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By Warren Coats
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Introduction

With the collapse of the Soviet Union, sufficient evidence had been generated to kill any serious case for centrally planned economies. North Korea and Cuba provide icing on that cake. However, there is less agreement about the optimal mix of public and private roles in basically capitalist, free market economies.

The American founding fathers endeavored to give us a government most likely to preserve the self-government (personal freedom) our forefathers came here to enjoy. Its powers were tightly limited (enumerated in Article 1 Section 8 of the Constitution of the United States). Its powers were shared among the Legislative, Executive, and Judicial branches of government (checks and balances). They created a Republic not a Democracy in an effort to find middle ground between the rule of the mob and dictatorship of the elite. Above all, our relationships with our neighbors and our government were to be governed by laws rather than the whims of those with power (rule of law).

Much can be said about the dangers to our freedom and way of life from the erosion of these founding principles. President Obama, for example, has extended the domain of the Executive Order to change laws he found inconvenient. He even rewrote the timetable in the Affordable Care Act to delay the implementation of some provisions despite having threatened to veto such delays when proposed by Republicans in Congress. Now the President is threatening to make and enforce his own rules for immigration out of his frustration with Congresses failure to do so. "Frustration over stalled immigration action doesn't mean Obama can act unilaterally" /2014/08/05/

The abuses of executive power for political ends by Richard Nixon shocked the nation and revelations of his abuses only get worse as more details are released (largely from the White House tapes). Abused of executive power by the IRS for political ends have received a lot of publicity recently, but the abandonment of the "innocent until proven guilty" principle may be less well known. The use and abuse of civil forfeiture (guilty until proven innocent) is one of many examples of the steady drift toward strengthening the government’s “law enforcement” at the expensive of individual rights. George F Will "The heavy hand of the IRS"/2014/05/01 Richard Rahn "abusive civil asset forfeiture laws" The NSA

1 Warren Coats retired from the International Monetary Fund in 2003, where he was chief of the Operations Division for SDRs in the Finance Department from 1982 - 88.
scandals are another. "Abuse of power" "Turning-a-corner-on-the-invasion-of-privacy" The most recent and shocking instance of the Obama administrations abandonment of the rule of law concerns Justice Department pressure that has lead many banks to close the accounts of porn stars and gun stores. "Under ‘Operation Choke Point,’ the DOJ and its allies are going after legal but subjectively undesirable business ventures by pressuring banks to terminate their bank accounts or refuse their business." "Operation Chokepoint" Reason Magazine. If that doesn't worry you, then add the erosion of the checks and balances meant to help safe guard our liberties from government abuse. A recent Washington Post article began: "Independent watchdogs of dozens of federal agencies decried on Tuesday what they said were Obama administration efforts to delay or stall their investigations.“ US inspectors general say govt has blocked access"/2014/08/05/

More dangerous than the executive branch of government making or ignoring laws, is the growing attitude among many of our fellow citizens that the “state” should protect them from themselves rather than from abuses by their neighbors near and abroad. Those with this view look to the state to provide then with opportunities, guidance, and protection for leading their lives, rather than to help them enforce agreements of their own making, provide security, and provide a safety net for those who have fallen. The latter view, that of the original and subsequent immigrants wanting to be free of oppressive states and to lead their own lives reflects a presumption of self-governance. The state exists to support the interactions of free individuals. The former, newer view might be called the nanny state view. Such a view calls for a larger more intrusive state, which, for example, selects your health insurance plan for you rather than allowing you to choose what you want. The state knows best.

The government's many intrusions into the private sector in the name of consumer protection, systemic risk mitigation, etc., create the need for private companies and industries to defend themselves from the state via lobbyists. See "House members who work for wall street center for public integrity investigation" Such lobbying may help prevent or limit economically damaging legislation but it often preserves or establishes privileges for existing firms. The never-ending battles of military defense firms to preserve weapon systems the military can’t afford or doesn’t want are well known examples. "Effort-to-revive-growler-jet-shows-that-despite-pentagon-spending-cap-wishes-can-come-true"/2014/04/29/, "Cost-of-pentagon-weapons-systems-up-a-half-trillion-dollars"/2014/04/30/ The reason that this shift in public attitudes is more dangerous than the current government’s abuse of power is that it undermines the usual public outrage that would correct it.

The nanny state world is characterized by a growing list of regulations and government supervision of business in an effort to fix the most recently observed problems. The price of such protection is the increased cost of doing business, which tends to crowd out small businesses and favor large ones, which can more easily absorb the compliance costs. The benefits of these regulations are often difficult to detect. Has Dodd-Frank really made it feasible to fail our largest banks (now larger
than they were just before the Great Recession), i.e. are they no longer too big to fail?

The self-governing, liberal state—"Liberalism unrelinquished"—is characterized by a government that sets and enforces the rules of the game (contracts, bankruptcy, property rights, etc.). The number and length of laws and regulations needed are dramatically fewer and infrequently adjusted. Rent seeking opportunities (exploitation of government regulations for private gain) are thus much smaller. Firms succeed or fail on the basis of how well they satisfy the needs of their customers and fix any problems along the way themselves.

In this note I illustrate these alternative directions—the liberal state vs. the nanny state—with an area of the growing regulation of business that has received considerable attention in recent years—banking supervision and the closely related area of monetary policy. I discuss the structure and regulation of banks in relation to my earlier proposals to replace discretionary monetary policy with a simple rule: "Real SDR Currency Board"

**Background: Evolution of Banks and their Regulation**

Almost from their origin over 4,000 years ago, banks have lent out some of the money deposited with them. In fact, what became banks started as lenders (of their own money) that later began to accept deposits of money, which they added to their lendable resources. When a modern bank lends money by crediting a deposit account of the borrower, it is creating money. Thus from the beginning of banking, credit and money have been mixed. The risk that a bank might lose the deposits that finance many of its loans (a bank run) has been a primary concern of banks from the beginning along with concern for the risk that a loan might not be repaid. These concerns dominate the reason for and focus of bank regulators.

Banks have been equally important in facilitating payments that could not be conveniently made face to face, especially with the growth of global trade. Rather than transporting gold or silver around to pay for oriental spices, Dutch and British banks issued Bills of Exchange (in effect a currency/bank note) promising its bearer the gold or silver backing it when redeemed at the issuing bank. Arrangements for clearing and settling Bills of Exchange among banks (netting the to and fro flows of Bills) further reduced the need to actually transport gold from one place to another. More recently (in the last two or three hundred years), banks developed means for making payments by transferring deposit balances that were more efficient than, though similar to, Bills of Exchange and dramatically more efficient than delivering cash via Wells Fargo express or in person.

Before a person could make a payment with a Bill of Exchange or by deposit transfer (by check), she had to deposit gold or silver with the bank. But before the public would entrust their money to a bank, the bank needed to convince it that it would be
safe there. Thus banks maintained high levels of capital (the owners own money in the bank) and made only relatively safe and liquid loans. The Real Bills Doctrine guided most banks to lend mainly for the financing of self-liquidating inventories. Nonetheless, from time to time banks were caught short when depositors lost confidence and withdrew their deposits in large numbers (bank runs). Focusing on the experiences of the United States, the bank panic of 1907 (the Knickerbocker Trust Company crisis), which saw a 50% drop in stock prices, was stopped when J. P. Morgan convinced other large banks to join him in providing the liquidity banks needed to reassure depositors that it was safe to leave their money with the banks, thus ending the deposit runs. This experience led to the creation of the Federal Reserve System (America’s central bank) in 1913 to provide such liquidity to otherwise sound banks (lender of last resort) when threatened by depositor runs.

The banking system that emerged in the U.S. was particularly fragile. The chartering of banks was largely a state matter and in collaboration with local business interests most states had adopted unit-banking systems (banks could not branch). This created and protected thousands of little bank monopolies, which thus enjoyed monopoly profits, while lowering the extent and quality of banking services. When the relatively new Federal Reserve mistakenly over tightened monetary policy starting in late 1929 to reign in the stock market bubble its overly easy policy had helped inflate during the roaring 20s (Friedman and Schwartz: "From the cyclical peak in August 1929 to a cyclical trough in March 1933, the stock of money fell by over a third."), more than 9,100 banks failed (38% of the total) as the public again lost faith in banks, rightly suspicious of the stability of unit banks. States began to eliminate the unit banking restrictions.

In another attempt to fix banking industry weaknesses, Congress passed the Banking Act of 1933 (so called Glass-Steagall Act). This act attempted to make banking safer by separating commercial banking (the traditional deposit taking and short-term lending activity of banks) from investment banking (the riskier market making, trading, financial market activities). It also established the Federal Deposit Insurance Corporation to insure small bank deposits. The FDIC was added against the opposition of President Roosevelt, his Treasury Secretary, and Senator Glass among others in response to strong political lobbying by community banks in order to protect themselves from the competition of larger, stronger (i.e. safer and more efficient) banks. For a long time these measures pretty much ended bank runs. However, by eliminating the need for depositors to care about the safety and soundness of their banks, the FDIC Act created the need for bank regulators to take over that market function. Thus bank risk taking was increasingly regulated by the government.

Regulation of bank risk taking, insider dealing (loans to friends and related parties), and minimum capital to absorb losses and keep owners interested in the soundness of their bank have been helpful but could be gamed by banks relying on deposit insurance to keep depositors. During the 1970s and early 1980s prudential regulations were relaxed and capital standards reduced. The Depository Institutions
Deregulation and Monetary Control Act (DIDMCA) signed into law by President Jimmy Carter in 1980 eliminated many of the distinctions between different types of financial intermediaries created by the Glass-Steagall Act. As a result discipline of bank behavior fell increasingly to government regulators.

The ultimate discipline of a poorly run bank is the withdrawal of its banking license and its merger with a healthy bank or liquidation. As the Savings and Loan crisis and banking crisis of the mid to late 1980s demonstrated, supervisors were reluctant to pull the plug on insolvent banks, hoping that with time their condition would improve, a practice known as forbearance. New laws attempted to correct this regulatory weakness. The Financial Institutions Reform Recovery and Enforcement Act (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991, (FDICIA) cleaned up the insolvent S&Ls and banks and provided tough rules mandating reluctant supervisors to close critically undercapitalized banks (requiring increasingly severe sanctions as capital declined), which came to be known as prompt corrective action. These laws increased the incentives for bank owners and large creditors to discipline bank risk taking. In fact, the regime has work quite well for many years. "Institutional and Legal Impediments to Efficient Insolvent Bank Resolution and Ways to Overcome Them"

With banking regulation thus strengthened, the financial sector was further liberalized by the Gramm-Leach-Bliley Act of 1999, which repealed much of the Glass-Steagall Act and its restrictions on bank interest rates, and other economic (as opposed to prudential) controls and allowed the merging of commercial and investment banking. This changed the institutional culture of commercial banking more than had been anticipated as conservative bankers were sidelined by aggressive investment banking traders. Under the watchful eyes of American bank regulators in the mid 2000s (the FDIC, Office of the Comptroller of the Currency, Federal Reserve, Federal Home Loan Banks and others), banks contributed to the U.S. real estate bubble financed by the Fed’s easy money policy (also experienced in the U.K., Spain, Ireland and other countries) and the subsequent Great Recession.

The unwinding of the real estate bubble would not have been particularly difficult or disruptive if it had not been for the government induced lowering of mortgage lending standards required by the two government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. When housing prices stopped rising, zero down payment, no doc, teaser rate mortgages, and especially the subprime mortgages forced on the market by the government began to default in large numbers. Charles Calomiris and Stephen Haber tell the fascinating story of how it happened in their new book “Fragile by Design.” Several things combined to create a tragedy.

The widespread restrictions on intrastate and interstate branching and the local banking monopolies they made possible were finally swept away by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (IBBEA). This launched a massive consolidation of banks operating nationally. In addition, economic regulations of banks (e.g., Reg Q interest rate ceilings, unit banking) were
significantly liberalized between the late 1970 to 2000, further strengthening the stability of the banking system. Prudential regulations, on the other hand, were further strengthened, though regulators failed to use the powers they had to limit risk or increase capital.

At the same time political movements promoting home ownership and income transfers to the poor in the form of subsidies for home ownership gained wider support. Community activist groups such as the Association of Community Organizations for Reform Now (ACORN) that had long advocated lowering lending standards to those in poor (and often black) neighborhoods found a champion in newly elected President Clinton. Under Clinton the Community Reinvestment Act (CRA) was strengthened and Fannie and Freddie where mandated (quotas) to increase the number of subprime mortgages on their books or that they guaranteed. To do so, they dramatically lowered their mortgage lending standards (3% down payments, no documents of income, etc.). In exchange for lowering their mortgage standards the GSEs (then privately owned) were exempted from normal capital standards and implicitly guaranteed by the government (made explicit when they were later declare bankrupt). In July of 1999, President Clinton bragged that: “Over 95% of the community investment... made in the 22 years of that [CRA] law have been made in the six and a half years that I have been in office.”

The final plank in this tawdry story (which was much nastier than summarized here) was the need for the Federal Reserve to approve bank mergers and acquisitions on the basis, in part, of an assessment of the acquiring bank’s performance in achieving CRA goals of increased subprime lending. To improve their scores, banks joined with the likes of ACORN in order to expand such lending in exchange for which such organizations supported the banks’ merger and acquisition applications.

There may well be a net gain to society from lenders/investors taking larger calculated risks in order to extend mortgages to riskier borrowers. After all most subprime mortgages are performing (i.e., being repaid on time). But the skills and judgment needed to qualify more marginal borrowers, and the instruments for allocating the financing of riskier mortgages to those willing and able to bear such risks are what the private sector does best and the government by its nature does poorly. A risker category of borrowers will need to pay a higher interest rate to cover the losses from those who default. It is acceptable for banks to invest in riskier assets expecting a higher return on average if they increase their capital cushion appropriately to absorb the occasionally higher than average losses. In the days of largely unregulated banking and no deposit insurance, banks held capital of 40 to 50% of their assets (100% of deposit and currency liabilities) in order to convince depositors that they were safe. But today’s regulated banks have been able to manipulate their mortgage business (via the GSEs and securitization) to avoid any regulatory requirements to increase capital. Bank shareholders were willing to go

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2 Calomiris and Haber page 217-8.
for the expected higher, but riskier, return and creditors were willing to let them because of deposit insurance and the expectation of a government (tax payer) bailout if things went wrong, as they subsequently did. And the government could not require banks to increase their capital against riskier mortgages without undermining its policy of promoting (subsidizing) those mortgages, a conflict of interest with devastating consequences.

The otherwise inexplicable collapse in lending standards and the financial crisis that followed is explained by the economic rent sharing collaboration between political groups like Acorn, the government, the GSEs, and the emerging megabanks to promote home ownership among those previously unable to qualify for a mortgage. The government and its political supporters achieved their political objective without adding line items to the Federal budget (until the bailouts were needed). Fannie and Freddie gained huge profits for a while (and high salaries and employment for political friends) backstopped by government guarantees. Megabanks achieved (bought) the Fed’s approval of their merger goals while shifting the risks onto the taxpayers. Is that sleazy or what? It is called crony capitalism to distinguish it from the real thing.

There are many pieces to the story of the Great Recession of 2008 plus -- "The U.S. Mortgage Market: The Good, the Bad, and the Ugly", "Financial Crisis: Act II, the Way Forward", but in yet another effort to further strengthen the effectiveness of banking supervision that had failed once again to protect the financial system from serious losses, U.S. Congress passed the “Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in 2010.

While FDICIA had created a largely effective insolvent bank resolution regime, concern remained with the problem of systemically important financial institutions, the so called “too big to fail” problem. Dodd-Frank forbids bailing out banks with taxpayers money and thus meant to end the too big to fail problem. However, many doubt that it really has, suspecting that its emergency override provisions will be invoked when push comes to shove. Moreover, the growing burden of more and more intrusive and complex regulations has hurt small banks more than large ones as compliance costs are a larger share of their income. The five largest banks in the U.S. are larger today than they were before the 2008 banking crisis. In 1913 the Federal Reserve Act was 31 pages. The Glass-Steagall Act was only slightly longer. The Gramm-Leach-Bliley Act that replaced it was 145 pages, four times as long. Dodd-Frank is a staggering 849 pages and has resulted in thousands of pages of new regulations and more are underway.

Even without regulatory capture, government supervision of banking will never be as flexible and effective as the regulation of risk taking by banks themselves, but that requires a legal structure that imposes the profit and loss consequences of bank behavior on the banks themselves. It is time to reverse the march of the nanny state—we are here to help you— approach and return to the more effective discipline of the market, i.e. of self-governing, self-responsible individuals within the
general framework of law provided and enforced by the state. In exploring a liberal state approach the risks being addressed by the above proliferation of laws and regulations can be divided into those protecting depositors and banks from depositor runs and those protecting investors from losses of their investments.

Preventing depositor runs

The nanny state approach has tried to prevent bank runs by insuring depositors against loss up to $250,000 per person. As a result the government has had to take on the responsibility of insuring that banks invest depositor money safely. Such supervision is needed to counter the moral hazard of insurance and government guarantees. When everything is not guaranteed by the state, bank owners have a financial incentive to protect depositor funds while earning the best possible, risk adjusted return. Bank staff are in the best position to flexibly judge all relevant factors when evaluating the credit worthiness of borrowers. The bank lending business is built upon the knowledge they have of their customers’ financial histories and prospects. Given the need for governments in rule of law countries to operate on the basis of clear rules, uniformly applied, government employees are necessarily at a disadvantage to banks in this regard. The more regulators are allowed to exercise judgment, the greater is the risk of corruption. Their comparative advantage is in limiting conflicts of interest within banks themselves, such as limits on related party (insider) lending and enforcing honest financial reporting. But who is better at evaluating the probability that a particular loan will or will not be repaid and thus the loan loss provisions that should be set aside—the lender or the regulator?

The liberal state approach would structure the rules of the game such that more reliance could be place on market participants to police bank risk taking and to choose the level of risk (and reward) they are willing to take. This approach would have several elements. First, only fit and proper persons should be allowed to own and operate banks and the minimum regulatory capital should be raised closer to the levels banks maintained before they were regulated and insured (perhaps 10-15% of total assets). Second: any losses from a bank’s failure should be born first by its shareholders, then by its junior, then senior creditors (bailing in), not tax payers (bailing out). Third, deposit insurance should be dramatically reduced to very low levels relevant to medium income families ($10,000). Furthermore, most of the large number of micro management regulations should be replaced with clear, transparent reporting requirements with sensible, internationally agreed accounting rules.

A more radical proposal that deserves serious consideration is to focus regulatory attention on bank liabilities rather than assets. When banks fund their assets with debt, they either honor the terms of the debt contract or default. The potentially

3 See John H. Cochrane: "Toward a Run-free Financial System" April 16, 2014
most volatile of such contracts for a bank are demand deposits (checking accounts) and savings deposits, which may be withdrawn on demand. When depositors or other bank creditors think that their bank is in trouble and might not be able to repay them, those in line first get the money available. Thus banks are prone to depositor runs (above the insured amounts). The banking system is made vulnerable to runs as a result of such financing. While depositors will eventually receive their share of the liquidated value of the failed banks assets, such payouts typically take several years to complete. Deposit insurance eliminated depositor concerns and thus runs but forced increasingly heavy regulation of the safety of bank loans and other assets.

During the great depression of the 1930s a group of Chicago economist proposed that banks be required to hold reserves (deposits with the central bank and/or short term government debt) equal to 100 percent of their callable deposits, which would make them completely safe and end any reason for runs.\(^4\) They built upon earlier proposals of Ludwig von Mises in 1912.\(^5\) This became known as The Chicago Plan.\(^6\) The focus on demand deposits is because of the critical role they play in making payments for which savings deposits are a close substitute. All other bank liabilities would be equity and maybe some long-term debt (such as fixed term deposits with a minimum maturity of one year and long term bonds).

The corporate income tax and other legal incentives have distorted the markets' preference for debt over equity. As a result far too much business is financed by debt to the detriment of the stability of financial markets. When people invest in equity rather than debt there is no promise of its value and thus no advantage to being first in line to withdraw the investment when they think its value might fall. This does not mean that share values cannot adjust quickly if the average market assessment of a company's profit prospects change, but those same forces work against overshooting as well. Regulation of the non bank financial markets (sometimes called shadow banks) requires much lighter regulation—largely transparent reporting—than banks.

The Chicago Plan would not necessarily change the amount of savings placed with banks (or mutual funds or similar investment vehicles) for on-lending but would change the character of its financing in ways that would make it immune to runs. Investors' choices of what equity to hold would provide greater market discipline of the riskiness of bank and mutual fund assets. Thus most regulation of risk taking would be by the market rather than by government.

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4 The plans supporters included such notable economists as Frank H. Knight, Lloyd W. Mints, Henry Schultz. Henry C. Simons, Garfield V. Cox, Aaron Director (Milton Friedman’s brother inlaw), Paul H. Douglas, and Albert G. Hart.
5 Jesús Huerta de Soto, Money, Bank Credit and Economic Cycles.
In fact, as a result of the enormous increase in bank deposits with the Fed as a result of Quantitative Easing, banks already hold more than one hundred percent reserves relative to their checkable deposits ($2,700 billion reserves vs. $1,600 billion in checkable deposits). However, the Chicago Plan would require full reserve backing of savings deposits as well, which currently amount to another $7,500 billion. Thus banks currently hold reserves at the Fed equal to about 30% of liquid deposits (checkable and savings deposits), which could easily be increased gradually to 100% over, say, the next ten years. A bank with liabilities consisting of callable deposits all of which are place with the central bank, and equity shares in the banks loans and other investments, doesn’t really need capital beyond the need for owners that pay attention to the bank’s management.

**Predictable and stable money**

Following the panic of 1907, the so called Bankers’ Panic, the government decided that the vulnerabilities of America’s highly fragmented banking system discussed above needed a lender of last resort to protect the system from periodic liquidity crises (depositor runs on otherwise solvent banks). This was seen as the primary function of the Federal Reserve System of twelve privately owned government chartered “central” banks created in 1913. In addition to temporary liquidity lending to banks (via the discount window) the Reserve banks (through the Federal Reserve Bank of New York) purchased government debt and other high quality financial assets in order to provide for the growth in the money supply (open market operations) demanded by the public as the economy grew. It supplies currency (Federal Reserve notes) to banks from its vaults around the country, and processes interbank payments of bank reserve deposits with the Fed as part of the check (and now electronic payment) clearing process. In its earlier days the gold standard requirement for the Federal Reserve to redeem its bank notes for gold, anchored monetary policy to the price of gold.

During the earlier gold standard regime from 1792 to 1934, the value of one U.S. dollar was fixed at $19.39 per ounce of fine gold, and then $35.00 per ounce from 1934 to 1971. However, President Lyndon Johnson’s two wars—the War on Poverty and the Viet Nam War (Guns AND Butter) financed with debt—pressured the Federal Reserve into over expanding the money supply, which produced increasing inflation and higher unemployment (stagflation). At that point, as the U.S. no longer had enough gold to honor its redemption commitment, President Nixon ended the U.S. commitment to buy and sell gold at its official price. According to the Triffin dilemma (the need for the country supplying the international reserve currency to run a persistent balance of payments deficit in order to meet the world’s demand for its currency, which would ultimately undermine international confidence in the ability of that country to redeem its currency for gold) this was inevitable eventually anyway. Yet, an official price remained, and was raised to $38.00 per ounce in 1971 and $42.22 in 1972. In 1974, President Ford abolished controls on the private
ownership of gold and freed its price, which rose to a high of $1,895 in September 2011 before falling below $1,275 in mid August 2014.

Under a strict gold standard, the central bank would issue and redeem its currency whenever anyone bought it for gold at the official price of gold (the system of a century ago was open only to central banks). In fact, however, during its gold standard days the Fed engaged in active monetary policy, buying and selling (or lending) its currency for other assets whenever it thought appropriate. Thus, rather than being fully backed by gold, the Fed’s monetary liabilities (base money) were partially backed by U.S. treasury bills and other assets. In addition, the fractional reserve banking system discussed above allowed banks to create deposit money that was also not backed by gold. The market’s ability to redeem dollars for gold kept the market’s dollar value of gold close to its official dollar value. However, the gap between the Fed’s monetary liabilities and its gold backing grew until the market (especially foreign holders of dollars) lost confidence in the Fed’s ability to honor its redemption commitment and President Nixon closed the “gold window” in 1971 rather than tighten monetary policy.

The Federal Reserve Treasury Accord in 1951 freed the Fed of its obligation to keep the government’s borrowing costs low, thus allowing it more independence to pursue price stability. Though the Employment Act of 1946 had saddled the Fed with ill defined and contradictory objectives (price stability and full employment), the loss of the gold anchor to the Fed’s monetary policy made it more difficult for it to resist Congresses demands that it take on more and more responsibility for employment and smoothing business cycles. The stagflation of the 1970s ended with inflation peaking at almost 15 percent until Feb Chairman Paul Volcker bit the bullet, pushing short-term interest rates temporarily up to 19%, and returned inflation to 2.5%. The intellectual and empirical foundation for Volcker’s stepping on the monetary breaks had been laid by Milton Friedman’s monetarism. The notion of a natural rate of unemployment, which could not be influenced by monetary policy, helped the Fed resolve its “dual mandate” in favor of price stability. Following that experience, the increasing independence of central banks from political pressures and their increasing skill at regulating the supply of money produced over twenty years of low inflation and more stable income growth referred to as the Great Moderation.

Many central banks around the world have attempted to replace the discipline of fixed exchange rates (which during the gold exchange standard era created at Bretton Woods seventy years ago meant indirectly fixing the price of a currency to gold through fixing its exchange rate to the U.S. dollar), with the more flexible but still relatively well defined rule called “inflation targeting.” As the U.S. housing bubble of the mid 2000s and the Great Recession of 2007-8 that followed have
painfully demonstrated, even successfully inflation targeting central banks have not mastered the business cycle or asset bubbles.\textsuperscript{7}

As with the nanny state’s propensity to pile on more and more financial sector regulations, the Great Recession, from which we have yet to fully escape, has led to greater and greater demands on central banks to restore full employment with monetary policy. Following its successful injection of badly needed liquidity in 2008 in response to the interbank market freeze up following the September 15, 2008 Lehman Brothers collapse, the Federal Reserve undertook all kinds of unorthodox measures to stimulate economic activity. In addition to lowering the Federal funds rate to virtually zero, the Fed implemented a number of unorthodox programs “to support the asset-backed commercial paper market, the mortgage-backed securities market, and money-market mutual funds.”\textsuperscript{8} These measures were followed by Fed purchases of long-term government bonds and agency issued mortgage-backed securities (so called quantitative easing).

These measures were not meant to and did not increase the growth rate of the money supply (the Fed paid interest on the resulting increase in bank reserves with the Fed in order to discourage banks from lending them). Rather these open market purchases were meant to repress interest rates in those markets in order to avoid losses to banks holding these securities and to encourage the revival of mortgage lending. These were quasi-fiscal measures rather than monetary measures and as such risk jeopardizing the Fed’s policy independence in the future. The Fed’s measures had only modest impacts on economic activity (investment and consumption spending)—it was, as we say, pushing on a string. The economy was not suffering from a lack of money, but, in addition to its need to reduce indebtedness (deleverage), it was suffering from policy uncertainty. Before businesses would invest for future growth, they needed some degree of certainty over the policy environment in which they would operate in the future.\textsuperscript{9}

The liberal state approach would give up the conceit that the economy can be fine tuned by continuously adjusting monetary (and fiscal) policy, and would establish clear rules for the behavior of the money supply (in the context of the market driven discipline of bank risk taking discussed above) to which market actors could adjust and plan. The gold standard era of money—especially the classical gold standard period from 1870 – 1914—enjoyed very stable value over the longer period and the economy enjoyed unparalleled growth in income and world trade. However, it suffered from several defects that led to its demise and argue against its return. First, central banks had too much discretion to depart from the rules of the gold standard game. This argues for eliminating such discretion and imposing very strict currency board rules. These rules require the central bank to passively buy or sell

\textsuperscript{7} See my earlier discussion of that period: "The D E Fs of the Financial Markets' Crisis"
\textsuperscript{8} Calomiris and Haber, page 204
\textsuperscript{9} Coats: "U.S. Monetary Policy: QE3"
its currency at its fixed price in response to the public’s demand, i.e. there would be no monetary policy. Second, the relative value of gold, like most individual goods or commodities varied over modest periods and thus did not provide a fully stable value for money fixed to it. This argues for a larger valuation basket of goods and/or commodities chosen so as to have as stable a value to the consumer price index as possible. Third, as money was issued by actually purchasing gold, its supply, and thus value, was subject to discoveries of gold and to improvements in the technology for refining it. Storage was also costly. This argues for the central bank issuing (and redeeming) currency by purchasing financial assets of equivalent market value (indirect redeemability) rather than all of the items in the valuation basket. These are available in unlimited supply with negligible “storage” costs.

To illustrate indirect redeemability, dollars might be issued and redeemed against U.S. Treasury bills equal in value to the anchor bundle of goods (the valuation basket). If the market value of the goods in the basket were higher than one dollar, anyone could buy them more cheaply by redeeming dollars for them at the Fed. But such arbitrage works just as well to regulate the supply of money when indirectly redeeming dollars for the basket using, for example, an equivalent value of U.S. treasury bills. If, for example, the basket cost $1.20 in the market, anyone could buy $1.20 worth of t-bills from the Fed for only one dollar. This arbitrage-induced contraction of the money supply would reduce prices in the market until a dollar’s value in the market was the same as its official valuation basket value. As the economy grew and the demand for money increased, this mechanism would increase the money supply as people sold their t-bills to the Fed for additional dollars.

The proposed system, which I have called the “Real SDR Currency Board,” is explained in more detail in the following two articles: "Real SDR Currency Board" and "Implementing a Real SDR Currency Board." It would establish a gold standard like, rule based system of market regulation of the money supply. The amendments to the historic gold standard system proposed above would significantly tighten the rules under which it would operate and strengthen the prospects of its survival.

The United States could easily amend its monetary policy to incorporate the above features – a government defined value of the dollar as called for in Article 1 Section 8 of the U.S. Constitution and a market determined supply. The Federal Reserve Act could be amended to restrict its supply of base money to passive currency board rules. All active purchases and sales of t-bills by the Fed (traditional open market operations) or lending to banks would be forbidden. The Fed would buy and sell t-bills against dollars passively in response to market demand. During a five-year transition period it would be allowed to lend to banks against good collateral in order to allow banks time to adjust their operations and balance sheets to the new rules.

The gold standard was an international system for regulating the supply of money and thus prices in each country and between countries and provided a single world
currency (via fixed exchange rates). Balance of trade and payments between countries were maintained (when central bank’s played by the rules) because deficit countries lost money (gold) to surplus countries, reducing prices in the former and increasing them in the latter. This led to a flourishing of trade between countries. This was a highly desirable feature for liberal market economies.

The United States could adopt the hard anchor currency board system described above on its own and others might follow by fixing their currencies to the dollar as in the past. However, there would be significant benefits to developing such a standard internationally as outlined in my Real SDR Currency Board proposal. One way or the other, replacing the widely fluctuating exchange rates between the dollar and other currencies with fixed rates or a single currency would be a significant boon to world trade and world prosperity. Replacing the U.S. dollar as the world’s reserve currency with an international one would have additional benefits for the smooth functioning of the global trading and payments system. Imbedding the system in the governance structures that already exist in the IMF’s Articles of Agreement would elevate monetary policy rules to the constitutional level recommended by James Buchanan.

**Conclusion**

The crony capitalism and regulatory burdens of the nanny state approach have grown to a level of near suffocation. A further slide in that direction will only increase the importance of political influence and power over the importance of competition and markets and stifle the growth in economic output that has lifted most of the world’s population out of poverty.

We need to develop a liberal state of clear rules and greatly increased reliance on individual choice to determine what is produced and where savings are invested. Narrow banks would be tightly regulated and the rest of the financial system would be lightly regulated to be transparent. Monetary policy would be replaced with a market-determined supply of money whose value is fixed to a small basket of representative good.

**References**


"Implementing a Real SDR Currency Board" July 2014.