

INTRODUCTION

ALTERNATIVES TO GOVERNMENT FIAT MONEY

James A. Dorn

The suggestion of depriving government of the monopoly of issuing money and of its power of making any money "legal tender" for all existing debts has been made here in the first instance because governments have invariably and inevitably grossly abused that power throughout the whole of history and thereby gravely disturbed the self-steering mechanism of the market.

—F. A. Hayek¹

Monetary Stability and Monetary Order

Money of stable value depends on price-level stability, which, in turn, depends on the existing monetary order or monetary regime. What kind of monetary order or regime is most likely to provide stable money? F. A. Hayek (1976, 1978) has suggested that a monetary regime characterized by free banking and competing currencies offers the best chance for achieving stable money.

In contrast, governmentally managed monetary systems having monopoly central banks with wide discretion are likely to experience monetary instability and upset the spontaneous market order. Indeed, the history of discretionary central banking has been characterized by persistent monetary disequilibrium, and during periods of depression and inflation the role of the state typically grew stronger.

It is important, therefore, to consider institutional changes that can improve upon the current governmentally managed fiat money regime. With this task in mind, the articles herein examine the performance of the current monetary regime, question the role of govern-

Cato Journal, Vol. 9, No. 2 (Fall 1989). Copyright © Cato Institute. All rights reserved.

¹From *Denationalisation of Money* (1978, pp. 116–17).

ment in the monetary order, and consider alternatives to government fiat money.²

Failure of Government Fiat Money

History has taught that lodging monopoly power over the nation's stock of currency in a purely discretionary central bank, unconstrained by a monetary constitution, is highly dangerous. The money-supply process is likely to become politicized, with monetary policy becoming subservient to fiscal policy and with monetary authorities exhibiting a bias toward inflation. Peter Bernholz (1988, p. 11), for example, tells us that "a study of about 30 currencies shows that there has not been a single case of a currency freely manipulated by its government or central bank since 1700 which enjoyed price stability for at least 30 years running."³

The Federal Reserve fits this mold. Although the Fed has achieved intermittent price stability since its inception in 1913, its long-run performance has been unsatisfactory, especially when compared to commodity-based standards such as the classical gold standard.⁴ In particular, by allowing the money supply to shrink by one-third between 1929 and 1933, the Fed caused the worst depression in U.S. history (see Friedman and Schwartz 1963); and by allowing the money supply to increase by more than tenfold in the last 30 years, the Fed provided the means for persistent inflation and allowed the price level to more than quadruple.

With the average annual inflation rate seemingly stuck in the 4.0 to 4.5 percent range, it is surprising that the Fed's reputation has remained largely untarnished. As Milton Friedman (1987, p. 362) remarked, "no major institution in the United States has so poor a record of performance over so long a period yet so high a public reputation as the Federal Reserve." Instead of seeing the current government fiat money standard as "an absurd system in which peo-

²The papers and comments in this volume were first presented at the Cato Institute's Seventh Annual Monetary Conference, "Alternatives to Government Fiat Money," held February 23–24, 1989, in Washington, D.C. The conference was supported by a grant from The George Edward Durell Foundation.

³Bernholz is referring to the study by Parkin and Bade (1978).

⁴Prior to the Fed, long-run price stability was the rule rather than the exception, although short-run instability was common. The WPI stood at the same level in 1900 as in 1750. However, since 1946 the CPI has increased more than sixfold, with no reversal in sight. See Bordo (1981) for a discussion of the performance of the classical gold standard in achieving long-run price stability. William Poole (1989, pp. 198–99) has noted that if price stability is the real measure of success for a monetary system, then the classical gold standard must be judged superior to a managed fiat money system.

ple cannot count on money's future purchasing power" (Yeager 1988, p. 265), the general public (and many economists as well) continue to regard the existing monetary system as sacrosanct.

It is irresponsible, however, simply to accept the status quo and say the Fed is doing a good job—or that the Federal Reserve and banking regulation are essential for sound money and a healthy economy. In fact, a strong case can be made that the current fiat money regime is inherently unstable. Taking this position, Richard Timberlake (1986, p. 638) has argued, "The history of monetary institutions reveals that every special intervention by government to regulate the monetary system—that is, to *compromise market functions*—has resulted in institutional changes that have both restricted freedom of enterprise in the production of money and reduced efficiency." Likewise, Friedman and Schwartz (1987, p. 311), in their examination of the role of government in the monetary system, come to the conclusion "that leaving monetary and banking arrangements to the market would have produced a more satisfactory outcome than was actually achieved through governmental involvement."

A Change in Tactics or a Change in Strategy?

Even though the tactics of Federal Reserve policy have changed periodically, the basic institution, our overall monetary strategy, remains the same. The most glaring example is that since 1975 the Fed has reported its monetary targets to Congress, but basic monetary law has remained unchanged. There are still multiple objectives that the Fed is supposed to follow in implementing monetary policy; Fed policy continues to drift without any legally enforceable precommitment to long-run price stability; and the quantity of money is still determined by a dozen central bankers on the Federal Open Market Committee (FOMC) whose personal wealth and tenure are largely independent of their performance.⁵ As such, Clark Warburton's ([1946] 1966, p. 316) characterization of U.S. monetary law as "ambiguous and chaotic" continues to ring true.

Public choice theory tells us that unless the rules of the game are changed so individuals face different incentives, one should not expect any significant change in the performance of existing institutions. The Fed is no exception. Imposing monetary targets on the

⁵On this condition, Friedman (1987, p. 379) remarks: "I have found that few things are harder even for knowledgeable nonexperts to accept than the proposition that 12 (or 19) people sitting around a table in Washington, D.C., subject to neither election nor dismissal nor close administrative or political control, have the power to determine the quantity of money."

Fed but not requiring compliance, allowing the targets to be set for six-month periods rather than specifying multi-year targets to avoid “base drift,” and not limiting the Fed’s mandate to a single objective of long-run price stability have resulted in confusion and uncertainty in the formulation of monetary policy. Although fresh faces will appear on the FOMC, the lack of accountability and the constancy of the underlying institutional framework for conducting monetary policy imply that the *strategy* of monetary policy will remain unchanged.

Better tactics can help improve the effectiveness of monetary policy, but limiting one’s discussion to tactics without considering changes in the overall framework for conducting monetary policy is likely to prove shortsighted. As Friedman (1987, p. 382) argues:

The problem of monetary policy instability is not chiefly a problem of right tactics by Fed decision makers, but inherent in the system itself. The chief problem is one of strategy or selecting the appropriate monetary framework for stable money, not the person who happens to be chairman at any given time. Until the proper monetary framework is adopted, therefore, we should not expect good intentions of Fed officials to secure sound money and stable prices.

With no clear mandate for price stability and with conflicting short-run policy objectives, the Fed will of necessity be subject to political pressure, even though in theory it is independent. Fed officials, however, are not subject to the democratic process: there are no direct elections to force them out of office. Combined with the lack of any market discipline, Fed officials continue to exercise broad discretionary power. Moreover, by conducting its policy meetings in secret and reporting its actions only with a lag, the Fed enhances its discretionary power and its ability to make tradeoffs in the short run.

The implicit game in monetary policymaking is for the Fed to make those tradeoffs that appear politically feasible at the moment, but not to stray too far from long-run price stability. The problem is that fine-tuning is impossible; trying to lower short-run interest rates by monetary expansion, for example, is like trying to put out a fire with kerosene.⁶ Fed actions designed to stimulate economic activity are

⁶Clark Warburton ([1947] 1966, p. 233) referred to central bank preoccupation with interest rate regulation and the sacrifice of monetary control as “upside-down monetary policy.” According to Warburton:

Interest-rate regulation came into vogue as the chief instrument, and later as the objective, of monetary policy. The latter was a fatal error—for it turned the quantity-of-money interest-rate relationship upside down. Central banks tried to use variations in the interest rate both as a technique and as a guide for the provision of a suitable quantity of money in the economy, whereas they should have used provision of a suitable quantity of money as a technique for achieving price-level stability and freedom of the rate of interest.

likely to destabilize monetary growth because excessive money growth now will have to be reversed at a later stage if inflation is to be cured, but doing so will engender a recession as expectations change and the economy adjusts to a new quantity of money.

The longstanding rules versus discretion debate over the conduct of monetary policy is really a debate over strategy versus tactics, that is, over a change in the institutional framework for monetary policy versus a change in the individuals making policy decisions and the operational procedures they choose to follow. It has been the failure of discretionary policy that has led Friedman and others to call for a rules-based approach to monetary reform. Friedman (1987, p. 379), in particular, has emphasized that “the power to determine the quantity of money . . . is too important, too pervasive, to be exercised by a few people, however public-spirited, if there is any feasible alternative.”

The purpose of this volume is to examine the strategy or institutional framework for monetary policy rather than to focus solely on the tactics of monetary policy. In addition, the discussion goes beyond the common rules versus discretion debate by considering alternatives that include the denationalization of money.

Strategies for Monetary Reform

In order to depoliticize the money-supply process, F. A. Hayek ([1979] 1987) has called for a “free-market monetary system.” Under such a system, good money would drive out bad money as private producers found it in their self-interest to supply their customers with money of stable value. According to Hayek (p. 383), “if we ever again are going to have sound money, it will not come from government; it will be issued by private enterprise.” He goes on to explain why:

Private enterprise can be expected to provide the public with money it can trust and use because it is profitable to do so, and competition will impose a discipline on private issuers to which the government has never been and cannot be subject. Unlike government, a private issuer must supply the public with a money as good as that of his rivals or go out of business.

Hayek calls for radical reform of monetary institutions because he is convinced that little meaningful change will occur under current institutions. “Our only hope for a stable money,” writes Hayek (1976, p. 16), is “to find a way to protect money from politics.” The erosion of the rule of law in modern democratic governments means that tinkering with the tactics of monetary policy to achieve greater price-

level predictability is futile; special interest groups that benefit from increased government spending will continue to drive Congress and exert pressure for “easy money.” Even if a monetary rule were introduced, it is unlikely to be enforced if it clashed with short-run policy objectives. Thus, from his perspective, Hayek ([1979] 1987, p. 388) concludes: “I do not see the slightest prospect that democratic government—under which every little group can force the government to serve its particular needs—can ever again give us stable money, even if its money-creation powers were strictly limited by law.”

The Fed’s ability to dodge accountability has also led Friedman (1987) to move away from calling for a mere change in operating procedures to calling for an effective end of central banking as we know it—by freezing the monetary base and allowing a parallel system of private competing currencies. As he notes, “I approve of Professor Hayek’s proposal to remove restrictions on the issuance of private moneys to compete with government moneys” (p. 374).⁷ Thus, while better operating procedures—better tactics—would be economically feasible and improve the conduct of monetary policy, Friedman (pp. 366–67) concludes: “The obstacle is not feasibility but bureaucratic inertia and the preservation of bureaucratic power and status.”

From the perspective of strategy, the problem of achieving stable money becomes a problem of implementing and maintaining a monetary constitution. What is required, therefore, is to introduce and enforce a new set of rules within which individuals will have an incentive to protect the value of money. Since self-enforcement in the public sector is unlikely to achieve sound money, the free-market alternative to government fiat money warrants careful attention. Even though Hayek’s scheme for competing private currencies is unlikely to be implemented any time soon, it is worthwhile to go beyond the status quo and consider proposals that would take monetary control out of the hands of government officials and return money to the competitive market process—“the only *process* by which we can find out what would be good money” (Hayek [1979] 1987, p. 387).

⁷Friedman (1987, p. 374), however, does not share Hayek’s opinion with regard to the ability of private currencies to compete with conventionally accepted government fiat money. In Friedman’s judgment, “the advantage of a single national currency unit buttressed by long tradition will, I suspect, serve to prevent any other type of private currency unit from seriously challenging the dominant government currency, and this despite the high degree of monetary variability many countries have experienced over recent decades.”

The Federal Reserve has been in existence for only a little over 75 years. Money of real value emerged long before the Fed, as individuals searched for a standard unit of account, a store of value, and a medium of exchange. At base, money is a market phenomenon, not a creation of government. What government has done is to replace real-valued money with fiat money and to divert attention away from the historical roots of money.⁸ The challenge is to study the history of monetary institutions and to develop monetary theory so as to improve current monetary institutions. Although free-market money may not be politically feasible now, it is useful to consider several different strategies for institutional change in light of the Fed's failure to deliver money of stable value. Moreover, the future path of monetary reform will be influenced not only by the failure of current institutions but also by the public's perception of how well alternative institutional arrangements might perform in achieving stable money and prices.

A Monetary Constitution

The papers by *James M. Buchanan*, *Richard H. Timberlake*, and *David I. Fand* all approach monetary reform from a constitutional perspective. Buchanan has long advocated a constitutional strategy in dealing with monetary reform.⁹ In his opinion, the present state of monetary affairs offers no guarantee for price-level predictability, and the case for continuing the current regime is deeply flawed. Attention, therefore, should be shifted to more fundamental reform—to changing the rules of the game in order to maintain the long-run value of money and to set the basis for prosperity. According to Buchanan:

There exists no monetary constitution, as such, in the United States. What does exist is an institutionally established authority charged with an ill-defined responsibility to "do good," as determined by its own evaluation. . . . Viewed in this perspective, it becomes difficult, if not impossible, to mount intellectually respectable defenses for continuation of the monetary institutions that are in being.

Timberlake examines the monetary clauses of the U.S. Constitution (in particular, Article I, Section 10) and finds no basis for the present fiat money regime. The government's monopoly of the right to create paper money, in other words, is an illicit license—one

⁸The free-banking systems in Scotland and the United States during the first half of the 19th century attest to the possibility of nongovernmental currencies. See, for example, White (1984) on the Scottish experience with free banking and Rockoff (1974) on the U.S. experience.

⁹See, for example, Buchanan (1962).

never envisioned by the Founding Fathers. By failing to uphold the convertibility principle inherent in the Framers' Constitution, the judiciary, in Timberlake's view, has allowed Congress to perpetuate the myth that government has a legitimate right to its monopoly over high-powered money. Thus, he writes, "The alleged prerogative of the state to control the monetary system through a legal tender power is a juridical myth."¹⁰

The Founding Fathers sought to ensure that politicians would not be tempted to use the central bank as an instrument of fiscal policy. That was the purpose of tying the circulating medium to a commodity anchor in order to limit its quantity rather than relying on a central bank to limit the quantity of an inconvertible paper currency. In this vein, James Madison (1831) wrote:

The only adequate guarantee for the uniform and stable value of a paper currency is its convertibility into specie. The least fluctuating and the only universal currency. I am sensible that a value equal to that of specie may be given to paper or any other medium, by making a limited amount necessary for necessary purposes; but what is to ensure the inflexible adherence of the Legislative Ensurers to their own principles & purposes?

Clearly, Madison well understood the public choice aspects of different monetary systems. In particular, he saw a need for convertibility in order to depoliticize the money-supply process and to ensure that a market-driven adjustment mechanism would bring about long-run price stability. It is precisely Madison's constitutional/public choice perspective that has been lost sight of and that Timberlake would like to restore.

Fand adopts Axel Leijonhufvud's terminology and describes the current fiat money regime as a "random-walk monetary standard." In Fand's view, the present monetary system is random in the sense that policy is uncertain, haphazard, and leads to erratic money and prices. What concerns Fand is that there is no precommitment to stable money in the Fed's charter. As a result, there is nothing to anchor the long-run price level. In such an environment, rational economic calculation will be more difficult than in a regime of stable money and prices. To remedy this shortcoming of the discretionary fiat money regime, Fand follows the route of Buchanan and Timberlake by arguing for a monetary constitution.

Private Currency and Free Banking

Under the gold standard, the long-run value of money was to a large extent protected from government abuse. But the historical

¹⁰Cf. Richmond Federal Reserve Bank President Robert P. Black (1987, pp. 233-34) who argues that there is no constitutional mandate for government fiat money.

gold standard was far from ideal. As Hayek (1978, p. 106) observed, "Though gold is an anchor—and any anchor is better than a money left to the discretion of government—it is a very wobbly anchor." A system of competing private currencies would improve upon the gold standard, in Hayek's judgment, because competition itself would act as a disciplinary force in maintaining the value of inconvertible private currencies. If such a system were put into practice, argues Hayek (p. 107), convertibility would be unnecessary. Nevertheless, Hayek would let the market decide on the best monetary institutions. It is conceivable, therefore, that convertibility could remain part of a private currency system if the public so desired.

With the introduction of a parallel private-currency system, monetary freedom would increase. The Fed would no longer retain its monopoly position and, as Hayek (1976, p. 22) notes, denationalization would result in "the abolition of monetary policy." Hayek wants to rid the state of its control over the quantity of money because he believes "the best the state can do with respect to money is to provide a framework of legal rules within which the people can develop the monetary institutions that suit them best."

In sum, Hayek's proposal for denationalizing money is a reaction to the loss of freedom and the increased uncertainty occasioned by replacing a market-driven monetary system operating under a rule of law—the classical gold standard—with a centrally directed monetary system operating under almost complete discretion. In his view, the failure of the managed fiat money regime to deliver stable money is detrimental to the long-run survival of a free society. "If we want free enterprise and a market economy to survive," writes Hayek (1978, p. 126), "we have no choice but to replace the governmental currency monopoly and national currency systems by free competition between private banks of issue."

The papers in this volume by *Gerald P. O'Driscoll, Jr.*; *Richard W. Rahn*; and *Lawrence H. White* take up Hayek's suggestion for denationalizing money. O'Driscoll argues that Hayek's pioneering work on private alternatives to government fiat money is but another example of his ability to formulate novel questions that open entirely new areas for research. Indeed, in a relatively short period of time, Hayek's probing questions have redirected attention from the tactics of monetary policy to the framework for private currencies and free banking.

That Hayek's ideas are gaining ground was recently brought out in an article in *Forbes*, in which Peter Brimelow (1988) discussed the significance of Hayek's denationalization proposal. The article states: "Privatized money, alias 'competing currencies' or 'free bank-

ing,' is an idea that you will be hearing much more about in the years ahead" (p. 243).

Rahn's paper reflects the *Forbes* theme and contends that private money is "an idea whose time has come." According to Rahn, both the information revolution and the introduction of global financial markets should permit greater experimentation with alternatives to government fiat money. However, he expects that a parallel currency system—in which a privately determined unit of account is defined in terms of a basket of internationally traded commodities and securities—is more likely to appear in Eastern Europe than in developed countries in the West. The failure of state planning and the inconvertibility of Eastern bloc currencies, argues Rahn, necessitate an alternative to state-controlled currencies. By providing individuals and businesses with a money of real value that can be readily exchanged for leading foreign currencies, Rahn's proposal is intended to give Eastern European economies an escape hatch from state planners, foster trade, and help ease the transition to a private market system.

While Rahn discusses one conceivable form that free-market money might take, White adopts a more general approach and traces the kinds of monetary institutions that might emerge from open competition. He suggests that historical episodes of free banking can give us clues about the types of monetary institutions consumers might choose in the absence of government intervention. But he concludes that historical precedents are an insufficient guide to the future shape of a laissez-faire monetary system, which would unfold in an evolutionary manner as new information became available and individuals exercised their freedom of choice. Trying to pin down the exact form of future monetary institutions flowing from a competitive market process is, therefore, futile. White's own hunch, based on his study of monetary history, is that individuals are likely to reveal a preference for convertibility and opt for a commodity-based private currency system (probably one based on gold). He is quick to remind us, however, "that the ingenuity of potential monetary entrepreneurs in devising contracts makes it impossible for any economist to list all the forms competitive money might take, let alone to judge authoritatively which forms would survive the market selection process in the future."

The Yeager-Greenfield Proposal

In their paper, *Leland B. Yeager* and *Robert L. Greefield* argue against the current monetary regime on the grounds that (1) there is no well-defined unit of account and (2) monetary disequilibrium is prevalent and can be eliminated only by a long, drawn-out, and often

painful adjustment process. To correct these defects, the authors propose a *laissez-faire* payments system in which there is an independently defined unit of account and no outside money. Under their system, the unit of account would be defined in terms of a comprehensive commodity basket, which would keep the real value of the unit stable. A private payments system would then operate to keep the nominal money supply in line with nominal money demand at the fixed price level. As such, the authors believe their proposal, which Allan H. Meltzer refers to as a “money of real value” or “MORV,” would eliminate monetary disequilibrium.

The Transition Problem

In considering strategies for monetary reform, one must face the problem of transition. Moving from one regime to another involves costs as well as benefits. The lower the expected costs of any regime change relative to the expected benefits, the greater the probability that a change will occur. The public’s perception of the costs and benefits, however, will be influenced by their understanding of the current regime, the state of the current regime, and the likelihood that a new regime will *significantly* improve upon the current regime.

The papers by *George A. Selgin* and *Jerry L. Jordan* touch on the transition problem by examining the shortcomings of the existing U.S. monetary system, which is hampered by an array of legal restrictions, and by suggesting feasible routes for moving toward a freer monetary regime. Like Hayek, both Selgin and Jordan think that greater monetary freedom would significantly improve upon the current government fiat money regime.

Removing Legal Restrictions

Selgin sees the current discretionary regime of central banking and government fiat money as inherently unstable. In his view, legal restrictions have weakened the financial system and created a false demand for a lender of last resort in the form of a monopoly central bank. Moving away from this system of government intervention toward a system of free banking and competing currencies, argues Selgin, would increase rather than reduce the stability of money and banking.

To facilitate the move toward a free-market monetary regime, Selgin recommends removing legal restrictions such as *anti-branching* laws, deposit-rate ceilings, and other regulations impeding banking competition. He would also replace the federal deposit insurance system with a private alternative in order to eliminate the problem

of moral hazard that plagues the present system. If such reforms were carried out, Selgin believes there would be no need for an official lender of last resort.

The transition from the existing system to a system of free banking and private currencies will be difficult. But in Selgin's view, the job must be done. "Dismantling bad bank regulations," writes Selgin, "is like cutting wires in a time bomb: The job is risky and has to be done in carefully ordered steps, but it beats letting the thing go on ticking. Once the fuse—the legal restrictions—is dismantled, the payload—central banking and fiat money—can safely be disposed of."

Steps toward Monetary Denationalization

Jordan is dissatisfied with the performance of the discretionary fiat money regime, which he sees as another form of collectivist planning. In his opinion, "The nearly universal rejection of collectivist approaches to economic activity should now start to include central banking and money creation. Private, competitive approaches offer greater stability and protection from political abuse, as experience demonstrates." He, therefore, proposes a number of reform steps to move us closer to a private currency system and free banking.

To guide us toward a laissez-faire monetary system, Jordan proposes that in the near term the United States and its major trading partners form a coalition to achieve price-level stability. Each member of the coalition would agree to limit the growth of high-powered money in order to maintain stable money and prices. Such an organization would serve to limit the discretionary power of central banks and set the basis for further reform. The problem, of course, is first how to get everyone to agree and then how to enforce the agreement.

Other near-term measures include floating the Fed's discount rate and treating it as a penalty rate (so that it exceeds the federal funds rate), reducing legal reserve requirements, paying interest on reserves, and prohibiting central bank intervention in the foreign exchange market.

Longer-term measures include requiring the courts to enforce specific performance with regard to contracts stated in units other than the U.S. dollar, exempting bank-issued electronic currencies from minimum reserves, eliminating open-market operations (except in the case of a national emergency), and privatizing federal reserve banks.

Following these near-term and long-term steps, argues Jordan, would permit the deregulation of banking, facilitate the development of a parallel currency system (especially as new technology was

introduced), and create the conditions for achieving stable money and prices.

Prospects for a New Monetary Regime

What would it take to move from the current discretionary fiat money regime to a regime in which the Fed is bound by a monetary rule, or to a regime in which the central bank itself is absent—for example, to a real gold standard, a commodity-reserve standard, or free banking and competing private currencies? The further one travels along this path, the more the state leaves the realm of money and the more the market returns. But the more radical the reform, the more disgruntled the public must first become with the current regime.

The Fed's reputation remains relatively unblemished, but if inflation climbed back into the double-digit range—in the absence of any supply-side shock—and nominal interest rates moved into the high teens, the political ramifications might be such as to fuel the debate over fundamental monetary reform. It is misleading, therefore, to think that only a prolonged monetary crisis such as a hyperinflation would generate a widespread movement for monetary reform. An acceleration of inflation coupled with memories of recent double-digit inflation and historically high nominal interest rates might be sufficient to change the status quo. It is also misleading to think that monetary reforms occur only as quantum jumps in the monetary regime when, in fact, most institutional changes occur gradually on a trial and error basis.

One positive development, for example, is the recent call by Rep. Stephen L. Neal (D., N.C.) to limit the Fed's mandate to a single objective, namely, achieving long-run price stability. His proposal, the "Zero-Inflation Resolution" (House Joint Resolution 409), aims at achieving zero expected inflation over a five-year period and then maintaining that condition so that business decisions would no longer be hampered by price-level uncertainty. Neal's proposal has the support of Federal Reserve Chairman Alan Greenspan and others within the Federal Reserve system. According to Greenspan (1989, p. 5):

The current resolution is laudable, in part because it directs monetary policy toward a single goal, price stability, that monetary policy is uniquely suited to pursue. While such influences as oil price shocks, droughts, depreciation of the dollar, or excise tax hikes may boost broad price indexes at one time or another, sustained inflation requires at least the acquiescence of the central bank.

Moreover, the objective set in this legislative proposal would promote the welfare of the American people, because price stability is a prerequisite for, over time, maximizing economic growth and standards of living. As the resolution spells out, the elimination of inflation would allow the economy to operate more efficiently and productively by reducing the need to predict and to protect against inflation. The elimination of inflation would allow interest rates to decline and would reduce the uncertainty about price trends that can discourage saving and investment.

By narrowing the Fed's mandate to the objective of long-run price stability, H. J. Res. 409 would increase the likelihood of ending the persistent inflation that has burdened the U.S. economy since World War II. Still, the absence of any enforcement mechanism to discipline Fed officials if they fail to limit money growth to a noninflationary path gives cause for concern about the probable success of this approach to monetary reform.

The papers in this volume force us to think about strategic changes in monetary institutions rather than just focus on changing tactics within a given institutional framework. In the quest for stable money, there are many paths. Discretion within a government fiat money regime has been tried and has failed. It is now time to explore new paths. The problem is that as long as the government holds a monopoly over currency and restricts innovation in banking practices, there will not be much room for private initiative and choice. As Hayek (1989, pp. 103–4) writes,

Under government patronage the monetary system has grown to great complexity, but so little private experimentation and selection among alternative means has ever been permitted that we still do not quite know what good money would be—or how good it could be. Nor is such interference and monopoly a recent creation: it occurred almost as soon as coinage was adopted as a generally accepted medium of exchange. Though an indispensable requirement for the functioning of an extensive order of cooperation of free people, money has almost from its first appearance been so shamelessly abused by governments that it has become the prime source of disturbance of all self-ordering processes in the extended order of human cooperation. The history of government management of money has, except for a few short happy periods, been one of incessant fraud and deception. In this respect, governments have proved far more immoral than any private agency supplying distinct kinds of money in competition possibly could have been.

Even if radical changes in U.S. monetary institutions are unlikely at present, marginal changes that chip away at the Fed's discretion and monopoly power are important. Rep. Neal's Zero-Inflation Resolution is a step in this direction. The near-term reform measures

advocated by Jordan would also be beneficial. Freezing the monetary base or adopting a nondiscretionary feedback rule to limit base-money growth to a noninflationary path and to stabilize nominal GNP would likely improve upon the discretionary fiat money regime.¹¹

The ultimate success of any reform measure in constraining the Fed's discretionary power and halting inflation, however, would depend on the implementation and maintenance of a monetary constitution. And this is where the problem lies, because as long as monetary power is lodged in a monopoly central bank subject to congressional pressure, there will always be an incentive for Fed officials to circumvent a given rule—unless that rule is anchored by an effective constitutional provision for disciplining monetary authorities as a *general principle*.

Presently the Fed is subject only to self-enforcement of its declared monetary targets and there is no penalty for noncompliance. Self-enforcement, however, is bound to fail within the public sector since there are no private property rights and no profit-seeking entrepreneurs who can gain by eliminating inflation or who lose by continuing inflation. Going beyond the rules versus discretion debate to a consideration of what type of monetary constitution is best able to provide a stable and credible monetary feedback is, therefore, of critical importance. What Hayek has done is to remind us that self-enforcement is best left to a competitive market process, which in the case of money and banking would weed out bad money and inefficient banking practices.

Customary habits of thought are hard to break. This fact is certainly true when it comes to conventional wisdom regarding the role of government in the monetary regime. Breaking away from the status quo and examining alternative monetary regimes can shed new light on old problems. Moreover, shifting attention from the tactics of monetary policy to the strategy for reform forces us to rethink the role of government in the monetary system.

Hayek's innovative work on the denationalization of money has opened the door for a new research agenda. His ability to reformulate traditional questions in monetary economics and to raise entirely new questions has been beneficial. In light of Hayek's work, one can ask such questions as:

- Can monetary disequilibrium be eliminated by a laissez-faire payments system?

¹¹See the comments by Bennett T. McCallum and Allan H. Meltzer (in this volume) for examples of nondiscretionary feedback rules intended to produce long-run price stability by controlling the growth of the monetary base.

- Would competition be sufficient to promote stable money in a *private* fiat money world or is convertibility also required?
- Would a nondiscretionary monetary rule be superior to a free-market monetary system, and which is more likely to be implemented and maintained?
- Is fractional-reserve banking inherently unstable or does banking stability depend on the overarching monetary framework and the legal restrictions that accompany it?
- Would the removal of legal restrictions and the institution of free banking leave any function for a lender of last resort?¹²
- What mechanism would prevent free banks from overissuing *as a group*?
- Does the existence of transition costs mean that any monetary reform will be stepwise (i.e., evolutionary) rather than a major one-time change in the monetary system?
- What immediate steps can be taken to depoliticize money and facilitate free banking?

The answers to these questions are by no means settled. But by asking such questions, the authors in this volume have paved the way for future research on the denationalization of money. In addition, the new research on free banking and competing currencies has tended to shift the burden of proof from those who favor market-oriented monetary systems to those who favor a continuation of the status quo. The failure of the discretionary fiat money regime cannot be ignored, nor can the fact “that there is no justification in history for the existing position of a government monopoly of issuing money” (Hayek [1979] 1987, p. 389).

References

- Bernholz, Peter. “The Importance of Reorganizing Money, Credit, and Banking When Decentralizing Economic Decision-Making.” Paper presented at the Cato Institute/Fudan University conference on “Economic Reform in China: Problems and Prospects,” Shanghai, September 1988.
- Black, Robert P. “A Proposal to Clarify the Fed’s Policy Mandate.” In *The Search for Stable Money*, pp. 229–37. Edited by James A. Dorn and Anna J. Schwartz. Chicago: University of Chicago Press, 1987.

¹²Thomas M. Humphrey (in his comment on Selgin) argues that fractional-reserve banking and the existence of outside money leave room for an official lender of last resort. But will this argument be relevant in the case of a Yeager-Greenfield system that has no outside money?

- Bordo, Michael D. "The Classical Gold Standard: Some Lessons for Today." Federal Reserve Bank of St. Louis *Review* 63 (May 1981): 2–17.
- Brimelow, Peter. "Do you want to be paid in Rockefellers? In Wristons? Or how about a Hayek?" *Forbes*, 30 May 1988, pp. 243–50.
- Buchanan, James M. "Predictability: The Criterion of Monetary Constitutions." In *In Search of a Monetary Constitution*, pp. 155–83. Edited by Leland B. Yeager. Cambridge: Harvard University Press, 1962.
- Friedman, Milton. "Monetary Policy: Tactics versus Strategy." In *The Search for Stable Money*, pp. 361–82. Edited by James A. Dorn and Anna J. Schwartz. Chicago: University of Chicago Press, 1987.
- Friedman, Milton, and Schwartz, Anna J. *A Monetary History of the United States, 1867–1960*. Princeton: Princeton University Press, 1963.
- Friedman, Milton, and Schwartz, Anna J. "Has Government Any Role in Money?" In Anna J. Schwartz, *Money in Historical Perspective*, pp. 289–314. Chicago: University of Chicago Press, 1987.
- Greenspan, Alan. "Statement by Alan Greenspan . . . before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs," U.S. House of Representatives, Washington, D.C., 25 October 1989.
- Hayek, F. A. *Choice in Currency*. Occasional Paper 48. London: Institute of Economic Affairs, 1976.
- Hayek, F. A. *Denationalisation of Money—The Argument Refined*. 2d (extended) ed. Hobart Paper 70. London: Institute of Economic Affairs, 1978.
- Hayek, F. A. "Toward a Free-Market Monetary System." 1979. Reprinted in *The Search for Stable Money*, pp. 383–90. Edited by James A. Dorn and Anna J. Schwartz. Chicago: University of Chicago Press, 1987.
- Hayek, F. A. *The Fatal Conceit: The Errors of Socialism*. Vol. 1 of *The Collected Works of F. A. Hayek*. Edited by W. W. Bartley III. Chicago: University of Chicago Press, 1989.
- Madison, James. "[Letter] to Mr. Teachle." 15 March 1831. In *The Complete Madison: His Basic Writings*, pp. 292–93. Edited by Saul K. Padover. New York: Harper and Bros., 1953.
- Parkin, Michael, and Bade, Robin. "Central Bank Laws and Monetary Policy: A Preliminary Investigation." In *The Australian Monetary System in the 1970s*, pp. 24–39. Edited by M. A. Porter. Melbourne: Monash University, 1978.
- Poole, William. "Comment" [on "Stability under the Gold Standard in Practice"]. In *Money, History, and International Finance: Essays in Honor of Anna J. Schwartz*, pp. 195–200. Chicago: University of Chicago Press, 1989.
- Rockoff, Hugh. "The Free Banking Era: A Reexamination." *Journal of Money, Credit, and Banking* 6 (May 1974): 141–67.
- Timberlake, Richard H., Jr. "The Feasibility of Free Banking Institutions." *Cato Journal* 6 (Fall 1986): 635–39.
- Warburton, Clark. "Monetary Control under the Federal Reserve Act." 1946. Reprinted in Clark Warburton, *Depression, Inflation, and Monetary Policy: Selected Papers, 1945–1953*, pp. 291–316. Baltimore: Johns Hopkins University Press, 1966.

CATO JOURNAL

Warburton, Clark. "Volume of Savings, Quantity of Money, and Business Instability." 1947. Reprinted in Clark Warburton, *Depression, Inflation, and Monetary Policy*, pp. 217–33. Baltimore: Johns Hopkins University Press, 1966.

White, Lawrence H. *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845*. Cambridge: Cambridge University Press, 1984.

Yeager, Leland B. "Domestic Stability versus Exchange Rate Stability." *Cato Journal* 8 (Fall 1988): 261–77.