A New Monetary Regime and the Future of Fiat Money

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1. Introduction

The crisis of 2008, marking a rupture with the era of "Great Moderation" should serve as an indicator that our monetary institutions are broken. But, contrary to the conventional wisdom, it is not "unrestrained capitalism" and bankers' greed that are the sources of our troubles. Rather, it is the government monopoly on the issue of money that ought to be blamed for our current problems – in the same way as it should be blamed for the Great Depression of the 1930s. Looking at the economic history of the 20th Century, the root cause of most economic crises was expansionary monetary policy, accompanied by regulatory mistakes that further compounded its effects. Moreover, inadequate monetary policy response in the immediate aftermath of the crisis made things worse.

While there might be disagreements over particular features of monetary policy prior to and during economic crises, the broader point is that the institutional environment in which the money is being supplied to the economy is deeply unsatisfactory. And it is not difficult to understand why. Central banking, by its definition -opaque, monopolistic, and discretionary- could deliver good results only if we made heroic assumptions about the benevolence and knowledge of central bankers. In a world where there are no omniscient and benevolent central bankers, and where central banks are part of the political arena, monetary policy is bound to produce bad outcomes.

This essay provides a conceptual framework aiming at understanding the relationship between the monetary institutions and real economic outcomes. We argue that a competitive monetary system would deliver better results, both in terms of price stability, and in terms of distortions to the real economy, than a system of discretionary central banking. Even if such solution is not attainable – and it probably isn't, at least not in the immediate short run – then reforms that credibly tie central bankers' hands should be considered. Among those, we argue, nominal income growth targeting provides perhaps the most intellectually satisfying answer to the ills of central banking.

2. A conceptual framework

In a market economy, the emergence of money is equivalent to a massive reduction of transaction costs. Even in a relatively primitive economy, comprising a very limited number of commodities, barter exchange is problematic as it requires double coincidence of wants of different market actors.

If the individual A has wheat and demands tomatoes, he has to find someone else who demands wheat and has tomatoes to sell. If there is no such person, then A has to exchange his wheat against some other commodity that happens to be demanded by those who are selling tomatoes. Needless to say, this process can very easily become rather complicated and can bring even a very simple exchange economy to a halt. Having a generalised medium of exchange circumvents this problem by enabling everyone to sell and purchase commodities regardless of the exact wants of their trading partners.

Beyond facilitating exchange, money provides individuals with a unit of account. Any non-rudimentary economic organisation needs to plan and to keep track of its costs and earnings. Money provides otherwise incomparable commodities with a common denominator and enables entrepreneurs, managers and families to engage in economic calculation. The more complex the economy becomes, the more urgent is the need for economic calculation. With a variety of modes of production, each requiring different capital goods, the existence of a monetary unit of account is the only way of comparing alternative business undertakings. A monetary market economy, in which factors of production are owned privately, ascribes prices not only to final commodities and services but also to various factors of production. As a result, businessmen and entrepreneurs are able to determine the most profitable way of supplying a certain service or commodity to the market. In fact, as Ludwig von Mises[1] demonstrated, the main deficiency of a socialist economy is that by eliminating private ownership of factors of production, it also eliminates markets and prices for them. As a result, in a socialised economy, it is no longer possible to assess the relative profitability of different ways of producing goods and services and the centrally planned economy is bound to degenerate into chaos. We ought to stress that the very same problem would occur if our economies suddenly went moneyless. Without monetary prices for factors of production, there can be no rational economic planning and behaviour.

In an idealised world, beyond being a medium of exchange, a unit of account, and potentially a store of value, money should, in principle, have no other effects on the real economy. The total quantity of money should not affect the use of real resources, total output or employment. Nominal variables should not modify economic behaviour any more than the rate at which “real” temperature is affected, whether we measure it in degrees of Celsius or Fahrenheit. If everyone’s money balances doubled overnight – and if everyone knew this was the case – we should expect monetary prices of everything to double too, without any effect on the real economy.

[1] Mises, L. von, *Economic Calculation In The Socialist Commonwealth*, [1920], http://mises.org/econcalc.asp

However, ours is not an idealised world, and it features, at the very least, two channels through which nominal variables can impact real variables. One obvious way in which money affects economic activity is through inflation. In most cases, an increase in the money supply is translated into an increase in the price level. In a world, where changing nominal prices is costly, inflation can thus impose real costs on businessmen, entrepreneurs and employees, who not only have to change the relevant prices and wages to keep pace with inflation but who also have to keep track of all the relative price changes that occur as a result of unilateral changes in prices. This becomes increasingly difficult as the rate of growth of the money supply increases and becomes unpredictable, as in periods of hyperinflation. Hyperinflation thus prevents rational economic calculation, as the value of the monetary unit in which the calculation is to be performed is subject to permanent change. The result is usually a demonetisation of the economy in question, or – preferably – a switch to some other currency.

Another channel of interaction between money and the real economy has been described initially by Wicksell[2] and economists of the Austrian School,[3] and pertains to a specific institutional framework in which the supply of money is linked to the availability of credit in modern economies. A monetary expansion, and an increased amount of money units provided by the institution supplying the currency is translated to a wider availability of credit in the economy. Because this process is not transparent, and because individual entrepreneurs might not have a complete model of the economy, they can confuse an artificial creation of fiduciary media with an increase in the savings rate. Higher savings ought normally to translate into higher investment rates, and into building up of a more capital-intensive structure of production. When, say, the central bank, increases the money supply and makes credit more easily available, entrepreneurs can engage in investment projects which they would have otherwise undertaken. They build up capital goods and arrange them in a way that would correspond to an economy with higher savings rate. However, savings rates have not increased, and people want to consume as much they initially did. Given that real resources are limited, the discrepancy between entrepreneurs' plans and the desires of individuals will be revealed and translated into the fact that some of the investment plans will not turn out to be profitable. In our, admittedly, very imperfect, world, adjustments are costly, and the economy will then have to go through a painful process of rearranging its factors of production in a way that corresponds better to preferences of individual consumers. When the initial monetary expansion has fuelled too massive

[2] Wicksell, K., *Interest and Prices*, [1898], http://mises.org/books/interestprices.pdf

[3] See, e.g., Hayek, F. A. von, *The Pure Theory of Capital*, University of Chicago Press, 1975, or Garrison, R., *Time and Money: The Macroeconomics of Capital Structure*, Routledge, 2000.

an investment boom – aided perhaps by a lack of prudential conduct in the banking sector – then it can be expected that the sudden and simultaneous adjustment from the part of all those who have directed resources to capital-intensive uses will induce large economic costs.

However, this narrative, commonly known as the Austrian Business Cycle Theory (ABCT), does not explain everything there is to know about the real effects of nominal variables. For instance, the theory does not tell us why periods of bust, following a monetary policy-fuelled boom, are associated with prolonged unemployment. Similarly, there is evidence that periods of disinflation, such as the one that took place during the Volcker years in the United States, are associated with downturns in real economic activity. This should be puzzling because a bust involves simply an adjustment of the structure of production that ought to relocate capital and labour into uses that are congruent with the actual savings rate. After all, a bust occurring in the capital intensive sector should be accompanied by an expansion taking place in sectors that use less capital and are producing the consumer goods in a less roundabout way. As a result, any resulting unemployment should be only temporary and should quickly be remedied by an eventual decline in wages.

Yet, we know that in modern economies, certain nominal prices are not flexible, particularly not flexible downwards. One reason might be due to behavioural considerations. After all, humans are not perfect automatons, and we shouldn't expect laymen to be familiar with the intricacies of construction of price indices which are necessary for making the proper distinction between real and nominal variables. As a result, it is not surprising that even sophisticated individuals confuse nominal and real variables, especially when it comes to their earnings. An even more serious reason for rigidities can be found in the economic organisation of the labour market. A variety of economists have described the factors that lead wages to adjust sluggishly – or not at all.[4] At the level of public policy, unions, minimum wage legislation and a plethora of regulations very often prevent nominal wages from quickly adjusting downwards and clearing the labour market. Whatever we might think of these barriers to adjustments, the reality of the political process makes them unlikely to disappear anytime soon. As a result we are living in a world where a generalised decline in prices – a non-issue in an idealised competitive economy – can have important real costs.

Given these considerations, the supply of money ought to move systematically in a way that avoids the Scylla of a monetary policy-driven booms and the Charybdis of painful deflations. An omniscient and benevolent central banker should, at least in principle, be able to solve that problem and

[4] For an overview of some of the factors causing price and wage rigidities, see, among others, Stiglitz, J.E., The causes and consequences of the dependence of quality on prices, *Journal of Economic Literature*, vol. 25, 1987, pp. 1–48, Romer, D., The New Keynesian Synthesis, *Journal of Economic Perspectives*, Vol. 7 (1993), pp. 5-22

oversee a growth of the monetary base which will not lead to distortions in the structure of production, and which will not create excess supply on some markets – especially not on the market with labour. But how useful is it to know that this problem could be solved under heroic assumptions about the knowledge and benevolence of policymakers? How does it inform our choice of appropriate monetary arrangements for the real world – one in which central bankers might be ignorant and might not have the right incentives?

3. The economics of money: An excursion into history of thought

As Gregory Mankiw argues[5], modern, post-WWII macroeconomics was born as a mixture of science and engineering. On the one hand, it was motivated by a desire to discover causal mechanisms that link various macroeconomic aggregates, but at the same time it was driven by an ambition to directly translate these findings – however preliminary or incomplete – into policy advice. The vision of society endorsed by the first generation of followers of John Maynard Keynes was therefore fairly mechanistic. If the right levers were pulled, the economy would react in a predictable fashion. Hence, a well-informed central banker or politician should be in a position to easily avoid the Scylla and Charybdis outlined above, and the only challenge would be to simply accumulate data about the behaviour of the macroeconomy and improve upon existing models.

This dominant view came to an abrupt end with the stagflation in the 1970s and with the rational expectations revolution in economics. A new generation of macroeconomists argued that a purely mechanical vision of the economy was not appropriate. Robert Lucas, for instance, became famous for the "Lucas critique"[6] which is of the view that policy changes map uniquely into the space of economic outcomes. In fact, if those policies change people's expectations – as they should if individuals are rational – then it can easily happen that the policies in question will not bring about the desired results. If, for instance, the central bank desires to stimulate economic activity by increasing the supply of money, then insofar as this process is transparent and as people expect prices to rise as a result, this stimulus will translate itself into rising prices alone.

This insight relates to a fundamental problem of monetary policy – and of economic policy in general. The economy is not a mechanical structure that would always react in the same way to

[5] Mankiw, N.G., *The Macroeconomist as Scientist and Engineer*, http://www.economics.harvard.edu/faculty/mankiw/files/Macroeconomist_as_Scientist.pdf

[6] Lucas, R, Econometric Policy Evaluation: A Critique, in Brunner, K.; Meltzer, A., *The Phillips Curve and Labor Markets*, Carnegie-Rochester Conference Series on Public Policy, 1, 1975, pp. 19–46

policy shifts, and it is impossible for policymakers to acquire a complete knowledge of the economy, which would be required to conduct discretionary policy.

Lucas' insight also relates to the incentive problem which has been later aptly described by Finn Kydland and Edward Prescott[7] as the time inconsistency problem. If the central bank has the ability to stimulate the economy by setting actual inflation above expected inflation, then a policy of low inflation will never be credible. If individuals expect low inflation, then high inflation will stimulate the economy – whereas low inflation will keep output unchanged. If individuals expect high inflation, then the central bank has to keep inflation high, lest the economy shrinks. Hence, no matter what people's expectations are, it pays for the central banker to engage in a policy of high inflation. However, given that people are able to see through this process, they will rationally set their inflation expectations high. As a result, monetary policy will lose its ability to stimulate the economy at all.

While the real-world relevance of time inconsistency for monetary policy has been questioned,[8] it should be obvious that we live in a world where central bankers usually err on the side of higher, rather than lower, inflation. A systematic bias in one direction cannot be explained solely by an insufficient knowledge of the economy, but rather by a systematic, incentive-driven bias that makes such errors individually less costly than the errors in the opposite direction.

It is safe to say that, provided the imperfections inherent in policymaking of any kind, and in monetary policy in particular, an arrangement that gives central bankers – however independent might they be – the discretion over the supply of money in an economy, is unlikely to be satisfactory. Indeed, it comes as no surprise that the literature on 'Lucas critique' and on time inconsistency was soon transformed into a broader debate about rules versus discretion in monetary policy. Followers of the rational expectations revolution in macroeconomics have since then argued that, instead of engaging in dubious fine-tuning of the economy, central bankers should stick to simple rules related to the growth of money supply and to changes in interest rates.

Obviously, the idea that monetary policy should be rule-based, or at the very least constrained by certain rules, did not originate in the 1980s. Much earlier, Milton Friedman[9] advocated a rule-based,

[7] Kydland, F. E.; Prescott, E. C., Rules Rather Than Discretion: The Inconsistency of Optimal Plans, *Journal of Political Economy* 85, 1977, 473–491.

[8] Blinder, A. S., What Central Bankers Could Learn from Academics--and Vice Versa, *Journal of Economic Perspectives*, Vol. 11 (1997), pp. 3-19.

[9] Friedman, M., A Monetary and Fiscal Framework for Economic Stability, *American Economic Review*, Vol. 38 (1948), pp. 245-264.

predictable growth in the supply of money, which would then result in a steady, predictable rate of inflation. During the years of the great moderation, however, the concern about the imperfections of monetary policy appeared to be only of secondary importance. To a certain extent, central bankers did adhere to rules, albeit mostly implicit and non-enforceable ones, and then, their performance appeared to be relatively acceptable. However, the financial meltdown of 2008 should have put an end to the rather naive idea that central banks somehow achieved a level of competency that they had not possessed previously.

The financial crisis has therefore revived interest in monetary issues and in the institutional structure in which central banks operate. In his recent piece, James Buchanan[10] argues that money creation should be subject to the same constitutional constraints as other elements of the federal government. The trouble with constitutionalism is that even the most elaborate and intellectually satisfying rules are not binding in the end, since the government cannot effectively enforce them from itself. The doubt that we can subject government-run money supply to effective constitutional constraints has led Friedrich von Hayek, relatively late in his life, to advocate the denationalisation of currency and competition between private issuers of money.[11]

Certain streams of libertarian theorists would even go further and claim that there is a case to be made for currency that would be backed by gold, and issued by private banks.[12] Moreover, some would suggest that the root of our monetary malaise is in the fractionary nature of deposits in modern banks, and that we therefore ought to create a system in which every demand deposit is subject to the 100-percent reserve requirement, and hence in which none of the demand deposits are lent away from the bank.

While there certainly is a place for legitimate discussion about optimal monetary arrangements, the insistence on a particular commodity (gold) and on a particular form of bank organisation (100-percent reserves) does not seem to square well with the Hayekian insight concerning our fundamental ignorance of social phenomena. There is a plethora of arguments for why gold, under present circumstances might not be the best commodity to tie our currencies to, especially in an environment in which rigidities and confusions about real and nominal variables are ubiquitous. Marginal costs of digging out gold do not strike us as being a particularly useful rule for growth of the money supply in the present age. The fact that gold was used both directly as a currency and as a reference point in the past says nothing about its relevance for the current debates.

[10] Buchanan, J.M., *The Constitutionalization of Money*, 2009, mimeo.

[11] Hayek, F.A. von, *Denationalisation of Money*, Institute of Economic Affairs, 1976.

[12] See, e.g., Rothbard, M., *The Case for the 100 Percent Gold Dollar*, http://www.mises.org/story/1829.

Likewise, we see little reason to ex ante prefer one specific form of bank organisation over another. To be sure, our present-day banks reflect both the forces of competition and of particular government interventions, and there is no reason to expect them to be identical on any relevant margin to what would have emerged from an undistorted competition process. Yet, this is not informative with regard to what would actually have emerged on a free market. The idea that we know, in advance, that gold is *the* commodity which should constitute the basis for our currencies, and that only 100-percent reserve banks represent an acceptable form of financial transacting, strike us as yet another instance of the “fatal conceit,” this time displayed by individuals of otherwise libertarian leanings.

4. Towards better monetary institutions

Brief as this exposition might be, it should be obvious at this stage that the currently existing institutions that supply money to the economy are not satisfactory. Central banks, in their attempts to stimulate the economy, are likely to create distortions in the structure of production, leading to periods of investment booms and subsequent busts. Moreover, excessive growth in the money supply is clearly linked to high inflation, with all of its costs, without any of the short-term alleged benefits.[13]

There is one additional reason why one ought to be sceptical of monetary institutions that give the discretion over the supply of money to the government. Traditionally, followers of Milton Friedman have described inflation as a purely monetary phenomenon.[14] However, this view is not entirely accurate, especially in light of the research that links inflation to government debt.[15] Governments have always tended to monetise their debts, once these have reached certain levels. The acclaimed independence of central banks does not seem to be a binding constraint on this activity, especially not in bad economic times. Even in Europe, with its experience of hyperinflations, and with the German attachment to sound money, we have seen the ECB to engage in direct monetisation of debts of the eurozone’s periphery. Likewise, nominally independent central banks have been used in past couple of years as parts of various bailout programmes, through which bad assets were moved

[13] For an empirical assessment of Fed’s performance, see Selgin, George, Lastrapes, William D. and White, Lawrence H., *Has the Fed Been a Failure?* (December 1, 2010). Available at SSRN: http://ssrn.com/abstract=1713755

[14] Friedman, M. and Schwartz, A.J., *A Monetary History of the United States, 1867-1960*, Princeton University Press.

[15] Sargent, T.J. and Wallace, N., *Some Unpleasant Monetarist Arithmetic*, 1981, http://www.minneapolisfed.org/research/QR/QR531.pdf

away from the ailing banking sector. While the merits and demerits of these policy steps can be disputed, recent events have shown that the independence of central banks in the West is a very fragile thing.

Given these worries about our present monetary institutions, it seems only appropriate to seek ways to improve them, in a way that would reflect these insights about the functioning of the economy and political process. From our perspective, a genuine reform of the monetary system ought to reflect two insights. First, our knowledge of the world and of the economy is imperfect and incomplete, and, in a strict sense, we do not know what an "optimal" monetary system should look like. Second, our policymakers, especially when given discretionary powers, are not necessarily benevolent, and cannot automatically be expected to use them to pursue "social good," however defined. In essence, we should be looking for a set of institutions that would be robust to our ignorance and potentially self-seeking intentions of those who are in charge of the money supply.

From this perspective, a system of free banking, as advocated by Friedrich von Hayek [REF], is clearly the alternative that appears to us as the most appealing. It is appealing because it allows the "optimal" monetary arrangement – which is ex ante unknowable – to be discovered through a process of competition. Furthermore, competition between different currencies imposes discipline on each issuer. Once a currency becomes excessively inflationary, or excessively deflationary, individuals and companies are free to switch to a different currency which would be more stable. Competitive forces would thus force banks issuing money to behave in a more responsible way than central bankers can be expected to behave.

There is a great deal of uncertainty surrounding the question of whether a competitive banking system is a realistic option in an era in which money has become so politicised.[16]After all, in our present situation, when central banks are in position to monetise governments' debts, how likely is it for the governments to renounce their control over currency, and even if they do, how credible would they be?

If anything, the events of 2008 suggest that the current equilibrium of central banking is more likely to be reversed in a direction opposite to the one suggested here – in a direction of governments' taking direct control over the money supply. If, for instance, the FED was eliminated from American political landscape, the likely consequence would not be a Ron Paul-like libertarian nirvana. More

[16] Eichengreen B., *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939*, Oxford University Press (1996) makes the argument that the extension of suffrage to working classes led to an inevitable politicisation of questions of money and credit. There is, however, a second reason too. Because governments tend to be the biggest debtors, they have a natural interest in controlling credit.

likely, Treasury Bills would be used as currency instead of US dollars, with potentially disastrous consequences.

Clearly, this is not the way in which the liberty-loving people would like a potential monetary reform to evolve. If a fully competitive solution is not available – and nothing suggests that it is, then it might be useful to attempt to tie the hands of central bankers as much as possible and to impose a set of institutional rules that make the functioning of central banks, and therefore growth of the money supply, predictable, transparent, and non-discretionary. In a world of central banks and central bankers, we ought to call for a constitutional reform along the lines of suggestions provided by James Buchanan. As noted earlier, the credibility of any constitutional rules is problematic, and it is not clear how deviations of monetary policy from constitutional rules would be policed. An optimistic constitutional vision would involve, in our perspective, a set of rules so simple and so transparent that the general public would be able to comprehend them and assess whether the central bank is abiding by them. Moreover, this vision would also involve a general public that would be well-informed about the social costs that inappropriate monetary policy can entail and would regard with disapprobation those central bankers that fail to deliver sound money.

In a sense, a monetary reform should involve a profound demystification of the business of central banking and a move away from a paradigm in which central banking involves a degree of expertise, which places it outside of the realm of public debates.

One compelling alternative in this regard could be the proposal put forward by a group of economists around Scott Sumner of Bentley University[17], who advocate nominal income targeting as the main reference point for central bankers. A nominal income growth target would, in principle, make the functioning of central banks automatic and based on a simple and very transparent rule.

Now, what are the main arguments for a nominal income growth target, as opposed to other targets that are commonly used by central banks? First, if the central bank committed to stabilising nominal income growth, it would respond with monetary tightening in periods of rapid economic growth and periods of rapid productivity increases. An inflation target, in contrast, fails to do that unless there are immediate inflationary pressures. As we saw in the early 2000s, monetary policy can be excessively expansionary – to the point of fuelling an asset price bubble – without being immediately translated into high rates of inflation. In this period, the monetary expansion was associated with declining prices of imports from China and with generally rapid rates of productivity growth, putting

[17] Obviously, other economists – Robert Hall, Bill Woolsey, Kevin Dowd or Robert Hetzel for instance – have long entertained similar ideas.

a downward pressure on consumer prices. So while a central banker targeting nominal income growth would have reacted to these phenomena by moderating the growth of money supply, discretionary central bankers used the rapid productivity growth to provide excessive liquidity to financial markets.

Besides being countercyclical, a nominal income growth target could be implemented in a way that would remove all discretion from central bankers.[18] The dollar could be defined as a fraction of some forward nominal GDP and it would be convertible into futures contracts at the target price. If nominal income was expected to deviate from the target, individuals would sell and buy these futures and therefore adjust the supply of money in way that would render the expected nominal GDP back on target.

The choice of a particular nominal income growth target is important, although not overwhelmingly so. A growth rate of zero, hence stabilizing a certain level of nominal income would result in a mild deflation rate roughly equal to the real growth rate of the economy. If we are concerned with nominal rigidities, we should probably not advocate this target as the required nominal cuts would lead to problems on certain markets. Based on 19th-century data, a 3-percent nominal income growth target would result in a quasi stability of the price level, while a 5-percent target would lead to a low, 2-percent inflation rate.

5. Conclusion

This essay makes two central claims. First, it argues that the currently existing institutional structure through which central bankers can exercise discretion over the money supply and interest rates is deeply flawed and responsible for a variety of economic ills which we have seen over the course of the past century. The fundamental root of this problem is institutional: central banks are government-run monopolies and are not subject to the same competitive discipline as other business entities. We do not know of any sound reason why the supply of money ought to be monopolised and left in the government's hands, however. Therefore, we believe that a system of competitive, privately issued currencies, would deliver a superior currency and also better outcomes in terms of macroeconomic stability.

Second, this essay argues that if discretion is part of the problem, then it could be partially remedied by tying central bankers' hands by a robust constitutional arrangement that would commit them to target nominal income, without giving them any mandate for discretionary action that would go beyond the nominal income target.

[18] Sumner, S., Money Rules, *National Review Online*, 14th December 2010.

Given the politicisation of monetary affairs, and the fact that governments have used central banks to inflate away their debts or to bail out private banks, the question remains whether either of these two arrangements could be made credible. When things go wrong, what can prevent the government from forcing the central banks to abandon its target and use it to bail out private institutions or to monetise government debt?

The answer is that, in principle, *nothing* can effectively deter the government from doing so, except for the popular majority. After all, although a government exercises a territorial monopoly of power – and in the strict sense it can go on unchallenged doing whatever it pleases – most present-day governments rely on some idea of legitimacy, which is derived from an arguably incomplete and contestable idea of how governments provide their citizenry and their economies with certain fundamental goods and services. If the general public had a better understanding of the links between various policy measures and economic outcomes, and if it had a better appreciation for the insights regarding the role of knowledge and its use in society, then the behaviour of self-appointed experts in the government and in central banks would be watched much more closely than it currently is. This essay is therefore a call to liberty-loving economists to become more effective educators and communicators. Without changing people's minds about what works and what doesn't in the sphere of public policy, and without eradicating some of the persistent myths about the benevolence and expertise of governments in regulating economic affairs, we cannot hope for a lasting change. Not in monetary affairs and not in any other area of public policy.