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Can Fiat Money Be Managed Effectively?

By Richard M. Salsman*

Advocates of free banking and the gold standard differ in kind, not just in degree, from the Keynesians and monetarists. That governments have failed in the last 20 years of fiat paper money to find rules to replicate gold's performance is a testament to the folly of interventionism.

The unanticipated disinflation of the 1990s is proving as disruptive to businessmen and investors as was the unexpected inflation of the 1970s. Yet widespread dissatisfaction with government monetary performance has not produced widespread agreement among economists on the appropriate remedy. Keynesians still advise that government be permitted the widest possible discretion in conducting monetary policy. Monetarists want restraints imposed on monetary officials, typically some predetermined growth in some measure of the money supply.

Advocates of free banking and the gold standard differ in kind, not just in degree, from the Keynesians and monetarists, recommending a complete separation of government from money and banking. The free banking-gold standard faction is a small but growing voice. But the failed Keynesian and monetarist proposals that have been in place for most of the last 60 years continue to guide the monetary bureaucrats and to shackle the thinking of monetary economists and central bankers worldwide.

A Monetarist Restatement

In a recent book, *Monetary Policy and Politics: Rules Versus Discretion*, George Macesich considers the Keynesian, monetarist, and free market approaches to today's monetary problems. He comes down squarely in the monetarist camp. He believes, with good reason, that an arbitrary central bank brings monetary mischief. But he denies that government should be separated from money and banking entirely. He is to be commended for an awareness of the free banking-gold standard argument as a basic alternative. But he does not understand it sufficiently to find it compelling. Unfortunately, the middle ground he occupies is comprised of weak and shifting sands.

Macesich concedes that he is tilling old soil. Decades ago, Irving Fisher,[1] Henry Simons,[2] and Milton Friedman[3] began waging a campaign from the Chicago school to impose rules on what they saw as an unconstrained monetary menace, the Federal Reserve. Friedman carries on the case for a rule-bound money monopolist today. Unfortunately, Macesich adds little to the argument. If anything, he reminds us of the weakness of the case for monetarism and the school's unjustified suspicion of free banking and the gold standard.

"Depoliticizing" Money

Macesich believes that subjecting a central bank to rules is "depoliticizing monetary policy." He argues that "institutional arrangements," not the "personalities of monetary policymakers" should be the foundation of monetary and economic stability. [1] But can monetary policy be nonpolitical? If it means anything, monetary policy means a government-directed process, and this cannot be "depoliticized." If restraints are to come from other branches of government, such as the legislature, or from the Constitution as interpreted by the judiciary, politics is inevitable. If restraint is to come from market competition, then a central bank with unique powers and privileges should be dismantled. But Macesich does not advocate the dismantling of central banking: he seeks to "improve" it.

What, precisely, about central banking needs fixing? Macesich observes that "Central banks are subject to political pressures" and tend "to manipulate money and monetary policy as a matter of bureaucratic survival. They are, after all, creatures of the national state. Their independence is more myth than fact." [74] He notes that the greater the latitude granted to a central bank, the greater the chance for trouble, and that "Discretionary authority, when granted to a central bank over domestic monetary policies ... constitutes a formidable reinforcement of nationalism in the economic sphere and creates an important source of instability." [74] To many, these difficulties suggest that central banking is a hopelessly political, destabilizing force. Can such an institution ever be reformed?

Macesich knows that "accumulated evidence shows that little trust can be given to government — subject as it is to majority rule — to behave itself and exercise monetary restraint." [136] How can we then expect this same entity to submit to rules? After all, Macesich tells us, "Central bankers cannot be expected to take seriously any theory or empirical evidence that would strive to constrain their activities." Moreover, "Central bankers are loathe to accept constraints because they view the exercise of monetary policy in unmeasured variables." [81-82] With this, he all but surrenders any hope that government will ever be stripped of its monetary prerogatives.

Consigned to living in a world of central banks, Macesich proposes bolstering the credibility, independence, and standing of central banking. "A key argument for proponents of well-defined guidelines ... is that the credibility of monetary authorities would be enhanced." [81] "To function and survive," Macesich argues, "a democratic market society must have a predictable monetary policy capable of anchoring long-term price levels." [137] He believes "a well-implemented and executed monetarist rule will serve to constrain money and the monetary system within a defined non-discretionary and lawful political system." [76] Of course, this begs the question. A nondiscretionary

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and lawful political system is what is required. Macesich does not prove central banking can be such a system by merely assuming it.

Macesich is concerned about the credibility of central banks, even though, in his own words, "It should be expected that an agency such as the Federal Reserve would push its own version of history." How? "Such activities might range from outright concealment of information that could be unfavorable to it ... to favoring a general framework in which agency activities would be interpreted so as to minimize any interpretation that it had made serious errors." [84] Attempts by Macesich and other monetarists to employ "rules" to excuse their behavior hardly solve the root problem.

Rules? What Rules?

Like other monetarists, Macesich devotes more space to the insuperable obstacles standing in the way of various money supply quantity rules than he does to defining or defending a valid one. He admits that the demand for money (velocity) can change, making a fixed growth in money supply unstable. He concedes banks can change their reserve ratios and mix of short-term loans, offsetting central bank policy.

For an advocate of rules, Macesich is murky on what rules should obtain. "No two rules are alike," he observes. "The range covers the complete spectrum from almost perfect rigidity to guidelines that come very close to supporting the existing degree of discretion." [29] He recognizes why "there is an almost scornful reception of some of these proposals by the opposition." [29] Macesich notes that price stability, economic growth, maximum employment and balance of payments equilibrium are "objectives shared by most countries." [4] He takes these as given and assumes government monetary planning can deliver them. Yet he concedes that conflicts arise from such an approach. "Reaching one goal may make it impossible to reach another."

Milton Friedman, the country's most prominent monetarist, has been no less elusive about the role of money and the appropriate monetary policy. In 1968 he wrote, "... we cannot predict at all accurately just what effect a particular monetary action will have on the price level and, equally important, just when it will have that effect. Attempting to control directly the price level is therefore likely to make monetary policy itself a source of economic disturbance because of false stops and starts."[4] The weak and unpredictable links between money and prices that he cites did not deter him from advocating a fixed rate of growth in the money supply. In fact, he viewed the weakness as justification for his prescription.

Similarly, Macesich observes that economists since WWII have admitted that "central banks cannot fine-tune real economic growth and that in trying to do so they may jeopardize the goal of price stability." [16] He notes that "In their eagerness to ... keep politicians happy, many central banks, including the Federal Reserve System with its anti-inflation policy, often lacked credibility." [16] But, says Macesich, "the blame lies primarily with Congress for giving the Fed the contradictory goals of promoting growth and reducing inflation." [16] He seems unaware that noninflationary growth was the norm in 19th century America, before the Fed was ever formed.

Macesich supports rules because, he writes, monetary authorities lack the knowledge and information necessary to practice discretion. Moreover, changes in monetary policy often have no direct effect on growth or employment. Macesich concedes that "Monetary authorities must often choose a particular operating target that is easier to manipulate with the instruments available... [5] In other words, central banks control what is easy to control. Macesich stresses that "It is not so much the exact nature of the rules that is important as it is the need to establish a credible commitment from monetary authorities to follow those rules." [20] Here he agrees with Friedman, who wrote, "I have always emphasized that a steady and known rate of increase in the quantity of money is more important than the precise numerical value of the rate of increase." [27][5]

What's the Best Regime?

Macesich believes "It is the monetary regime, not monetary policy, that must be modified." [62] He laments "the shortcomings of the free market arrangement," which include "the tendency to over expand or over contract the money supply. The market failure analysis of free markets," he says, "would suggest a role for government." [63] He seems unaware or unpersuaded by the theoretic-historical case for free banking and recent criticism of the "market failure" assumption as applied to money.[6] He does not tell us why booms and busts have occurred during government managed money. He simply presumes free market money is unstable. His low opinion of pre-Civil War banking seems to be based on a 1957 slanted account by a Federal Reserve research staffer.[7] He seems unaware of subsequent studies that are quite favorable to free banking.

Macesich mistakenly concludes that "American experience tends to leave most people skeptical about the extension of the free market to monetary arrangements." [59] He seems ignorant of the trouble that arose when government intervention was extended into free monetary arrangements. Yet, he notes, "... monetary affairs are seldom left alone. Indeed, they readily become critical political issues. Proper institutional restraints are necessary." [59] This should leave one suspicious of intervention, not free markets.

Nowhere in his book does Macesich cite cases where monetary officials have been properly constrained. To the contrary, there are numerous cases where artificial restraints on government have been set aside because government had a different agenda — the Gramm-Rudman balanced budget legislation of 1985 is just one example. In fact, Macesich concedes, "institutional arrangements" to restrain monetary authorities "have not been forthcoming thanks to government and bureaucratic restrictions on experimentation with alternative monetary arrangements." [65]

What About the Gold Standard?

Might Macesich find the gold standard to be an effective constraint on central banks? He does describe "the constraints on discretionary authority imposed by the gold standard on central banking" [46] and recognizes that "In the past, the international specie standard and fixed exchange rates seemed to keep the American experience within prescribed bounds. Even so, it did not always work well." [59] Yes, but why? He has no clear sense of the inherent instability of a mixed system — or what a fully free system would be. He does say that "The 19th century integration of market processes has been impaired by the emergence in every country of a greater measure of state intervention, particularly in monetary affairs." [75]

Macesich admits a distinction between the classical gold standard (1814-1914) and the managed gold standard (1914-1971) and that "economic performance in Great Britain and the U.S. was better under the classical gold standard than it has been under the managed fiduciary standard." [69] Macesich believes advocates of the gold standard "idealize" its performance, and says 1814-1914 saw 12 major panics and 14 recessions in the U.S. But he gives no citations and no reason why these are attributed to the gold standard. He says 1946-1979 showed an admirable "stability" in real output and although there was not price stability, people became used to it and adjusted. Thus, he concludes, "The evidence suggests that a fiduciary monetary standard based on a monetary rule for steady, monetary growth could provide the benefits of the gold standard without its costs." [72] But this is an odd period to cite, given that it was a mix of gold (Bretton Woods) and fiat paper money, and from 1971-1979 there were no "rules" to speak of.

Macesich blames the gold standard for the manipulations and rule-breaking of central banks. "In order to operate correctly, the gold standard required participating countries to obey the rules of the international gold standard game." [93] But it was central banks that broke the rules. He admits, for example, that the Federal Reserve "sterilized" or set aside excess gold reserves and that "on price policy and on tariffs policy, the U.S. undermined the rules of the international gold standard." [102] He writes that the policy of the Fed was "jeopardizing the long-run future of the gold standard." [102] He speaks of "the Federal Reserve's ineptitude in the 1920s and 1930s." [106] Yet he reserves blame for those who were "mesmerized by the gold standard." [107]

History aside, he says, "The international gold standard cannot now be restored." Why? He remarks that the United States used to uphold individual liberty — but now endorses social controls and "such objectives as full employment and various social safety net programs. Inevitably, these objectives imply intervention and regulation. And the only mechanism presently available for this is the national state and its bureaucracy, including the central bank." [74] In other words, we are stuck with central banking because we are stuck with the welfare state. In part he is correct. A welfare state needs a central bank to finance its excesses.

Macesich is right that "The gold standard cannot be understood, as it cannot be operated successfully, except as part of the socioeconomic, political, and philosophical system in which it was developed." [76] Of course, this system is capitalism. But he does not think highly of it. He believes that "ideological currents unleashed by capitalism inadvertently erode the moral foundations of capitalism. A capitalist society, oriented as it is toward self-interest, depletes its morality." [130] In the end, the author's suspicion of the gold standard is not so surprising. He is suspicious of capitalism, its political prerequisite.

In the end, "There is little ground for believing that contemporary popular democracies and their political authorities are willing to forego discretionary policies which a return to a gold standard, or for that matter the establishment of a fiat money regime governed by a rule, would require." [136] Popular opinion seems to carry greater weight for Macesich than does the theoretical-empirical case for gold.

Monetarism Old and New

As indicated above, Macesich is tilling old soil. In 1936, Chicago school economist Henry Simons wrote the seminal essay, "Rules Versus Authority in Monetary Policy."[8] Despite concern for the preservation of free enterprise, Simons distrusted free markets in money and banking and believed strongly in monetary interventionism. Most monetarists share this contradiction.

Simons wrote, "It may be conceded that the requirements of the gold standard and the prestige of gold has occasionally enforced some discipline on government finance," but as for gold as the base of a monetary system, "it seems almost beyond diabolical ingenuity to conceive a financial system better designed for our economic destruction." Simons blamed the monetary contraction on the alleged "shortage" of gold and its hoarding by investors and depositors. He promised to devise "what kind of monetary rules might be adopted to make capitalism a more workable system." Of what might they consist? "We need to design and establish with the greatest intelligence a monetary system good enough so that, hereafter, we may hold to it unrationally [*sic*] — on faith — as a religion, if you please."

Simons concluded that "it is essential that the power to issue money and near-money should increasingly be concentrated in the hands of the central government." What is the rule? It should be "definite, simple, and expressive of strong, abiding, persuasive, and reasonable popular sentiments." "Any one of many rules (or sets of rules) would probably serve about as well as another." This from the man who finds it "diabolical" that mankind converged on gold as money over the course of 2500 years.

Nearly 60 years later, monetarists continue trying to rectify this contradiction and are no closer to devising a set of workable rules than they are to making central banks adopt such rules. Assessing his own 1985 proposals for restraining the Fed, Milton Friedman wrote, "I am not optimistic that they will be adopted. The obstacle is political: as with any bureaucratic organization, it is not in the self-interest of the Fed to adopt policies that would render it accountable. The Fed has persistently avoided doing so over a long period. None of the tactics that I have proposed is new." He went on to note that "By keeping monetary policy an arcane subject that must be entrusted to 'experts' and kept out of politics, incapable of being judged by non-experts, the Fed has been able to maintain a high public reputation, despite its poor record of performance. Each chairman after another, in testimony before Congress, has emphasized the mystery and difficulty of the Fed's task and the need for discretion, judgment, and the balancing of many considerations."[9] Four years later he believed a computer should replace the Fed, though he offered no specifics on the qualifications of the programmers. "Past history suggests that nothing short of the elimination of the Fed and its replacement by a computer not subject to reprogramming can provide confidence that a zero-inflation monetary policy will in fact be followed — and even that might not."[10]

On one rare occasion, Milton Friedman expressed apprehension about fiat paper money and admiration for commodity money. "We are sailing in uncharted waters," he said at a conference in 1986. "There is no historical precedent for the system we now have. Until 1971, every major currency tended to be linked to a commodity. Now, no major currency is linked to a commodity. In the past, currencies have been temporarily set free. There is no indication that the current situation is temporary. With a commodity base, usually gold, you had a stable, long-term anchor to the price level. That allowed prices to fluctuate a great deal in the short-term, but they eventually returned to where they had been. Now we have no long-term anchor to the price level. We have a collection of national fiat standards with no link between them."[11]

There is No Real Debate

The rules advocates often recognize the political essence of central banking, but do not see it as an obstacle to better performance. Macesich believes its failures can always be explained or excused by the crude state of economic science. He asks, for example, "How is this economic stability to be achieved, and do the authorities have the technical tools necessary to do their job given the state of economic science?" [2] By resting his answer on the state of economic science, not on the nature of government, Macesich gets it backward: the state of economics advances when it grasps every more complex economic activity — precisely the kind of activity government is least able to replicate centrally.

Where the advocates of discretion believe central banking can succeed with the right men, the advocates of rules believe central banking can succeed with the right tools. Both are naive for believing that central planning can succeed. The failure of central banking is only another instance of the general failure of central economic planning. The fundamental difference between free banking and central banking is the difference between a free market and a system of central planning. More precisely, it is the difference between private planning based on economic profit and bureaucratic planning based on political expediency.

When it comes to central banking, monetarists and Keynesians agree more than not. Macesich speaks admirably of Keynes because he "argued in favor of an enlightened elite of bureaucratic managers who would carry out the required program. The net result would be that collective objectives would be superimposed on an individual's calculus." [128] Monetarists and Keynesians both attack free banking and the gold standard. They both defend central banking and fiat money. They differ only in the policy target the Fed should aim at: interest rates or money stock. They implicitly embrace the doctrine that through the judicious management and intelligent appointees, government can replicate the outcomes of free markets. Although the actual favorable performance generated by free banking and the gold standard is their ideal, they repeatedly malign genuine free market money.

Beyond Monetarism

Today, most monetary economists take central banking as an unquestioned axiom. Unlike their 19th century counterparts, they do not consider the alternative of free banking versus central banking. They are locked in a much narrower debate about "discretion versus rules," about *how* a central bank should manipulate money and credit, not whether we are benefited by state-directed money and credit at all. Few other branches of economics simply presume that the market does not work. Even Milton Friedman and the monetarists, considered by many to be advocates of free markets, actively oppose free banking and defend the legitimacy (if not the practice) of central banking.

In many ways this results from a misreading of free banking history and a credulous respect for central banking and its professed aims of economic growth, full employment, and price stability. But central banking has a far more significant purpose, and that is to finance and support unlimited governments that spend beyond taxing and borrowing capacities. Only when we recognize that a chief purpose of central banking is to support unlimited government and not to stabilize the economy or the banking industry will we understand the futility of coaching the institution to do something it is neither capable of nor interested in doing.

The traditional debate concerning discretion versus rules presumes that government must manage money. Macesich does not so assume — he allows a fundamental alternative into the debate, but he gives the alternative short shrift, merely nodding to the growing challenge posed by the free banking-gold standard school without answering its arguments.

In retelling the case for monetarism, Macesich only reminds us of the need to go beyond monetarism. Monetarist prescriptions are futile because they concern themselves with the quantity instead of the quality of money. Money of high quality is stable, reliable, rare, valuable, portable, divisible, durable, and above all not subject to political manipulation. History demonstrates that only gold and gold-convertible currency constitute true quality in money. As long as the unit of account is defined and dependable and the quality of money is established, the quantities of various money substitutes will be linked to that anchor as if by a chain. The quantity of money will depend on its quality, not the other way around.

Instead of a debate about "rules versus discretion," about the way government should intervene in money, we should encourage a debate about the proper monetary *standards* consistent with free markets. A standard is neither set by decree nor manipulated by expediency. A standard is some measure by which values can be compared or judged. In coinage, the standard is the established proportion by weight of fine metal and alloy. For centuries, as an example, the dollar was defined as a fixed weight of gold and alloy. Paper money and checking accounts evolved as convenient representations of gold, as notes promising to pay money, and hence were denominated in dollars. This was lost with the abandonment of gold-linked money substitutes and the adoption of fiat money. The monetary standards arrived at freely by market choices were dismissed as chaotic or barbaric. Today's debate dismisses standards altogether and quibbles over the rules by which the monetary rulers shall rule.

Despite the failings of government monetary management, monetarists join with Keynesians in trying to improve upon it. Despite its virtues, they both actively misrepresent and deride gold money. In the field of money and banking they share a faith in government planning and a distrust of market outcomes. Only an age of interventionism could be mired in a "debate" about how rulers should rule free economic choice. It was not always this way. The classical economists defended free banking and the gold standard with great insight. There are economists today who concur with the classicals, but they are a minority of the profession. Should their influence grow, we shall have genuine debate.

That mankind over centuries converged on gold as money is a testament to the wisdom of voluntary market choice. That governments have failed in the last 20 years of fiat paper money to find rules to replicate gold's performance is a testament to the folly of interventionism. Monetarists and Keynesians may never come to recognize such basic distinctions. But those who do will participate in a renaissance of free market monetary economics.

Endnotes

[1] Irving Fisher, *Stabilizing the Dollar* (NY: Macmillan, 1920),

[2] Henry C. Simons, "Rules Versus Authorities in Monetary Policy," *The Journal of Political Economy*, 44 (1936), pp. 1-30.

[3] Milton Friedman, "A Monetary and Fiscal Framework for Economic Stability," *The American Economic Review*, 38 (1948), pp. 245-264.

[4] Milton Friedman, "The Role of Monetary Policy," *The American Economic Review* 58 (March 1968).

[5] From Friedman's *The Optimum Quantity of Money and Other Essays* (Chicago: Aldine, 1969).

[6] See Roland Vaubel, "Competing Currencies: The Case for Free Entry," in *The Search for Stable Money* (Chicago: The University of Chicago Press, 1987), pp. 281-296.

[7] Bray Hammond, *Banking and Politics in America* (Princeton: Princeton University Press, 1957).

[8] Henry C. Simons, *loc. cit.*

[9] Milton Friedman, "The Case for Overhauling the Federal Reserve," *Challenge*, July/August 1985, pp. 4-12.

[10] Milton Friedman, "Whither Inflation?," *The Wall Street Journal*, July 5, 1989.

[11] Quoted by Lindley H. Clark, Jr., "Monetary Economics Sails in Uncharted Waters," *The Wall Street Journal*, April 1, 1986, p. 33.

PRICE OF GOLD

	1991	*1992*	*—— 1993 ——*	
	Jun. 6	*Jun. 4*	*May 27*	*Jun. 3*
Final fixing in London	$364.85	$338.40	$374.75	$374.70

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