BOOK REVIEWS

The China Miracle: Development Strategy and Economic Reform

Justin Yifu Lin, Fang Cai, and Zhou Li
Hong Kong: Chinese University Press, 1996, 340 pp.

China has created an economic miracle since its economic reforms began in the late 1970s, becoming the fastest growing economy in the world. Gross domestic product has grown at an average rate of 10 percent annually for the past 18 years, and personal income and living standards have improved significantly. China may become the world's largest economy early next century.

The great success of China's economic reforms has attracted worldwide attention. *The China Miracle* is a book that addresses the following questions: How did China's economic reforms create the miracle? Why has there been such a dramatic difference in China's economic performance since the reforms? Despite the reforms, why is there a "boom-bust" cycle in the Chinese economy? Can China continue its growth? What are the general implications of China's experience for other economies in transition?

The authors of this book have been involved in many of the decision-making processes during China's economic reforms. Combining their first-hand experience and solid training in modern economics, the authors provide new insights into China's economic development strategy and reforms from both theoretical and empirical perspectives.

The main argument of the book is that economic performance and growth depend crucially on the choice of development strategy. The China miracle is the result of China's having chosen the right development strategy—that is, pursuing the economy's comparative advantage and abandoning the "heavy-industry-oriented" or "leap-forward" development strategy adopted during the pre-1979 reform period.

According to the authors, the dream of China's socialist revolution was prosperity for the people and the country. After the People's Republic of China was established in 1949, Chinese leaders chose a leap-forward strategy that required the development of heavy industry, as in the Soviet model, to catch up with Western industrialized countries. However, at

Cato Journal, Vol. 18, No. 1 (Spring/Summer 1998). Copyright © Cato Institute. All rights reserved.

that time, China was an economy with very scarce capital but abundant labor. To implement the heavy-industry-oriented strategy, the Chinese government had to use a centrally planned economic system that forcefully allocated scarce resources to the heavy-industry sector. At the macro level, the government controlled the prices of credit, hard currency, energy, raw materials, labor, and necessities of life to artificially lower the costs of the development of heavy industry. At the micro level, there was no managerial autonomy. Firms' production decisions were made according to the state plan. Production costs and profits were also controlled by the state. That economic system resulted in a distorted industrial structure with poor incentives and low allocative efficiency.

Comparing experiences in China and other countries, the authors conclude that the leap-forward strategy failed, not only in communist countries like China and the former Soviet Union, but also in India and other noncommunist countries, because it could not accelerate economic development. Indeed, the authors argue that China's stubborn adherence to a heavy-industry-oriented development strategy is the fundamental cause of China's failure to achieve sustained development before 1979.

The authors contrast China's pre-1979 development strategy with the comparative-advantage strategy of development adopted by Japan and the four Asian Tigers—Hong Kong, Taiwan, South Korea, and Singapore. Although the initial economic conditions in those countries were very similar to those in China, they achieved a high and stable level of economic growth during the last few decades by choosing the right development strategy. The authors believe that the main reason for those countries' success is that they had let their own comparative advantages come into full play at each stage of their development.

Chapter 5 provides an overview of China's reform process. The main philosophy behind the reforms was based on the idea of the late leader, Deng Xiaoping: crossing a river by groping one's way from one stone to the next. From 1978 to 1984, China's economic reforms were focused on improving micromanagement institutions to improve the incentive mechanism. Farmers and enterprises were given more autonomy in production and management.

Before the reforms, farmers were under the People's Commune (collective farming) system. They were told what to do, how to do it, and how much they would be paid. The poorly designed payment methods did not reflect each farmer's actual contribution to production. That system seriously hampered incentives for farmers to produce. Farmers' real income hardly increased at all during the commune period. The shortage of agricultural products became a persistent problem.

China's economic reforms started in the rural areas. The household responsibility system replaced the previous system. Land was assigned to each household. After fulfilling its contractual obligations, each household was allowed to retain the remaining output. The system significantly stimulated the farmers' incentives to produce, and, consequently, agricultural production increased rapidly. The hitherto chronic shortage of agricultural products was over.

A similar reform was extended to urban areas. Enterprises were granted a certain degree of autonomy in production, investment, and income distribution. Enterprise managers and workers then had incentives to increase production and improve the efficiency of resource utilization.

As state-owned enterprises had more autonomy and nonstate enterprises began to emerge, the rigid centrally planned resource-allocation system no longer fit the needs of the economy. In the second phase of reform (1984–91), the main focus was on reforming the planned allocation of resources. A dual-track resource-allocation and price system was adopted. Through this newly established market mechanism, part of the resources flowed to the labor-intensive sectors that had been suppressed under the traditional economic system. As a result, the economic structure improved and the growth rate accelerated.

The reform of micromanagement institutions and the resource-allocation mechanism revitalized enterprises. But unequal competition arising from dual-track factor prices and rent-seeking behavior also created enormous chaos. In the third phase (1992 onward), the reforms were focused on the macro-policy environment, with the goal of establishing a "market-socialist economy."

China's reforms have led to rapid economic growth, improved economic incentives and efficiency, adjustment of the industrial structure, and exploitation of comparative advantage. However, many new problems have emerged along the way.

First, the boom-bust cycle of growth and inflation has been persistent in China's economy. When the government tightens its control of the economy, economic performance is poor (bust). Slowing economic growth prompts the government to loosen its economic policy, including increasing the supply of credit. The economy often responds vigorously and grows at a faster pace (boom). But then, institutional arrangements inside the traditional economic system become increasingly incompatible, resulting in economic chaos. Therefore, the government has to return to the traditional method to tighten its control over the economy. Thus, "chaos leads to a retrenchment program," and "retrenchment leads to a bust." Then the cycle begins again. This cycle has caused fluctuations in the growth rate and may become an impediment to China's sustained economic growth.

Second, corruption has become an increasingly serious problem. The dual price system creates a gap between planned prices and market prices and has led to rent seeking. The nonstate and the autonomous state enterprises certainly have an incentive to use bribes and other measures to seek rents from the state allocation agencies. Thus, the corruption of government officials has grown rampant. It has also caused widespread public resentment and has become a source of social instability.

Third, despite the great success of China's overall economic reforms, the performance of state-owned enterprises has worsened. State-owned enterprises have become the biggest drag on the economy and drain on the government treasury. According to the authors, the problems of state-owned enterprises are rooted in the traditional economic system and the lack of well-defined property rights. Nominally, state-owned enterprises belong to all the people, but they cannot be operated by all the people. In the reform process, more autonomy for state enterprises often created abundant opportunities for the managers and workers to steal state profits and property. To reform the state enterprises, it is essential to clarify property rights—a task that remains the most difficult part of China's reform process.

The authors believe that the above problems result from the fact that reforms of the overall market environment lag behind reforms of micromanagement institutions and resource-allocation mechanisms. To solve the problems, China must reform the macro-policy environment, complete the transformation of the old development strategy, and establish a competitive market economy.

In Chapter 9, the authors summarize the lessons from China's reforms. A key lesson is that China's economic reforms have been a gradual process of experimentation, which started with improving micromanagement institutions, moved to reforming the planned resource-allocation mechanism, and, finally, changed the overall environment and developed a market economy. This way, China has maintained a balance between speed and stability during the reform process and has avoided political and social turmoil. The majority of workers and farmers have benefited from the reform, and their support of it makes the reform process irreversible. The successful experience of China's reforms provides useful lessons for other reforming economies.

In conclusion, the authors point out that the key to sustained growth in China is further market liberalization. As long as China can carry out the reforms that help it exploit its comparative advantages, the country will continue to prosper.

This book provides a very impressive and comprehensive overview of China's economic reforms and development. At certain points, however, the reader wishes for a more detailed and cohesive treatment of key arguments. For example, the relationship between the development strategy and the choice of economic institutions, which is at the center of the book's arguments, needs further analysis and illustration. Despite that, the book could serve as a useful textbook for students or as a reference for scholars of the Chinese economy. It also could be of interest to general readers interested in China's development.

Ling Li
Towson University

After 1989: Morals, Revolution and Civil Society
Ralf Dahrendorf
New York: St. Martin's Press, 1997, 179 pp.

The collapse of the Soviet Union continues to fascinate scholars and political observers. One of the latest in a long series of post-1989 musings is *After 1989: Morals, Revolution and Civil Society,* a collection of papers by Ralf Dahrendorf. Well-known among theorists of democracy, Dahrendorf has been active in the academic as well as the political world: warden of St. Antony's College at Oxford for the past decade and director of the London School of Economics for the decade prior to that, he had also been a European Commissioner during the early 1970s. With such a background, he may well be expected to write what he describes as "neither a work of scholarship nor a popular tract, but both." Predictably, however, such hybrids are more likely to be neither. But that does not mean that *After 1989* does not offer some interesting insights.

The essays in this book cover a span of six years, from 1990 until 1996. Mostly ceremonial speeches, they show a genuine concern with many of the great questions of political science: What is the purpose of revolution? What is the relationship between economic and political institutions? What is the meaning of civil society? What are some of the principal challenges of modernity? How do we build meaning into our lives? That Dahrendorf asks those questions in the context of the changes that took place in the former Soviet Bloc indicates that he recognizes the crucial importance of those changes, their rich potential to teach us profound lessons about the nature of Western liberalism, and its ability to usher humanity into the 21st century. Whether those lessons can be learned, however, depends on two issues: first, whether we ask the right questions; and second, whether we have the facts straight. While Dahrendorf falls somewhat short on both, he does touch on several important themes.

In his first essay, he defines the 1989 revolution as a quest for democracy. He notes, however, that the term is ambiguous, for it refers to both the constitutional context (formal democracy) and "equality" (substantive democracy or equality of outcome; in his words, democracy "become real"). His conclusion follows, not unexpectedly: "The revolution of 1989, like other revolutions before it, was bound to disappoint those who entered it with extravagant hopes for a new world of unconstrained discourse, equality and fundamental democracy" (p. 12).

To begin with, it would be impossible for that (or any other) revolution to create all the conditions for democracy in such a short time. Thus Dahrendorf's pessimism is rather surprising. Writing less than a year after the fall of the Berlin Wall, he declares that the revolution of 1989 "has created conditions which militate against successful political reform, effective economic reform and the firm establishment of civil societies" (p. 13). In reality, the evolution of political and economic institutions throughout the former Soviet Bloc, while very uneven, has been proceeding in a roughly linear progression in the direction of greater liberalization. This is not to say that prosperity is within reach for most of the population, by any means. The destruction of communism will take many decades to undo. But even in Central Asia there has been progress in privatization and greater political participation. Perhaps by setting the goal of the revolution too high, Dahrendorf is bound to expect it to be unreachable.

A number of factual misconceptions as well prevent him from understanding the complexity of the 1989 revolution. He writes, for example, that "in East and Southeast Central Europe the collapse of the nomenklatura has left behind . . . an administrative vacuum," yet one of the paradoxes of the revolution was precisely that the *nomenklatura* managed to change political colors with enviable, opportunistic talent. Andrew Nagorski documented that very well in his 1994 book *The Birth of Freedom*. Not that there are no new faces among the post-revolutionary elites, notably Vaclav Havel, Lech Walesa, Viktor Orban, and Emil Constantinescu. But especially in the former Soviet republics, the emerging leaders, such as Boris Yeltsin and Edward Schevarnadze, to name but the most liberal, were surely members of the old guard.

The lack of radical change in the socio-political structure of these nations was not without some advantages. In the first place, the old technocratic elite (admittedly undertrained and generally mistrained, by Western standards) had learned some important skills of organization and adaptation. What is more, fratricide was thereby avoided in the already tortured, poverty-stricken wasteland of postcommunist Eastern Europe. But the price was high, as Alexander Solzhenitsyn anticipated in *The Gulag Archipelago*, where he warned against the temptation to forget the crimes of communism lest nations be haunted by a guilt-ridden past. Many of the *nouveaux riches* are seen as ruthless and soulless; they are envied, sometimes even detested, at the very least not trusted. The vacuum that was left was not as Dahrendorf indicates, "administrative" but moral.

Not that Dahrendorf is oblivious to the enormous thirst for moral renaissance that both preceded and followed the 1989 revolution. Quite the contrary. He purports to seek "moral objectives" that humanity should strive for, but defines them mainly in negative terms: they are what liberty and capitalism are not. In brief, they are "citizenship and civil society," which go "one step further than elections and markets." Invoking political theorist Giovanna Zincone, Dahrendorf says that the path from "subject" to "citizen" is "the path to freedom." He defines "citizenship" vaguely as "a set of entitlements common to all members of society." Yet he seems to want it both ways, for he also insists that "no one should be made to take a particular choice or even be guided towards it; freedom includes the options not to choose at all or to choose wrongly." But if "obligations" are to mean anything, surely they must involve an element of necessity, or else there is nothing obligatory about them.

In the final analysis, it appears that Dahrendorf is not particularly comfortable with freedom even as he appears to embrace it. On the one hand, he seems to favor liberalism in both a political and economic sense: "The creative chaos of associations coalesces as if guided by an invisible hand into the setting in which the greatest number find the greatest life chances. In economic terms, the market describes that setting; in political terms, it is the public" (p. 78). On the other hand, however, he deplores "the greedy individualism" he feels the market approach necessarily presupposes.

Dahrendorf comes close to endorsing capitalism. He applauds the Open Society as "the world of democracy and the market economy, [which are the two components of] the constitution of liberty" (p. 46). He praises them both as "eminently reasonable ways of organizing our affairs." But they are not enough: their main drawback is that "they do not offer people a home" (p. 57).

That home is civil society and its "creative chaos," which somehow protects us against the inconveniences of the state of nature as well as "against those arising from monopolistic claims by self-appointed minorities and indeed majorities" (p. 56). Just how civil society does that is not clear. Dahrendorf seems to secure the answer by definition, for he says, "Civil society is a society of citizens who have rights and accept obligations, and who behave in a civil and civilized manner towards each other" (p. 78). In other words: utopia. Predictably, Dahrendorf does not come much closer than his countless predecessors to telling us just how to achieve it.

His disappointment with the post-1989 conditions in the former Soviet Bloc are probably colored by his high expectations of what constitutes an ideal civil society. He states, for example, that "the instruments of government are crumbling in the tender hands of dissidents-turned-rulers" (p. 97); yet this surely is too strong, for no outright "crumbling" has happened in any of those countries. (Belarus and Turkmenistan never quite emerged from authoritarianism.) Similarly, the claim that "the new economism of capitalists is no less illiberal than the old one of Marxists" (p. 99) is far too radical; it ignores the many changes that have taken place even in the slow-moving′nations of Central Asia. The charge that former Czech Prime Minister Vaclav Klaus is guilty of "democratic authoritarianism," and the claim that Klaus actually "opposes civil society" even as he "strengthens central government" (p. 97), would be considered even by Klaus' Czech foes as hyperbolic.

It is curious to see a book such as this, appearing eight years after one of the most extraordinary events of the 20th century, proclaim categorically that since all revolutions must be prevented because "all revolutions fail," the 1989 revolution too, by implication, should not have taken place. Dahrendorf's conclusion that "the first requirement of the constitution of liberty [is] to make sure that [revolutions] need not happen" is thus nothing short of mystifying. While that statement is undoubtedly true in some vague conservative prudential framework, Dahrendorf apparently fails to recognize that of all revolutions, the one that ended communism not only had to happen but continues to be happening each day, as its people begin the arduous journey toward a civil society. They barely know how to define that concept; but they have faith that some day, perhaps even in their lifetime, they will enjoy its fruits. Their patience and courage are surely an example to us all, and the tragedy of what they rejected a constant reminder that freedom is far easier to lose than to build.

Juliana Geran Pilon
International Foundation for
Election Systems

Classical Liberalism and International Economic Order: Studies in Theory and Intellectual History
Razeen Sally
London: Routledge, 1998, 226 pp.

In today's debate about free trade and the global economy, who are the rightful heirs of Adam Smith and the classical liberal tradition? Are they the builders of a "new global architecture" who seek free trade and financial stability through multinational institutions? Or are they the neoclassical economists with their abstract models of perfect markets, perfect knowledge, and optimal equilibrium? The answer is neither, according to Razeen Sally, a professor of international political economy at the London School of Economics, in his provocative new book.

This book is rich in the history of ideas but also in spirited argument. Its ambition is to revive classical liberalism as a way of thinking about the global economy and to apply its wisdom to the current policy debate. Sally deftly defines the system of political economy first expounded by the Scotsmen Adam Smith and David Hume—a system built on individual liberty, spontaneous order, and the evolution of law and other institutions to provide the "rules of the game" for mutually beneficial commerce. He surveys the intellectual refinement of classical liberalism in the 20th century, from Frank Knight, founder of the Chicago School, through Jacob Viner, Wilhelm Ropke, and Jan Tumlir, with a bow to F.A. Hayek along the way.

The author draws a sharp distinction between classical liberalism and its modern intellectual step-siblings—neoclassical economics and neoliberal institutionalism—that dominate today's argument for trade liberalization. The trouble with neoclassical economists, according to Sally, is their reliance on abstract economic models that ignore the political, legal, and social context in which markets function. Their models assume perfect markets in which rational actors maximize their utility under budget constraints to reach equilibrium, while the classical liberal approach relies on empirical observation of how markets really work. Neoliberal institutionalists are equally mistaken in their reliance on international organizations, negotiations, and intergovernmental policy coordination to advance liberalization. Ignoring the classical liberal insight of spontaneous market order, they believe that only vigorous intervention on a multinational level can save the global economy from disorder and beggar-thy-neighbor trade wars.

A number of prescriptions and warnings for international economic policy flow from classical liberal analysis. First, the death of the nation state is greatly exaggerated. Sovereign nations remain the principal source of laws that set the rules for international commerce. International arrangements such as the World Trade Organization more accurately reflect the will of their member states than constrain their actions. The key to a sound international economic order is sound domestic policies of stable money, free markets, and protected rights to property and contract. As Ropke argued, a liberal international economic order, ''like charity, should begin at home.''

By the same logic, interventionist policies at home breed interventionist policies abroad. Tumlir argued that the breakdown of international economic order between the two world wars was caused primarily by the rise of statism within nations, not by a lack of cooperation among them. This growing intervention in domestic economic affairs put pressure on governments to insulate their economies from outside competition. Thus, according to Tumlir, ''protectionism is the inherent logic of the redistributive state working itself out externally.''

Second, a classical liberal approach warns against vesting power in multinational organizations, even when their stated mission is market liberalization. This ''liberalism from above,'' as Sally describes it, contains inherent dangers. It leads to ''complex mechanisms of intergovernmental cooperation, with their tendency to degenerate into political cartels that encourage discretionary power and bureaucratic expansion while avoiding both domestic political accountability and market disciplines.'' According to Sally, ''Neoliberal institutionalist enthusiasts of intergovernmental cooperation almost wholly ignore such features of 'international government failure.' ''

A more enduring and principled approach to liberalization would be what Sally alternatively calls ''liberalism from below.'' This approach relies on nation states as the principal actors in setting international economic policy. Those policies are determined through trial and error, in response to internal political pressures and institutional competition with other states. As individual nations discover the benefits of unilateral liberalization, other nations face a kind of market pressure to adopt more liberal policies to keep up with their more prosperous free-trading neighbors. In this way, competition in an unrestrained global policy market leads to better policies, just as competition spurs better production methods in a free domestic economy.

Third, classical liberal thought weighs heavily in favor of unilateral free trade. Even if free trade is not always the optimal economic policy according to neoclassical trade theory, it is virtually always the best policy in the broader context of political economy. As Viner argued, protectionism—no matter what its underlying theoretical justification—often invites retaliation by other nations. Once trade barriers are imposed, they create a political constituency that makes them difficult to remove even after the original justification has long passed. Policymakers simply lack the information necessary to intervene in an intelligent and beneficial manner, even if a policy may exist in theory that would be superior to free trade.

Ultimately, the classical liberal approach puts the argument for free trade on more solid ground. "Modern advocates of protection," Sally writes, "have not learnt the lesson taught by the classical economists: the presumption against protectionism, while having a (hardly cut-and-dried) theoretical rationale, relies heavily on the empirical observation that government intervention is usually short-sighted, with an unavoidably inadequate understanding of the coherence of economic phenomena. Usually, this leads to results more harmful than those that follow from nonintervention. As the more policy-attuned neoclassical trade economists would put it, the costs of government failure usually outweigh the costs of market failure in international economic policy."

Classical Liberalism and International Economic Order buries the myth that free trade is a utopian dream incompatible with the realities of this world. As Sally demonstrates in this important book, in a world of imperfect people and imperfect governments, free trade is the most realistic policy of all.

Daniel T. Griswold
Cato Institute

The Fluttering Veil: Essays on Monetary Disequilibrium

Leland B. Yeager; edited and with an introduction by George Selgin
Indianapolis: Liberty Fund, 1997, 441 pp.

Economists of all persuasions should welcome this collection of Leland Yeager's critical work on monetary disequilibrium. Yeager is a serious thinker who does not burden his readers with trivia. His work emphasizes fundamental issues for which he has constructive and, at times, unique contributions. These essays reflect the path of Yeager's thinking on monetary affairs over several decades, and thereby highlight major theoretical and policy problems that have beset the economics profession and the U.S. economy over this time span.

The major sections of the book, after the Editor's Introduction, are: (I) Monetary Disequilibrium and Its Consequences (Chapters 1–3); (II) Monetary Misconceptions (Chapters 4–8); (III) Keynesianism and Other Diversions (Chapters 9–12); and (IV) Avoiding Monetary Disequilibrium (Chapters 13–18). Virtually every selection in the book is worth reading for its fundamental insights on the nature of money, how money is supplied, and how people behave when they have money in their hands or wish that they did.

Three or four of the selections are major advances in the economic profession's valid comprehension of monetary theory and policy. Those pieces are so fundamental that no practicing economist can afford to be unfamiliar with them. At least three, "Essential Properties of the Medium of Exchange" (Chapter 4, 1968), "The Significance of Monetary Disequilibrium" (Chapter 10, 1986), and "A Laissez-Faire Approach to Monetary Stability" (Chapter 15, 1983), rank as contributions of the same importance as W.H. Hutt's "Yield on Money Held," Don Patinkin's "Price Flexibility and Full Employment," and Milton Friedman's "Optimum Quantity of Money," to mention just a few.

The first selection, "A Cash Balance Interpretation of Depression," published in 1956 when the Great Depression was still in recent memory, emphasizes the analytical and policy simplicity of concentrating attention on the stock of money when treating economic depression. Yeager notes here that analysts may regard a depression either as an excess demand for money or as an excess supply of goods—the Walrasian identity. Policy can do nothing about the excess supply of goods, which is only "excess" at the prevailing price level, but it can readily supply the deficient money at very little cost. Otherwise, wages and prices must suffer an agonizing adjustment downward to reach some subterranean price level.

That article reveals the beginnings of Yeager's absorbing interest in adjustment from an economic disequilibrium. In "Essential Properties of the Medium of Exchange," Yeager took issue, as did some other economists including this one, with the notion that money was just one asset in a liquidity "spectrum," different in degree but not fundamentally different in kind from other financial assets. Those other financial assets were obviously stores of value similar to money and could be held as such. They therefore could substitute for each other and for money, and all that remained was a means to measure their elasticities of substitution with money. I remember having similar thoughts in the mid-1950s, and trying to develop a meaningful and measurable hypothesis to test them. I thought then that some measure of the velocity of money would reveal the elasticity I was looking for.

Yeager, however, took the analysis along a different line. Instead of working on the question from the demand side—that is, how people demand money relative to, say, Savings & Loans shares, wheat, or government bonds—he approached the issue from the standpoint of market adjustments in the various "near" moneys and money itself. Everyone knew that money was special in that it was the medium of exchange. But Yeager was the first to point out that *only* money was the medium of exchange. It is always the "other" item in all transactions. Everything except money clears its demand with its supply in a market, but money being the medium for all those other market clearings is bereft of a market for itself. Too bad for money, because that characteristic means that money can only reach its equilibrium through its obverse relationship in all other markets. Its "price," perforce, is the reciprocal of the average of all other prices. An economist's mind can envision "all other markets" easily enough, but all other markets do not reach their respective equilibria by someone thinking through their ultimate positions. As Yeager emphasizes repeatedly in this work and throughout the book, the process of an all-markets' adjustment is often slow, painful, roundabout, resisted, and institutionally hampered. No other commodity or financial asset has this problem. Even the nearest of "near" moneys clears in a single market. For example, if an excess supply of S&L shares tried to appear, falling prices for the shares and rising interest rates would prevent the "supply" from ever appearing. The shares cause no pervasive disruption in other markets. Money, however, is always acceptable. People want it, Yeager observes, because they can so readily "unwant" it (p. 93).

In the selections, "What Are Banks?," "Individual and Overall Viewpoints in Monetary Theory," "Money and Credit Confused: An Appraisal of Economic Doctrine," and "The Significance of Monetary Disequilibrium," Yeager treats in detail several conceptual differences and distinctions of which an observer must be conscious when dealing with monetary institutions and the economy's adjustment to disequilibrium conditions. First is the difference between adjustment in "the" money market and adjustment in the market for any other good or service, emphasized so painstakingly in "Essential Properties."

Another major distinction is between banks as creators of money and any other businesses, including nonbank financial intermediaries, that do not create money. Being creators of money, banking operations are a part of the cumbersome adjustment process previously described.

Likewise the central bank is different from the commercial banking system. Both create money, Yeager notes, but the central bank does so as part of a deliberate policy without reference to any profit-and-loss constraints. Banks, however, create money (demand deposits) indirectly, as an unintentional byproduct of their lending operations. Individual bankers do not know they are creating money, and often deny vehemently that they do.[1] "Since [the creation of] money is a by-product of the banking system's nominal expansion [of credit]," Yeager properly reasons, "[banks'] costs and revenues are not those of producing nominal money" (p. 120). Therefore, bank-created money, which is willy-nilly a medium of exchange, is outside any cost-revenue-equilibrating market process.

Yeager also stresses the difference between rational behavior for an individual and what would be rational behavior for society as a whole. Since "society" cannot think or behave apart from the thoughts and actions of individuals who make up society, collective "rationality" is not a basis for meaningful action. Therefore, a disequilibrium condition does not necessarily yield to a simple rational solution without much travail and gnashing of teeth. Yeager sharply criticizes the attempt by the rational expectations school to define away any disequilibrium in the face of clear-cut factual evidence that economic depressions and inflations are indisputable evidence of the same (p. 225).

[1] For more on this subject, see Timberlake (1988).

Given Yeager's analyses of money's properties, the unreliability of institutions that create and monitor money, and the difficulties of monetary adjustment in the absence of a bounded money market, what could be the solution?[2] Yeager pungently notes that the present system is "preposterous," as indeed it is. Here we have, or at least espouse, a free-market system for all goods and services that works demonstrably better than any alternative order. It not only produces the maximum quality and quantity of goods and services that everyone wants. It also encourages cultural values, arts, science, conservation of natural resources, and morality. Yet, we continue to tolerate uncritically a monetary system that has the flexibility and adaptability of glass, one for which the supply of the particular unit is only remotely related to the demand for it, and one that cannot clear its own market without untold and undesirable ramifications to the rest of the economy. How can the rules and institutions that govern money be amended to encourage a smooth-working market-driven medium of exchange?

Yeager does not mention the fact—probably because he thinks it is too obvious—that the circumstances, times, and places that witnessed the appearance of moneys have been legion, and never under any sanction or initiation from the state. Yet, in every country in the world today, the state jealously controls monetary systems with the strictest authority. Could the ubiquitous assumption of state control perhaps be the problem?

Yeager agrees that the state and its central banks are a major problem. However, even with angels guiding central banking policies, the absence of a single market in which money can clear properly is still a major difficulty. In his (and Robert Greenfield's) "A Laissez-Faire Approach to Monetary Stability," Yeager comes to grips with the intrusion of the state into day-to-day monetary affairs, and with the peculiarity of the market for money.

The crucial element of disequilibrium in present-day monetary systems, besides what central banks foment, Yeager and Greenfield contend, is the identity of the unit-of-account and the medium-of-exchange. This identity in real life is the "scruffy" one-dollar bill. No other unit of measure is so combined and confused with its agent of measure.

The U.S. Constitution provides for Congress "To coin Money, regulate the value thereof, . . . and fix the standard of weights and measures" [Art. 1, Sec. 8]. Section 10 then declares that, "No State shall . . . coin Money; emit Bills of Credit; [or] make any Thing but gold and silver Coin a Tender in Payment of Debts." Congress has properly fixed the standard of weights and measures, as it was so authorized, without any attempt to manufacture yardsticks and balance weights. Its parallel function with

[2] Rigorously defined, "the" money market is the Yeager concept in which the quantity of money desired by everyone tends to an equilibrium with the quantity in existence. The popular concept of "money market," in which short-term interest-bearing securities are demanded and supplied at different prices and interest rates, is simply an enduring misnomer.

respect to money, however, has been pervasively and grossly abused. Over the decades since the writing of the Constitution, what was supposed to be a nonpolitical commodity-anchored unit of account has become a government monopoly of legal tender fiat paper money. Besides the loss of the gold mooring through deceitful political and judicial machinations, the unit of account, originally specified in gold (and silver) but now simply fiat paper, has become identical to the medium of exchange both in concept and in practice.

Yeager would reverse that unconstitutional distortion of the monetary system. He and Greenfield label the system they have devised the BFH system.[3] To understand the workings of BFH, they suggest that one should begin by putting aside any preconceptions about money and simply consider the operation of a gold standard unencumbered with a central bank or any other government trappings. Let Congress prescribe a unit of account labeled, say, a Unit. For the moment let the Unit be a weight (ounce) of gold. Unlike the original U.S. gold Eagle, the gold Unit is not legal tender.

Indeed, in the BFH system, legal tender does not exist, and why should it? Why should the state force us to accept its particular money any more than it forces us to accept a particular brand of toothpaste or a particular brand of yardstick—unless, of course, the state senses how flawed its money actually is? Neither does the state in the BFH system coin money, and it regulates money's value only in specifying the weight of gold of certain limited denominations. If one ounce is a Unit, half an ounce would be a Half-Unit, and so on. All money is coined by private firms. These firms and other private firms, such as banks and mutual funds, issue media of exchange that satisfy people's common requirements for transacting business and making other exchanges.

Given that the Unit (of account) is legally specified as one ounce of gold, any privately produced medium of exchange (Medex) would have to be of a value equal to the gold Unit. No government agency or central bank would oversee or "guard" this relationship, any more than a fox "guards" a chicken house. Government's only monetary function would be to enforce contracts entered into by private firms and households. Competition among Medex producers would keep any advertised Medex value-constant in terms of gold. As Yeager and Greenfield remark, like a dash of cold water: "Money would not exist" (p. 368). Their plan is a barter system, but a very refined form of barter. Their Unit is a property that exchanges for other property by means of competitively produced Medex.

I have used gold to describe the BFH system because explaining it with a single familiar commodity is easier. However, instead of gold, Greenfield and Yeager use a broad-based commodity Unit. Their Unit

[3] The term "BFH" refers to three economists, the late Fischer Black, Eugene Fama, and Robert Hall, who have proposed monetary systems with some of the elements that Yeager and Greenfield use.

is defined as the total market value of a bundle of easily recognized and commonly used commodities that would accurately reflect the market value of "all commodities." However, no agency would store those commodities or redeem the Unit by direct convertibility into the designated bundle. "Instead, its value is fixed by definition" (p. 368). Space does not permit a detailed description of how private producers of Medex would maintain its value in terms of the Unit, but the gold analogy suggests the stabilizing mechanism.

In the final chapters of *The Fluttering Veil,* Yeager acknowledges the practical political difficulty of revising the monetary system along the lines he and Greenfield so painstakingly sketch. Even though the present system is "preposterous," he is certainly correct that any reform in the direction of laissez-faire production of money is almost impossible. Since the BFH system would revoke the federal government's lucrative seigniorage from the printing of legal tender paper money, its fate is sealed for perhaps the next century, or for whatever time it takes for civilization "as we know it" to reinstitute constitutional bounds on Leviathan.

Nevertheless, Yeager's insightful and cogent analysis is there for the ages. Its truths cannot be politicized. And though the momentum of contemporary institutions will doubtless preclude adoption of the BFH system, at least we can say, "Thank you Leland Yeager. Perhaps events in the 22nd century will vindicate your labor."

Richard H. Timberlake
University of Georgia

Reference

Timberlake, R.H., Jr. (1988) "A Reassessment of C.A. Phillip's Theory of Bank Credit." *History of Political Economy,* Vol. 20, No. 2 (Summer): 299–308.