An Agenda for Monetary Action

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Not quite 40 years ago, the newly minted Nobel laureate Friedrich A. Hayek issued his famous appeal for freedom of choice in currency. He didn't object to governments issuing money; he only objected to governments monopolizing the right to issue money. He expressed the hope that "it will not be too long before complete freedom to deal in any money one likes will be regarded as the essential mark of a free country" (Hayek 1976: 22).

You'd think that the world would have made up its mind by now. Money is as old as the hills. Credit, the promise to pay money, is as old as trust. Still we earthlings still search for an answer.

The Need for Sound Money

The need for sound money is urgent and obvious. Yet we must pause to consider that there is nothing either obvious or urgent about the idea of sound money to the people who own so much of the other kind. The asset-holding portion of the community has hugely profited by zero-percent funding costs and the levitation of stock, bond, and real estate prices. The Dow is back to its highs. The U.S. Treasury is borrowing at yields that would lead a visitor from Mars to conjecture that the government is actually solvent. The dollar value of gold has been falling since 2011—meaning, reciprocally, that the world's faith in the pure paper dollar has been rising since 2011.

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If there's a crisis in money, it's news to most moneyed people. The bald fact is that we, believers in markets, are out of step with markets.

Fundamental monetary reform is no easy sale in this time of not-so-terrible measured economic growth and sky-high asset prices. In the era of quantitative easing (QE), the dollar is still the Coca-Cola of world monetary brands. Not many would disdain to pick up a greenback if they saw one lying on the sidewalk. From the vantage point of monetary reform, the Republican takeover of Congress was not quite satisfying. Jeff Bell, running in New Jersey on a gold standard platform against Democrat Cory Booker, lost by a margin of 56 to 42 percent.

Still, it does amaze me that the system in place remains in place. You could write a book about its many demerits, and some of us have. One hundred years ago, we had the gold standard. Today, we have the PhD standard. One hundred years ago, the stockholders of a nationally chartered bank were responsible for the solvency of the institution in which they owned a fractional interest. Today, we have too big to fail.

Progress is the rule in American enterprise. Retrogression is the rule in American money and banking. With respect to the dollar and high finance, we seem to be going backwards.

Pressing for Alternative Monetary Arrangements

This is not the counsel of despair. As people consent to monetary arrangements, so may they withhold their consent and press for alternative arrangements. It's easy to forget that in mid-20th century America, no citizen could lawfully own gold. Principled men and women ended that New Deal fatwa as well as the kindred prohibition against entering into contracts specifying payment in gold. Writing in the snail-mail era, Hayek compared the government's monopoly over money with its monopoly over the post office. E-mail disrupted the post office. Maybe bitcoin or bitgold will disrupt the Fed.

Something should disrupt it. Every new financial crisis brings a bigger, more radical central-bank intervention. You wonder what they'll do the next time. At crisis-wracked intervals since 1993, they have pushed the federal funds rate steadily lower—to 3 percent, 2 percent, 1 percent and now zero percent. In Europe, the authorities have dropped short-dated yields to less than zero.

The great British journalist Walter Bagehot warned that ultra-low interest rates induce speculative bubbles. "John Bull can stand anything but he can't stand 2 percent," was Bagehot's epigrammatic phrasing of that idea. He meant a positive 2 percent.

The Yellens, Draghis, and Kurodas are going to force a reconsideration of the theory of interest. Joseph Schumpeter (1934: 159) called interest a "permanent net income." He had in mind what Eugen von Boehm-Bawerk (1922: 1) had noted earlier, namely, that interest "flows to the capitalist without ever exhausting the capital from which it comes and therefore without any necessary limit to its continuance."[1] Well, yes and no. The Swiss government two-year note changed hands recently at a price to yield minus 14.5 basis points to maturity. *Minus* 14.5 basis points, mind you. The minus sign means that your principal instead of growing, shrinks. Continuously invested at that particular negative rate, one's principal would be sawed in half in 478 years.

Asset Bubbles Engineered by Central Banks

What's new today isn't ultra-low interest rates. They were as low in Queen Victoria's time as they are today. They were as low during Harry Truman's presidency as they are today. What's new is governmentally sponsored asset booms superimposed on ultra-low interest rates.

The complicity of the American financial establishment with this species of price control is another kind of monetary novelty. Interest rates are, of course, prices. They are the prices that set investment hurdle rates and that discount the present value of estimated future cash flows. They are the investment traffic signals of a market economy.

If you recall, the Fed was conscripted into government service in World War II. It became the bond-buying arm of the Treasury. Nor, come the peace, did the Treasury set its captive free. The Fed chafed under its continued subjugation. It bridled at pegging bond yields at 2 1/4 percent in the face of a virulent postwar inflation. Others protested, too, including the head of the New York Stock Exchange and the house economists at Bankers Trust and the National City Bank, today's Citibank. To strike a preemptive blow against flyaway

[1]For an excellent introduction to the theory of interest and its history, see Conard (1959).

asset prices, the Fed ordered that no one could buy stocks using margin debt. It was cash on the barrelhead or nothing.

You know the world has changed when the Fed not only doesn't resist an interest rate–induced bull market but actually sponsors one. In 2011, under gentle questioning from the CNBC correspondent Steve Liesman, then chairman Ben Bernanke expressed his satisfaction at the lift-off of share prices. He singled out the Russell 2000 small-cap index for special mention. Its angle of ascent was even steeper and therefore more stimulative than that of the S&P 500. As justification for these intrusions, the Fed cited the theory of the so-called portfolio balance channel. My friend Paul Isaac, a talented Wall Street practitioner, assesses such radical policies in simpler language. They are, he observes, "the largest, most explicit and prolonged exercise in trickle-down economics in American history."

With respect to the radicalization of monetary policy, investors en masse resemble the sleepy frog in the warming saucepan. They don't jump out while the jumping's good. At that, professional investors couldn't jump if they wanted to. They are paid to invest, not to pass judgment on the administration of monetary policy. Monetary criticism is our line of work, not theirs. As a rule, theirs pays better.

The temperature in the Federal Reserve saucepan rose to the boiling point as long ago as October 15, 1998. It was an options expiration day, therefore a day primed for stock-price volatility. Out of the blue at 3:04 p.m. EST came news of a one-fourth of 1 percent cut in the federal funds rate. In the next 56 minutes, the S&P 500 leapt by 7 percent. Long Term Capital Management was then combusting, but the world was hardly coming to an end; the unemployment rate stood at just 4.5 percent. Members of the Fed's open market committee knew which buttons to push, and they've kept right on pushing them.

It's a sign of the times that these interventions have come to seem normal. I am reminded of Daniel Patrick Moynihan's phrase "defining deviancy downward." In monetary policy, the once unspeakable—indeed, unimaginable—has become the commonplace. You get a sense of how far we have come—either up or down, according to political and monetary preference—by recalling the close of the Bretton Woods system in 1971. The dollar had been defined as 1/35th of an ounce of gold. On August 15, 1971, President Richard Nixon redefined it as a piece of paper. Foreign governments had been entitled to exchange unwanted greenbacks for gold at that statutory rate. Nixon withdrew the privilege. Bretton Woods was far from the real gold standard. But it did exert a helpful check on American public finance. How starchy and orthodox it seems from the vantage point of QE.

It did not seem orthodox to Hayek. Good riddance to it, he said in 1976. "Wholly Keynesian" was his malediction on the post–World War II monetary structure. You can only begin to imagine what Hayek would say about central banks conjuring dematerialized scrip on computer keyboards.

The Bogeyman of Deflation

To what end do they conjure? Why, to beat back "deflation." By deflation, the mandarins mean a substandard rate of inflation. How the statisticians can calculate inflation rates to tolerances exacting enough to validate the debates over the difference between, for instance, 2 percent per annum and 1.7 or 1.8 percent per annum is beyond me. Neither do I understand why the central bankers refuse to admit that, in a time of technological wonder, prices ought to be falling. As it costs less to make things, so should it cost less to buy them.

Mario Draghi, president of the European Central Bank, is a champion of faux statistical precision. He has announced his determination to steer the fortunes of the continent of Europe according to the squiggles of something called the "five-year, five-year euro inflation swap rate." That would be a market-based expression of inflation expectations for the half-decade starting in 2019. Curious minds will wonder how any mortal being could accurately divine such distant events.

Let us now imagine the scene in the boardroom of a German bank in the spring of 1914. A directors' meeting is in progress. The chairman of the board polls the assembled about the financial outlook. "Anyone care to venture a forecast of the rate of inflation eight years out?" he inquires. Here is what nobody says in reply: "A great war will shatter Germany and the world. Nothing will ever be the same again. The German cost-of-living index, now set at 1, will hit 218,000 million come November 1923. The mark will become worthless, after which it will become very worthless."

Returning to the 21st century, Switzerland is pledging to defend its currency with its last ounce of breath—that is, to protect it from unwanted appreciation against Draghi's euro. The Swiss National

Bank is not purely a central bank. It is partly a wealth fund, partly a conjuring act. Its mission is to protect Swiss exporters against a too-high Swiss franc exchange rate. To this end, the SNB creates Swiss francs by the gondola-car-full. With those francs it buys euros. And with those euros (or some of them), it buys dollars. What to do with the dollars? Why, the Swiss buy American equities, $27 billion's worth at last report. Here's a metaphysical head scratcher. The francs cost nothing to create. Ditto, the euros and the dollars. Yet these disembodied monetary claims secure equity ownership in American public companies—something for nothing, indeed. On November 30, Swiss voters go to the polls to cast their ballots on a referendum that would effectively take the Swiss National Bank out of the money-spinning business by requiring it to hold substantially more gold than it currently does. While the technical merits of the Swiss proposal are debatable, I applaud the spirit of this popular revolt against mandarin rule.[2]

The Question of Trust

Trust is at the root of all monetary systems. Ours is peculiarly faith-based. We trust the central bankers—not you and me, perhaps, but most people. This trusting majority includes—critically—most people who hold the central bankers' money. In their turn, the central bankers trust the accuracy of the government's statistics on which they profess to be dependent. And the central bankers trust their so-called dynamic stochastic general equilibrium models. These are the econometric models that failed to flag the most disastrous credit event in the professional lives of the model builders. What the mandarins distrust is the resiliency of the price mechanism.

And yet, as I say, markets trust the mandarins. Sentient people are lending at some of the lowest rates in 50 years. They will be repaid in a currency of no intrinsic value that the Federal Reserve has pledged to depreciate at the rate of 2 percent a year. Still, they lend: 30-year Treasury bonds are priced to yield just 3.09 percent.

Classical Gold Standard versus the PhD Standard

Under the classical gold standard, prices and wages were expected to adjust to economic disequilibria. Under the PhD standard, it's

[2]The Swiss have now depegged the franc from the euro, and the November 2014 gold referendum failed to be passed (Ed.).

interest rates and exchange rates and asset prices that are expected to do the adjusting.

You know about the gold standard. Money was a weight or measure, specifically a weight or a measure of gold. Bank notes were convertible into gold. The central banks of gold standard nations stood ready to exchange notes for gold and gold for notes at the fixed and statutory rate. Bullion moved freely from one gold standard nation to another.

In 1959, the Federal Reserve Bank of New York published a monograph on the workings of the classical gold standard. The author, Arthur Bloomfield, summarized thus:

> From about 1880 to 1914, the exchange rates of the various gold standard countries moved within narrow limits approximating their respective gold points without the support of exchange restrictions, import quotas, or related controls, which were virtually unknown even for currencies on paper or silver standards. . . . This remarkable performance, essentially the product of an unusually favorable combination of historical circumstances, appears all the more striking when contrasted with the turbulence of post-1914 international financial experience and remains, even today, a source of some measure of fascination and indeed of puzzlement to students of monetary affairs [Bloomfield 1959: 9].

Well, if Eisenhower-era America scratched its head over the classical gold standard, what will futurity make of the PhD standard? Likely, it will be even more baffled than we are. Imagine trying to explain the present-day arrangements to your 20-something grandchild a couple of decades hence—after the crash of, say, 2016, that wiped out the youngster's inheritance and provoked a central bank response so heavy-handed as to shatter the confidence even of Wall Street in the Federal Reserve's methods.

I expect you'll wind up saying something like this: "My generation gave former tenured economics professors discretionary authority to fabricate money and to fix interest rates. We put the cart of asset prices before the horse of enterprise. We entertained the fantasy that high asset prices made for prosperity, rather than the other way around. We actually worked to foster inflation, which we called 'price stability' (this was on the eve of the hyperinflation of 2017). We seem to have miscalculated."

A Modest Reform Agenda

Bearing in mind how little disposed is the monied world for thoroughgoing overhaul, perhaps we should not disdain the opportunity for achieving some small, symbolic victories.

To this end, Cato's Center for Monetary and Financial Alternatives could assemble a modest action agenda for the new Republican Senate. Why not—as a gesture of bipartisan comity—a bill to add, rather than subtract, a monetary bureaucracy? I would support legislation to create a new Department of Unintended Consequences within the Federal Reserve. Give it a big budget and a new, properly imposing headquarters building with lots of neon signage.

What about reaching another hand across the aisle to the liberals and introduce a bill to institute free-range, fresh-from-market, organic interest rates in lieu of the government-issued hothouse kind?

Finally, and here I borrow from my friend Larry Parks, why not introduce a bill to remove federal taxation from U.S. Gold and Silver Eagles? As Larry observes, "Existing statutes and Supreme Court decisions already authorize these coins as legal tender currency for their face amounts. . . . If the IRS were to treat these coins as U.S. currency instead of 'property' in accordance with existing law and stop taxing them, economic laws will trump political laws" (Parks 2014: 3).

I will account us victorious when the name of the chairman of the Federal Reserve Board is just as obscure as that of the head of the Weight and Measures Division of the Department of Commerce. Come to think of it, the monetary millennium will arrive when the dollar reverts to a tangible weight or measure—and perhaps, when the Weights and Measures Division and the Federal Reserve Board are joined in bureaucratic matrimony.

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