the balance sheet. Asset price increases need not be accompanied by debt increases, but when they are then the subsequent declines in asset prices have much broader implications.

Some 20 years ago, mortgage equity withdrawals (MEWs) during refinancing had been only 1 to 2 percent of personal disposable income. However, by the 2004–06 period MEWs reached 9 percent of disposable income, which was enough to drive consumption spending in the national economy from about 65 percent of GDP to 70 percent. That increase in a $14 trillion economy fueled an extraordinary boom in auto sales, furnishings, appliances, consumer imports of all kinds, as well as remittances to other countries.

Between 2001 and 2007, Americans extracted several trillion dollars from the equity of their homes during refinancing. For far too many families, the expression, "my home is my ATM" had real meaning. Current consumption spending was being financed by debt.

Then, quite suddenly, in the summer of 2008, it was no longer possible to refinance, house prices plunged, and there was no more equity to withdraw.

What followed were misguided policies of government to maintain the bubble-level of household consumption spending through transfer payments—distribution of the proceeds from the issuance of massive amounts of new government debt. New borrowing by government replaced borrowing by households, total national debt continued to grow while household balance sheets shrank. Fiscal policy actions became part of the problem, not the solution, and monetary policies cannot correct the mistakes of the rest of government.

Instead of greater latitude for discretion in the use of monetary and fiscal policies for "pump-priming" nominal demand, we would have been better off to allow real estate and other asset prices to adjust to the underlying supply and demand conditions without the issuance of massive new claims on future taxpayers. The inherent resiliency of a market economy would then have begun to restore prosperity based on economic fundamentals, not "bubblenomics." Instead, the lack of fiscal discipline has undermined confidence that policymakers will succeed in maintaining monetary discipline.

Inflation: The Unlegislated Tax

Other advocates of targeting higher inflation do so as a consequence of the enormous budget deficits and the piling up of unsustainable levels of national debt. Such advocacy reflects a defeatist outlook with regard to the prospects for returning to adequate fiscal discipline. But, even if one is resigned to long-term fiscal irresponsibility, public editorializing and blogging about the desirability of greater inflation—at least compared to the alternative policy options—dilutes their own case.

We know that it is *unanticipated* inflation that is an effective tax, so denying the intent to reinflate while actually pursuing inflationary policy actions would more effectively achieve their purpose. We also know that a theoretical *fully anticipated* inflation can never be achieved—especially because of the very large stock of non-interest-bearing currency that is held by someone. However, the degree to which individuals and businesses can take actions to protect themselves from greater expected inflation reduces the effectiveness of this type of taxation.

Lyndon Johnson deliberately chose inflation as the expedient way to transfer resources to the government because he did not want Congress to debate the merits of the Vietnam War versus the Great Society programs. For President Johnson, the "tax no one has to vote for" was a way to avoid the constitutional requirement that taxes had to originate in the Ways and Means Committee of the U.S. House of Representatives.

Today, one motivation for advocating the inflation tax is that it is a way to impose taxation on the very large share of the population that is exempt from the income tax, while at the same time asserting that a political pledge of "no tax increases for low-income people" has been kept. This cynical cop-out will be successful in forestalling fiscal disaster only to the extent that the public at large is surprised by the timing and extent of the acceleration of inflation.

Proponents of higher U.S. inflation are either unaware or unconcerned about the effects of debasement of the world's primary reserve currency on other countries. As we saw in the highly inflationary period of the failed presidency of Jimmy Carter in the late 1970s, the persistent appreciation of currencies that seek to maintain low inflation compared to the United States creates political problems in those other countries, especially the smaller open economies that are heavily dependent on international trade.

No doubt some advocates of higher inflation recognize that current foreign holders of longer-term government debt will suffer both capital losses as interest rates rise and an erosion of purchasing power through inflation, the same as domestic holders. I doubt that troubles them. They may not understand that the resulting depreciation of the international value of the dollar also will impose exchange translation losses on foreign holders, both private and official. They might even welcome such a tax imposed on foreigners—clearly a case of taxation without representation. The inflation tax is not only dishonest, it is regressive, divisive, and leaves us poorer as a nation.

Objectives of Monetary Arrangements

Elsewhere (Jordan 2006) I have written at length about the nature of money and the role of government in the provision of money. I found it interesting that two highly respected American leaders, James Madison and Abraham Lincoln, had quite different views about government's role in the provision of money. In the early

19th century debates about national banks, Lincoln (1839) was clear in stating, "No duty is more imperative on that Government, than the duty it owes the people, of furnishing them a sound and uniform currency."

In contrast, Madison (1820) thought the challenge was to provide sound money *in spite of* government, saying,

> It cannot be doubted that a paper currency, rigidly limited in its quantity to purposes absolutely necessary, may be equal and even superior in value to specie. But experience does not favor reliance on such experiments. Whenever the paper has not been convertible into specie, and its quantity has depended on the policy of the Government, a depreciation has been produced by an undue increase, or an apprehension of it [in Padover 1953: 292; see Dorn 1988: 90–91].

I interpret Buchanan (2010: 258) as coming down on the side of Madison: "The Constitution remains the ultimate sovereign authority rather than the government." Some 15 years earlier, Buchanan (1994: 4) warned, "It is in the monetary responsibility that almost all constitutions have failed, even those that were allegedly motivated originally by classical liberal precepts. Governments, throughout history, have almost always moved beyond constitutionally authorized limits of their monetary authority."

The debate about "rules versus discretion" in the conduct of monetary policy is once again in vogue. My view is simple: Wherever there is discretion in the conduct of economic policies—whether monetary or fiscal—there is moral hazard. Debate about the role of asset prices—whether dot-com share prices or residential house prices—in the formulation and implementation of economic policies will need to strive for better consensus regarding the *objectives* of such policies.

No doubt in the years ahead we will also debate and probably test the hypothesis that monetary policy is a fiscal instrument, a way to finance government. If indeed the "fiscal dominance hypothesis" is correct—a society that is unwilling or unable to achieve fiscal discipline will not maintain monetary discipline—there will be another financial crisis and another opportunity to implement institutional constraints on policy discretion. For the debates to be fruitful, the objectives must be clear.

Several decades ago Henry Wallich, a member of the Federal Reserve Board, said that a place that tolerates inflation is a place where no one tells the truth. He understood money in the same way the Framers of the U.S. Constitution did when they gave authority over money to the new U.S. Congress. Money is a part of a market economy's information system; the meaning of a dollar should no more be subject to change than the number of inches in a foot.

Whatever one thinks of the merits of a specie standard for currency, Benjamin Franklin (1729) was clear in his reference to "a Measure of Values," because the sentence giving Congress power over money also assigns the fixing of weights and measures.

As much as I respect and admire Madison and others that gave us our Constitution, I regret two instances where they used the word "regulate" and I firmly believe they had something in mind quite different from later usage. When they gave Congress the authority to "regulate interstate Commerce," I am convinced that they meant "to regularize." The sole purpose of the clause was to ban the tariff and nontariff barriers that had surfaced among the states under the Articles of Confederation; it was not to give the Federal authorities vast control over everyday life of citizens.

The second use of the unfortunate term was "and regulate the value thereof" regarding the money of the country. Here I am convinced they meant "specify the units of money and the specie content thereof." Jefferson preferred the name "dollar" for the new national currency because a Spanish coin very familiar to most people was called a "*dolar*." However, the weight of gold in a unit of this new money was not the amount of gold in the Spanish coins of the same name, but was the same as in a British pound. In other words, the newly independent country would have money that had a different name than the mother country, but would be equal in value.

In addition to the constitutional basis for seeking institutional arrangements that provide a money of unchanging purchasing power, there are strong economic arguments for doing so, as J. S. Mill suggested. People choose to use as money that entity that economizes best on the uses of real resources in gathering information about relative values and conducting transactions. The productivity of money comes from the liberation of these other resources so that they may be used to produce the goods and services sought by consumers.

Honest money enhances knowledge about relative values of both goods and assets, now and far into the future—this is the quality dimension of money. The frequently referred to but little understood cost of inflation is the loss of output over time resulting from deterioration of the quality of money—that is, the reduced reliability of information available about relative values of factors of production, goods, and assets.

In societies where changes in money prices are contaminated by the uncertain and changing purchasing power of money, false signals are sent to businesses and households. Bad decisions are made, resources are misallocated, and real incomes fail to rise at their potential rate. Nominal interest rates respond to shifting expectations about the future purchasing power of money. Changes in real interest rates are obscured, so resources are misallocated. Since saving and investment decisions are affected, growth is impaired. The notion that more employment and output can be had with a bit more inflation must be soundly rejected.

Ludwig von Mises cautioned about the common misinterpretations of terms such as inflation and deflation, as well as expressions such as price level and price stability. Economists disagree about which consumables to include in price indexes, the appropriate weights, and which, if any, asset prices to include. However, economists can agree on the conditions that would prevail in the absence of price-level changes. Without price-level disturbances, businesses and households would make all decisions based on the assumption that all price changes currently observable or expected in the future are *relative* price changes—that is, they reflect changes in the underlying real forces of demand and supply.[1]

Relative price changes in a market economy are signals that resources are better used by shifting away from lower- to higher-valued uses. Similarly, when money is stable in value, higher real returns to real productive capital are clearly reflected in market interest rates, and not obscured by a changing inflation premium.

The most effective and efficient utilization of a society's resources is achieved only when all participants in a competitive, free-market economy can make decisions in the belief that the purchasing power

[1]Naturally, if all price changes are relative price changes, for every observed or expected rise or decline in some prices there must be corresponding declines or rises in other prices (appropriately weighted).

of money is neither rising nor falling. All price and interest rate changes are then the result of shifts in the demand for or supply of goods, services, and productive resources. These conditions yield the greatest wealth and highest standards of living over time.

Whether one sides with Lincoln, arguing that it is the *duty* of government to provide the nation with honest money, or one agrees with Madison, holding that we must seek institutional arrangements that will ensure honest money *in spite of* politicians, there should be no debate about the *objective* of providing honest money.

Essentials of Monetary Reforms

A characteristic of fiat money arrangements of the past century has been asset price bubbles that ultimately burst and cause great economic damage. Some historians assert that the motivation for establishing the present monetary arrangements in the United States was to avoid repeats of the 1907 banking panic and earlier episodes of financial instability. If so, they have not been successful in meeting that objective.

We sometimes have been told that bubbles like the dot-com episode in the 1990s are inevitable and that the best we can hope to do is respond in ways that minimize the real economic consequences. We were even told that it takes a new bubble to cure the problems caused by the prior bubble. The fallout of the bursting of the housing price bubble of the past decade showed that to be a mistaken prescription.

Some of the recent past episodes of boom and bust in the United States and other fiat money systems could have been dampened if the formulation and implementation of monetary policy actions had more closely mimicked the rules of a true gold standard with a rule-based lender-of-last-resort facility. I have written elsewhere (Jordan 2006) about the implications of the permanent income hypothesis in conjunction with a Wicksellian natural rate hypothesis in a world of productivity surprises, and will not repeat those arguments here. However, an important implication is that a "virtuous deflation"—declines in prices of current outputs—should not be resisted by monetary injections.

Relative prices of longer-lived assets versus shorter-lived goods and services must be free to change. If economic forces are pressing down on prices of goods and services, but monetary actions are

geared to prevent such declines, then asset prices will inevitably rise more than otherwise. If misdiagnosed, bubbles occur. Even so, what is happening on the liability side of household and business balance sheets determines the extent of economic damage resulting from the decline of asset prices.

The widespread damage to the U.S. economy in 2008–09 resulted from the excessive debts incurred by American households. Those debts were motivated by an institutional structure that encouraged subprime lending and overconsumption of housing. In contrast, Canada—with its sound mortgage practices and stable financial institutions—did not have banking problems, business failures, unemployment, and other shocks to their economy. Our emphasis should be on institutional arrangements that will prevent another debt-default cycle.

While I am totally in favor of an end to government-sponsored enterprises (such as Fannie Mae and Freddie Mac), more needs to be done to avoid future crises. The root of the U.S. housing problem was the passage of the Community Reinvestment Act during the failed presidency of Jimmy Carter in the 1970s, as well as subsequent legislation and regulation that led to overconsumption of housing. Those problems need to be corrected.

Furthermore, as long as we continue to have managed fiat monetary arrangements, we must at least establish some rules that constrain the discretion in both formulation and implementation of policy actions. With regard to objectives, we should seek legislation to replace Humphrey-Hawkins—the Full-Employment and Balanced Growth Act of 1978, which mandates simultaneous pursuit of both low inflation and low unemployment—with the sole objective of price stability to safeguard the purchasing power of money. Such an objective would not preclude the movement of some index of current output prices moving inversely with changes in productivity developments.

In order that discretionary pursuit of financial stability does not interfere with the primary mission of *monetary stability*, legislation should immediately establish strict rules for the lender-of-last resort facility. While some financial intermediaries are too big to close, none should be deemed too big to fail—that is, to wipe out equity holders and unsecured creditors. In fact, bailouts of creditors of both financial and nonfinancial firms should be banned by law.

In order to permit currency competition, including the eventual development of private issuance of media of exchange, Congress should legislate specific performance in contracts. Contracts denominated in foreign currencies should also be enforceable. The monopoly money aspect of legal tender laws inhibits innovation and is inconsistent with rights of individuals and businesses to enter freely into legally enforceable agreements.

A further step toward institutionalizing monetary discipline would be to denationalize gold stocks and permit specie-backed privately issued currencies to compete with domestic and foreign fiat currencies.

Our Daunting Challenge

The United States and other countries, as well as some local and provincial governments, are now facing massive debt bubbles. Debts incurred by any level of government are simply claims on future tax receipts. When the nominal claims to streams-of-interest payments and eventual return of principal exceed all reasonable expectations of future tax revenues, it is a bubble—just as certainly as when homeowners can no longer afford their mortgages.

Holders of the liabilities of governments expect to be repaid in real purchasing power, even if return of principal is decades in the future. Yet, they have contractual rights only to nominal units of fiat money. Whenever the taxing authorities can no longer generate sufficient nominal money units by imposing ever greater tax burdens on the assets, labor, and enterprise of citizens, either default on debt or currency debasement must occur.

Moving toward honest money—and away from discretionary government fiat money—is essential for future prosperity and freedom. Postponing real reform will only delay the day of reckoning.

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