

INTRODUCTION

REFORMING THE MONETARY REGIME

James A. Dorn

Monetary law in the United States is ambiguous and chaotic, does not contain a suitable principle for the exercise of the monetary power held by the Federal Reserve System, and has caused confusion in the development of Federal Reserve policy.

—Clark Warburton

The Chaotic State of Monetary Law

Present U.S. monetary law incorporates neither the “convertibility theory” of monetary control nor the “responsibility theory,” leaving monetary law in the chaotic situation Clark Warburton found it in 1946.¹ The Fed continues to operate in a fully discretionary manner. Under the current fiat money regime, there is no constitutional limit binding the central bank to a noninflationary path of money growth; there is no legislative mandate to achieve a stable value of money. As such, the erratic nature of monetary policy continues and there is no firm commitment to achieve long-run price stability.²

Cato Journal, Vol. 5, No. 3 (Winter 1986). Copyright © Cato Institute. All rights reserved.

¹The opening quote is from Warburton ([1946] 1966, p. 316). In that article he distinguishes between the convertibility theory of monetary control—incorporated in the Federal Reserve Act of 1913, but discarded by the monetary legislation of the early 1930s—and the responsibility theory of monetary control, which has never been embodied effectively in U.S. monetary law. Under the convertibility theory, the decisions of households and businesses determine the optimal quantity of money and the government’s role is to ensure convertibility among monies and of each money into the standard money. Under the responsibility theory, government is held accountable for controlling the stock of money and maintaining its value (pp. 291–92).

²This is not to say that price-level stability may not be an important objective of monetary policy, but simply that this objective is not the sole objective of policy and may be traded off for other policy goals; hence, the experience of “creeping inflation.” Fed officials certainly consider price-level stability important, but they are not constrained to that policy by law. Without such a binding constraint, the future trend of the price level is uncertain, and this uncertainty is greater than it would be under a rules-based regime.

Current law specifies no single objective for monetary policy and lacks an enforcement mechanism to achieve monetary stability. The multiplicity of goals and the absence of an appropriate penalty-reward structure to maintain stable money is evident from Section 2A of the amended Federal Reserve Act (Board 1984, p. 6):

The Board of Governors . . . and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates. . . . Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved. . . .

The lack of any effective constraint on the discretionary powers of the central bank reflects Congress's failure to safeguard the value of money, as intended in Article I, section 8 of the Constitution, and has led to a monetary system characterized by significant uncertainty about the future value of money. This uncertainty—as a chief feature of the present monetary regime—has been noted by Karl Brunner (1984, p. 187): “participants in the socio-economic game do not know what the course for the next three or six months or the next five years will be. Even the policymakers do not know what they will do in three or six months or in one year. The creation of uncertainty appears in the prevailing context of policy institutions as a more or less deliberate instrument of monetary policy.” The recent statement of the Shadow Open Market Committee (1985, pp. 2–3) confirms this:

Money growth has shifted from high to low every three to five months since early 1984. This pattern increases uncertainty and discourages long-term planning. Further, the trend rate of money growth is rising, reopening the prospect of another round of inflation. . . . The only way to avoid the high costs of inflation and disinflation is to avoid inflation. Inflation will not be avoided unless the Federal Reserve and the pro-inflationists in Congress and the Administration accept a long-term commitment to achieve stability.

Thus, even though inflation has been reduced dramatically under Chairman Volcker—from the double-digit rates of the late 1970s to 3.6 percent in 1985—the path to this disinflation has been highly erratic in terms of the behavior of money growth rates.³ Nor is there

³According to Fand (1985, p. 60): Monetary management under Volcker has been “wildly volatile and topsy-turvy. . . . One has to go back to the 1940s to find such erratic behavior in the money supply. Quarterly money growth shot up from minus four percent to 17 percent in 1980, and from three percent to 17 percent in 1982, while plummeting from 18 percent to three percent in 1983–84. In the six years before Mr. Volcker, the highest quarterly growth rate was only eight percentage points above the lowest.”

any guarantee of future price-level stability, especially in light of the double-digit growth of M1 during 1985.

The lack of any anchor to limit the inflationary drift of U.S. monetary policy—a policy Axel Leijonhufvud (1984, p. 23) has referred to as a “random walk monetary standard”—continues to allow for the politicization of monetary policy, posing a danger to the stability of the entire economic system. Within a fiat money regime, there will be obvious pressures to run budget deficits and later reduce the real debt burden via inflation. In addition, in a modern democracy with downward wage rigidities, there will be political pressure to move toward “full employment” by accelerating inflation. In the longer run, politically unacceptable rates of inflation will be met by mounting pressures for wage and price controls, which adversely affect economic efficiency and attenuate economic and personal freedoms. The lack of a permanently stable monetary order therefore upsets the free market order and threatens the future of democracy.⁴

From the standpoint of public choice theory, it appears that the adverse consequences of erratic money cannot be avoided unless the control of base money becomes depoliticized, that is, until there is a constitutional constraint on the money-creating powers of the central bank. Accordingly, Milton Friedman (1984) has shifted his focus from improving the Fed’s operating procedures or the *tactics* of monetary policy to considering how monetary *institutions* can be reformed to improve the prospects for price-level stability.⁵ His preferred rule is now to freeze the monetary base, eliminating the money-creating powers of the Fed. As Friedman notes (p. 51): “The great advantage of this proposal is that it would end the arbitrary power of the Federal Reserve System to determine the quantity of money and would do so without establishing any comparable locus of power and without

⁴In modern democracies, says Haberler (1981, p. 19):

[C]overnments overreact even to comparatively low levels of unemployment and associated inflation—by excessive monetary-fiscal expansion, thus accelerating and perpetuating inflation; by ill-conceived regulations, by price and wage controls, and by import restrictions and subsidies in different forms to noncompetitive firms and industries. This leads to an enormous growth of government bureaucracy and stifling taxation—a potent discouragement of saving and investment—and to economic inefficiencies. Thus, the growth of productivity slows down and comes to a halt which makes it still harder to stop inflation. This vicious circle undermines the foundation of the capitalist, free market economy, and endangers the future of democracy itself.

⁵Compare Brunner (1984, pp. 187–88): “Discretionary management is prone to drift into depression or permanent and erratic inflation associated with intermittent recessions or stagnation. This experience directs our attention to the choice of a monetary regime. The *nature* of the monetary *order* and not the specific actions within a discretionary regime emerged in recent years as the central issue of a more fundamental policy problem.”

introducing any major disturbances into other existing economic and financial institutions." In this way, the chaotic state of existing monetary law would be replaced by a simple monetary rule constraining the growth of base money to zero. Friedman expects such a rule (or even a close approximation) to reduce the uncertainty of the present discretionary regime and produce a more stable price level over time.

Addressing the Fundamentals

Even though it may be agreed that the present fiat money regime can be improved by an effective monetary rule, the question about the exact form of the rule is still undecided; the search for stable money continues. Moreover, after the first-order question about the form of the monetary regime is decided, there is still the second-order question of how to implement and maintain the desired regime. The political economy of monetary reform cannot be ignored.

In order to address the fundamental issues surrounding monetary reform, the Cato Institute held its third annual monetary conference—**The Federal Reserve: Reforming the Monetary Regime**—in Washington, D.C., February 21–22, 1985. Papers were presented in four major policy areas: (1) an appraisal of the Fed's policymaking function; (2) the conduct of Fed policymaking under the current fiat money standard; (3) monetary discipline under a rule-driven regime versus a discretionary regime; and (4) the problems of changing to an alternative monetary regime. The refined versions of the conference papers along with comments by noted economists and policymakers form the core of this volume.⁶

In the opening paper, William Poole finds that within the present discretionary monetary regime, there is a close correspondence between the political process and the Fed's money-supply process. Although it is not possible to observe directly the motives of policymakers, one can derive their motives from the underlying institutional framework, and therefore act "as if" monetary policymakers' motives can be observed. The stop-go nature of Federal Reserve policy is evident and reflects, in part, the political constraints impinging on Fed behavior, contrary to the Fed's assertions of independence. The myopic nature of the political process spills over to the money-supply process and the "number one problem syndrome"—focusing on the crisis of the moment—results in policies that are inconsistent over time. Greater Fed independence, says Poole, is not the answer to erratic monetary policy, nor is better management. The

⁶The paper by Wells and Scruggs was accepted apart from the conference proceedings.

real solution lies in the adoption of a money growth rule that will limit the central bank's discretion and achieve price-level stability. The movement to an alternative monetary regime, however, requires a careful analysis of the existing political process and the motives of policymakers.

The interrelationship between fiscal and monetary policy is examined by Karl Brunner. He notes that a persistent, noninflationary monetary policy tends to lower nominal interest rates by reducing the inflation premium. Such a policy, however, is unlikely to exist in the context of permanently large deficits, Brunner warns. Indeed, with large permanent deficits, there will be an upward drift in the basic real rate of interest, a higher risk premium, and the persistence of an inflation premium signaling an accommodative monetary policy. A noninflationary monetary policy, therefore, is a necessary—but not sufficient—condition for relatively low nominal interest rates. In addition, there must be a persistent policy of holding the deficit to a small fraction of national income. Since permanently large deficits point to eventual inflation, the noninflationary monetary regime will become threatened in this environment; it is likely that political pressure will force the monetary regime to adjust to the fiscal regime. Hence, there is a need to constrain deficit spending so that a noninflationary monetary policy can be implemented with confidence.

Jerry Jordan has the same basic message as Brunner: effective monetary reform must be preceded by responsible fiscal reform. An end to the deficit-ridden fiscal regime is therefore a necessary condition for long-run price stability. To move to a more stable fiscal and monetary regime, Jordan recommends requiring a balanced federal budget and limiting the amount of debt that the Fed can monetize. The latter would be accomplished by legally establishing the maximum monetary base and allowing it to increase at a rate sufficient to maintain price stability—a scheme Axel Leijonhufvud has proposed. In a fiscal regime with persistently large deficits, however, monetary policy will become, of necessity, an instrument of fiscal policy.

The institutional evolution of the Federal Reserve is traced by Richard Timberlake. He begins by examining the monetary institutions prior to the Federal Reserve Act—the gold standard, national banking system, “independent” Treasury, and private clearinghouse system. The political pressures for monetary reform that culminated in the Federal Reserve Act of 1913 are carefully discussed. Timberlake then examines the Banking Act of 1935, the Federal Reserve System as it evolved after 1935, and the Monetary Control Act of 1980. What emerges is a picture of an imperial Fed. Ending the Fed's

hegemony, says Timberlake, requires privatizing the 12 Federal Reserve Banks and ending the Fed's monopoly of base money by freezing the base and allowing a market for private currencies. Timberlake also would privatize the Treasury's gold stock. These reforms, he believes, would restore the monetary system to one that is more consistent with individual freedom and a stable price level.

Lawrence Roos, a former president of the Federal Reserve Bank of St. Louis, provides first-hand evidence of the inherent conflicts of U.S. monetary policymaking. From his experience on the Federal Open Market Committee (FOMC), Roos observes that current monetary policy is characterized by the lack of clear and consistent policy goals. Fed policymaking is myopic and there is little consensus on longer term objectives. Instead of directly controlling the quantity of bank reserves to achieve persistent price-level stability, the Fed finds it more convenient to target short-run interest rates and to focus on whatever policy objective appears most pressing. The multiple and inconsistent policy objectives make it impossible to hold the Fed accountable, which is precisely how the Fed protects its discretion.

Paul Craig Roberts criticizes the Fed for its failure to pursue a steady policy of noninflationary money growth, which is what the Reagan administration recommended in 1980. The roller-coaster conduct of monetary policy, says Roberts, has derailed Reagan's supply-side policy. If supply-side economics is to be effective in promoting incentives to work, save, and invest, it requires a stable monetary framework. Under the present fiat money regime, however, the Fed's primary concern is to maintain its discretionary power. And this self-protective incentive acts to "crowd out" the administration's policy goals. To make the Fed more accountable, Roberts recommends placing the Treasury secretary on the FOMC, reducing the terms of the Board of Governors, and reducing Fed secrecy.

President Robert Black of the Federal Reserve Bank of Richmond agrees with Roos that under the Fed's current legislative mandate there is no overriding policy objective. Instead, the Fed reacts to whatever policy problem seems most important at the time, whether it be unemployment, inflation, or high interest rates. A discretionary monetary policy based on fine tuning the economy, however, is bound to be destabilizing. To avoid the uncertainty of the present discretionary regime, Black recommends price stability as the predominant goal of monetary policy. This objective would be attained by controlling the monetary aggregates, in particular, M1. Targeting M1 to achieve a stable value of money, says Black, would be consistent with the intent of Article I, section 8 of the Constitution, and would increase the Fed's credibility and independence.

Robert Hetzel explains the political rationale for the current discretionary monetary regime, discusses the impact of this regime on the formulation of monetary policy, and considers the possibility of congressional acceptance of a meaningful, more specific mandate for the conduct of monetary policy. Like Black, he advocates price stability as the most meaningful policy mandate. But as long as Congress's main concern is the effects of monetary policy on income distribution—especially on interest rates—Congress is unlikely to accept price stability as the sole objective of monetary policy. Nevertheless, Hetzel notes that conducting monetary policy by targeting the federal funds rate is not a politically efficient method of redistributing income. Therefore a legislative mandate requiring the Fed to stabilize the value of money may become politically acceptable.

To achieve a stable price level, stable interest rates, and stable exchange rates, Marc Miles recommends returning to a Bretton Woods-type monetary system. He claims that in today's world economy, the Fed cannot hope to control the quantity of money and instead should focus directly on stabilizing the *value* of money. Price rules—setting the dollar price of some standard commodity or commodity bundle and stabilizing dollar interest rates—should be instituted to stabilize the value of the dollar in the global economy. Miles's contention that the existence of global money markets, such as the Eurodollar market, attenuates the Fed's ability to control the supply of dollars is contested by Anna Schwartz. There is no evidence, says Schwartz, that the Eurodollar market (or domestic money substitutes) interferes with the Fed's control of the domestic money stock; thus, there is no reason for abandoning a money supply rule as the most effective way to achieve price-level stability over the long run.

William Butos observes that the failure of the Fed to achieve price-level stability is directly related to the so-called knowledge problem. This problem concerns the decentralized nature of economic knowledge and the difficulty the Fed has in observing the underlying structure of the economy. Without detailed knowledge of the economy's structure and its dynamics, the Fed is left to react in a piecemeal fashion to current economic problems. And, in many cases, this discretionary approach to policy furthers the very problems that the monetary authorities seek to resolve. Butos therefore explores alternative monetary regimes to see how each might solve the knowledge problem. He thinks that a money growth rule would avoid many of the problems of discretionary monetary policy, but still sees difficulties with implementing such a rule. F.A. Hayek's proposal for abolishing monetary policy altogether and instituting a regime of

competing private monies is of interest, says Butos, but needs further analysis.

Historical evidence of the stability of the U.S. Free Banking Era (1837–63) is offered by Arthur Rolnick and Warren Weber. They point out that if the institutional framework is one that penalizes unsound banking practices, competitive banking will perform efficiently. It is only when the underlying institutional arrangement rewards or fails to penalize irresponsible banking decisions that private banking becomes unstable. In the case of the Free Banking Era, the authors found that the state bond requirements provided valuable information about the stability of bank portfolios to note-holders, which helped prevent individual bank failures from disrupting the entire banking system. If free banking is not inherently unstable, there is little need for government intervention, except to define the “rules of the game”; that is, banking regulation should be informative rather than interventionist.

Donald Wells and L. S. Scruggs provide further evidence of the stability of unregulated private banking. They show that banking crises typically have stemmed from excessive government regulations that limit branching, restrict private note issuance, and set reserve requirements. The establishment of federal deposit insurance, which itself has serious flaws, was a reaction to these problems. The authors contend that a movement to a free-banking regime with competing private currencies would be socially beneficial and result in greater price-level and economic stability.

Ulrich Kohli and Georg Rich examine the success of the Swiss central bank’s monetary targeting procedure. Since 1975 the primary instrument of monetary policy has been the monetary base. In 1980 the Swiss National Bank (SNB) actually began setting the money supply targets in terms of the base. Thus, unlike the Federal Reserve, the SNB has instituted a money supply rule and adopted price-level stability as its “ultimate objective.” Within this policy framework, the SNB has achieved a relatively low average rate of inflation, indicating that a monetary base rule is a reliable means of achieving price-level stability. Because the SNB has largely avoided the erratic monetary policy characteristic of the U.S. central bank, it has achieved a credibility that has escaped the Fed. The Swiss central bank, however, remains what the authors call a “pragmatic monetarist,” since it stands ready to modify its monetary base target if exchange-rate considerations so dictate. The SNB’s predominant consideration, however, is price-level stability. The two major lessons identified by the authors are the necessity of policy consistency in maintaining a

noninflationary growth of the monetary base and the need for some flexibility in implementing this policy.

In the final paper, Roland Vaubel carefully examines the case for competitive versus governmental supply of base money. He begins by discussing the barriers that national governments have erected to prevent currency competition from foreign central banks and from private money producers. Next, he considers whether the restriction of competition from foreign central banks can be justified on "welfare-theoretic grounds," whether there is a case for private currency competition, and whether there is any role for government provision of base money. He makes a strong case for free currency competition among central banks, arguing that such competition would lower the expected rate of inflation. After analyzing the many objections to the private supply of base monies, Vaubel finds no conclusive argument for restricting private monies. Finally, with respect to whether the government ought to supply base money, Vaubel finds the public-goods argument for a governmental money monopoly redundant, and suggests that the only way to test the relative efficiency of government versus private monies is to allow open entry into the money-producing business. This would also be a test of whether there is a natural monopoly in the supply of a common currency. Thus, currency competition is the only reliable way to discover the most efficient monetary arrangement. In response to Vaubel's paper, Philip Cagan suggests that if the Fed's erratic monetary policy persists, "competitive monies may develop through the back door" as individuals search for stable money.

The Road to Monetary Reform

The chaotic state of U.S. monetary law, which leaves the Fed with vast monetary powers, calls for a careful consideration of the institutional changes needed to promote monetary stability. In particular, it is useful to consider the choice of a monetary regime and the probable operating characteristics of alternative regimes, because as Friedman (1984, p. 24) notes:

The conduct of monetary policy is of major importance: monetary instability breeds economic instability. A monetary structure that fosters steadiness and predictability in the general price level is an essential precondition for healthy noninflationary growth. That is why it is important to consider fundamental changes in our monetary institutions. Such changes may be neither feasible nor urgent now. But unless we consider them now, we shall not be prepared to adopt them when and if the need is urgent.

Achieving meaningful monetary reform requires an understanding of the probable impact of alternative monetary regimes on the maintenance of price-level stability. It also requires an understanding of the type of political arrangement necessary to implement and maintain a monetary constitution. The papers in this volume are concerned not merely with patching up the present discretionary monetary regime but with finding an alternative road to monetary stability that may one day become politically viable.

In order to avoid detours on the road to monetary reform, it is essential to know what regimes are more likely than others to produce long-run price stability, a more competitive banking system, and a more efficient price system. By considering the characteristics and effects of alternative monetary regimes, as well as the incentive structure of the present regime, the papers in this volume will help lay the groundwork for future reform.

References

- Board of Governors of the Federal Reserve System. *Federal Reserve Act and Other Statutory Provisions Affecting the Federal Reserve System, As Amended Through April 20, 1983*. Washington, D.C.: Board of Governors, 1984.
- Brunner, Karl. "Monetary Policy and Monetary Order." *Aussenwirtschaft* 39 (1984): 187–206. Reprint Series No. C-137. Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester.
- Fand, David. "Paul Volcker's Legacy." *Policy Review* 34 (Fall 1985): 58–63.
- Friedman, Milton. "Monetary Policy for the 1980s." In *To Promote Prosperity: U.S. Domestic Policy in the Mid-1980s*, pp. 23–60. Edited by John H. Moore. Stanford, Calif.: Hoover Institution Press, 1984.
- Haberler, Gottfried. "The Great Depression of the 1930s—Can It Happen Again?" In *The Business Cycle and Public Policy, 1920–80*. A Compendium of Papers submitted to the Joint Economic Committee, Congress of the United States, 28 November 1980. Reprint No. 118. Washington, D.C., American Enterprise Institute, January 1981.
- Leijonhufvud, Axel. "Inflation and Economic Performance." In *Money in Crisis*, pp. 19–36. Edited by Barry N. Siegel. Cambridge, Mass.: Ballinger Publishing Co. for the Pacific Institute for Public Policy Research, 1984.
- Shadow Open Market Committee. *Policy Statement and Position Papers*. PPS-85-2. Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, 22–23 September 1985.
- Warburton, Clark. "Monetary Control under the Federal Reserve Act." *Political Science Quarterly* 61 (December 1946): 305–34. Reprinted in Warburton (1966), pp. 291–316.
- Warburton, Clark. *Depression, Inflation, and Monetary Policy: Selected Papers, 1945–1953*. Baltimore, Md.: The Johns Hopkins University Press, 1966.