Money, Markets, and the State

Do our current financial troubles result from bad monetary policy and an abandonment of the gold standard? Benn Steil, director of international economics at the Council on Foreign Relations, and Manuel Hinds, former finance minister of El Salvador, discussed this question at a Cato Book Forum for their book, *Money, Markets, and Sovereignty*, on May 19, 2009. At a Cato Book forum a month earlier, on April 17, George Selgin, professor of economics at West Virginia University and author of *Good Money*, offered his thoughts on the roots of modern monetary policy and the power of private currency.

BENN STEIL: How do we account for the fact that every five years or so there's a major currency crisis and we're unable to develop any coherent response to it? In our book, we point out that globalization today is exceptionally unusual. If you look at earlier periods of globalization, particularly the late 19th century, what you see is that ideas of free trade went side by side with the idea of a universal monetary standard. So it's not coincidental that in the late 19th century, as countries started to coalesce around the idea that free trade might be mutually beneficial, they also coalesced around the idea that we needed a universal monetary standard to facilitate this—which was the classical gold standard.

On the other hand, if you look back through history and examine periods of protectionism—such as the 18th century, when ideas of mercantilism were at the forefront—those always went side by side with the idea of monetary nationalism, that it was the ruler's prerogative to determine what money should be, how it should be valued, and what could and could not be considered money within the borders. Of course, you did have money moving back and forth across borders, but you had floating exchange rates because rulers were continually debasing their money. Money fluctuated radically in value as it crossed borders.

But here we are in the early 21st century, when you have on the one hand the most liberal global trade and investment regime we've ever seen, and on the other, the most extreme doctrine of monetary nationalism that governments have ever contrived. We've never seen a period of history like the one we've been in since 1971, where all the currencies around the world are tied to nothing of intrinsic value. They are simply conjured by governments as a manifestation of monetary sovereignty.

That we're having trouble accommodating this situation wouldn't have been surprising to an economist in the 1930s—of the right or the left, of the free market variety or the anti-market variety. We talk in the book about the views of Friedrich Hayek on the one hand and Karl Polanyi on the other, both of whom considered it absolutely obvious that in order to have free trade and safe global capital flows, you needed to have a universal monetary standard. Both of them agreed this was gold. Of course, Hayek had sympathy with the liberal international trade order and Polanyi had a lot less sympathy with it, but they both agreed that gold was absolutely necessary to free trade.

Many economists believed that once we lost this idea of a universal monetary standard, and national currencies routinely fluctuated against each other, capital flows—which in the late 19th century had been extremely stabilizing and acted as an equilibrating mechanism to bring about the quick end of crises—would actually be massively destabilizing. Every time you had any sort of banking crisis, the reaction of investors, both foreign and domestic, would be to sell the currency en masse because they wouldn't believe that the old parities would be restored. They would naturally assume that things were going to get worse.

What we are experiencing today I would argue is not actually surprising at all. It is something that was anticipated by economists of the right and left in the 1930s. It's not a fundamental flaw with the idea of globalization or the idea that we should have a liberal international trade and investment regime. It's a flaw in the system of monetary nationalism that we're currently pursuing.

MANUEL HINDS: The world faces the problem of not having a true international currency where the supply of money is not dependent on political conditions within any one country. Because there is no global currency, countries are forced to use money issued by a single country—in our case, the United States. But within the United States, the Federal Reserve isn't as concerned with what is going on in the global market for its currency as it is with internal U.S. politics. The world uses fiat money—and it could be anybody's criteria employed to determine how much of it is going to be created.

This is one way of doing things. A second would be to have a true international currency, but then who is going to determine this? Will we have a politician saying whether we have to increase the supply of money?

A third way would be to have a commodity currency like gold. We had this currency for several centuries, but it was perfected in the 19th century. The real gold standard existed between the 1880s and 1914. It has been maligned because it is a

system in which the supply of money is not something we can manage. It is unthinkable in the current time to have a currency without discretion over how much is printed. But this was the big advantage of the gold standard: it remained outside the control of any one person, it was really something that was determined by the market and the price of gold.

There are many people who are now discovering the gold standard and finding that it functioned rather well. First, it was an international system. It was accepted everywhere. It was determined by the market and had very clear rules. The central banks participated in the gold standard not because their governments decided that it was the best way of organizing international trade, but because international trade was organized in that way.

Something I would like to mention, however, is deflation. Bernanke and many other people say we need to avoid deflation, which happened with the gold standard. In the long term, the gold standard kept the price level the same, but in the very short term, there were fluctuations. The gold standard has certain mechanisms through which prices have to go down again. There was a little inflation, a little deflation, and in the very long term you had almost zero inflation. But then, for example, between 1870 and 1890, and almost reaching to 1910, there was a long world deflation in which prices went down by 25 percent. You will probably say this was the most horrible depression in the world and actually people called it a great depression, but they were talking about the great depression of prices, not of production. This was the period in which Germany and the United States became industrialized. It was one of the most progressive periods in history—and prices were going down.

When you look at the gold standard, you realize many claims about it are myths. For instance, it is a myth that it stopped growth because of inelasticity of supply. Or that it created deflation and thus led to a reduction in production. It was not like that. The problem was that the system had constrained the politicians, and so there came a moment when they decided they didn't want to follow it anymore. They wanted to have their own monetary policy. They didn't want to be part of a global system. They launched the gold exchange system, in which they started creating currency outside the strict rules of the gold standard—and the contradiction began there.

Benn Steil

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This contradiction—between a system that was not discretionary and politicians using discretionary monetary policies—created conflicts and several crises, and eventually lead to the Great Depression. After that, the Bretton Woods system was created, which was still based on gold but gave the countries certain discretion to create money.

Now we reach our current system, which started when Nixon demonetized gold in 1971. Because we have free-floating currencies, each country can decide how to trade its money. If they are creating too much money, their currency will depreciate. But then again, we hit the same problem that we had. We don't have an international currency, we use the dollar, and the dollar has a big privilege because people around the world think in dollars. If the Fed decides to reduce interest rates, others tend to reduce interest rates—and if the Federal Reserve decides to increase interest rates, interest rates will increase.

That was the case until very recently. Now you see the Federal Reserve lower interest rates and interest rates in the market go up. It is because people are starting to doubt the dollar. They are starting to buy gold again and to stop passing dollars through the financial system. In three months, the Fed more than doubled the creation of money in the U.S. and it still didn't go through to the people—to Main Street, as they say. The ability of the Federal Reserve to create monetary policy is starting to skid. It is no longer what it used to be.

If the Federal Reserve abuses its power, people will stop believing in the dollar, and they will find something else. They will find a new currency, which will be gold, or the Euro, or whatever, and that is going to be a real problem for the United States.

GEORGE SELGIN: Mismanagement of money—and mismanagement of money serious enough to cause serious economic crises—has been the rule rather than the exception so long as central banks have been in charge of managing money.

The Federal Reserve was established in 1914 ostensibly to end financial panics like the one that had broken out seven years before. Within four years of the Fed's creation, starting from what was then a very low rate of inflation, the inflation rate passed 20 percent. It was the worst inflation in U.S. history, except for that during the Civil War. Then 1920 brought the most severe deflation in U.S. history. Fortunately, there was no New Deal or stimulus package in response to that crisis, so the economy recovered within a year. But then the Fed was at it again, fueling what became the great bull market of the late 1920s. I don't have to tell you what the Fed did after that; you all presumably know the story of the great monetary contraction that started the Great Depression. Then, just as the economy was beginning to struggle to its feet in the mid 1930s, the Fed decided to double bank reserve requirements, plunging it into

depression yet again. Then came World War II with serious inflation—disguised by price controls, of course—and then . . . well, you get the general idea.

The Fed's record has been lousy throughout its existence. The same can be said for other central banks around the world. In fact, the Fed has been one of the best: the typical central bank's record has been far worse—somewhere between the Fed's and that of, say, the Reserve Bank of Zimbabwe. That's why the dollar is, relatively speaking, so popular even now.

Why do we put up with it? Why do we let governments manage money in the first place, when they routinely make such a botch job of it? The answer the central bankers give is twofold. First, and more fundamentally, they argue that only governments are trustworthy enough to issue money or that only government authorities can issue trustworthy money. They also claim that financial panics in the absence of central banks would be even *more* serious than they've been with central banks in charge.

That second argument is false on two grounds. First of all, it's empirically false, in that pre-central banking panics were not as severe, certainly not in this country, as post-central banking panics have been. The worst of the pre-Fed panics was in 1907, and all three of the panics that broke out within the first 20 years of the Fed's existence were far more serious than it. Also, the pre-Fed panics were not the result of unhindered markets, but were products of unwise and misguided government intervention in the U.S. financial system, much of it dating to the Civil War period. Canada, during the 19th century and right up to the thirties, avoided major financial crises without a central bank. It relied instead on a completely decentralized and private commercial currency system with notes issued by various large nationwide banks. It was a famously stable financial system. Regarding Great Britain, we could tell a similar story. England suffered repeated financial crises in the 19th century. Scotland managed to avoid them. England had a central bank. Scotland had a decentralized, free banking system.

The more fundamental argument given for government control of money and for the existence of central banks is the claim that only governments can be trusted to supply money. That claim dates back to ancient times. Its roots lie not in paper money, to which it's mainly applied these days, but to coinage. Ancient governments—

George Selgin

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kings and princes—insisted that only they could be trusted to coin money. This claim, which soon became a dogma, was the basis of the so-called "sovereign right of coinage" or the "coinage prerogative" of government. This ancient coinage prerogative is the ultimate foundation for the entire modern apparatus of government management of national money supplies, including central banking. The Federal Reserve's legal authority, for example, rests solely on Congress's constitutional power to coin money, which is just the old ancient and medieval prerogative of coinage being continued into modern times. Of course, ancient and medieval governments enjoyed many prerogatives of which modern governments have been thankfully deprived.

How is it, then, that the coinage prerogative has managed to survive intact into modern times? The answer is that people, including economists—and despite economists' general opposition to monopoly and despite their knowledge of how governments throughout history abuse their monetary powers—believe in the ancient claim that if you let the private sector coin money, you will end up with bad money. But what if this ancient claim on which all modern government regulation of money rests is wrong? What if it can be shown that the private sector, if ever given a chance to coin money, would do a better job than government? If that could be proven, it would mean that the entire legal foundation for government control of money is basically rotten.

So has there ever been a case where, somehow, despite ancient and medieval dogmas condemning the practice, coinage was left to private enterprise? If there has been, what was the outcome? Was it the case, as so many economists predict, that Gresham's Law led to bad money driving good money out of circulation?

My book tells the story of one such episode, and its title answers the question. In the 18th century, the British economy found itself without any decent coins for retail trade and wage payments. The royal mint was producing few silver coins because silver was legally undervalued. The government gave up coining copper partly because of complaints about distribution—too much in some places and none at all elsewhere—but it did so mostly because its copper coins were easy to counterfeit, and were being counterfeited aggressively. No copper and no silver, hence no money for most payments.

It's then that the private market stepped in. When the government refused, despite entreaties from entrepreneurs, to supply decent coins, the entrepreneurs themselves, beginning with major industrialists, started to strike their own coins. By the early 1790s, there were no fewer than 20 distinct private mints striking custom coins that were issued all over England and other parts of Great Britain. These supplied the bulk of the money used for wage payments and retail exchange during those crucial decades. In

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Regime attempts to shut down Cato University

Chávez Fails to Silence Cato's Message of Liberty

In May, the Cato Institute conducted another session of its successful Cato University in Caucagua, Venezuela. This time, however, the government of Hugo Chávez took exception to Cato's teaching of individual liberty and free-market, limited government principles and sent the National Guard to disrupt the event.

Prior to Cato's arrival in Venezuela, state television and online media told Venezuelans that Cato was coming to set up a training camp for young subversives, a camp at which they would be taught techniques for overthrowing Chávez.

Once the event started, the Chávez government claimed that Cato University, conducted with the help of the Venezuelan-based, classical liberal think tank, CEDICE, lacked the proper permits to operate as a university. While Cato was teaching young Venezuelans about the benefits of individual choice in a free society, a state representative of the ministry of higher education arrived, accompanied by reporters from state television and the National Guard, and harassed the conference organizers. Even after being told that Cato University was not, in fact, a university, the Chávez government did not back down. Instead, it changed its tactics, accusing Cato University of engaging in false advertising.

The government then took the step of detaining Alvaro Vargas Llosa, a Peruvian intellectual and speaker at the event. He was released after three hours by airport authorities, but only on the condition that he not speak about the political situation in Venezuela, a condition he did not adhere to.

Later, Chavistas, not officially sanctioned by the Chávez government, picketed in front of the Caracas hotel in which CEDICE was holding its 25th Anniversary Conference, waving signs denouncing the Cato Institute and accusing it of working with the Central Intelligence Agency and Washington military interests to create subversive dissent among Venezuelans. These protests were carried on state television.

The reaction of the Chávez regime to two gatherings of market-liberal intellectuals demonstrates how tense the situation has become in Venezuela. But it also demonstrates how necessary Cato's mission of promoting liberty is—and how fearful the ideas of liberty are for those who would wield excessive state power.

Cato University attendees gather in Caucagua, Venezuela, in May to discuss classical liberal ideas. The National Guard was sent to disrupt the event. State television stations and Internet sites spread propaganda charging Cato and local cosponsor CEDICE with setting up a training camp in subversive tactics to overthrow the government. The government's tactics ultimately failed and Cato's message of liberty remained loud and clear.

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towns where either local, private coins or official coins could be used in exchange, private coins commanded a 100 percent premium over the other coins—which is to say you had to pay twice as much if you used the legal tender money! That's the market's verdict, the one that really counts.

Eventually private coinage was, of course, snuffed out. But in case you suppose that it was snuffed out because private coins were harming the public, it's easy to prove that that wasn't the case. When it decided to outlaw private tokens, the government still hadn't put its own coinage act together. Consequently people were literally left begging for cash of any sort. A government that was truly concerned about people having better money wouldn't have forced them to settle for having none at all!

To conclude: it's admittedly a long way from Great Britain in 1789 to the United States in 2009, but even the relatively distant past can harbor important clues to answering today's pressing public policy questions. One of those question is, must we forever remain at the mercy of the error-prone central banks? Must we forever suffer from the financial crises they cause again and again and again? Ancient dogma tells us that we have no choice. History, on the other hand, suggests that government's ancient monetary prerogative belongs in the same scrapheap into which most other medieval princely powers were tossed long ago. Perhaps central banks, which owe their existence to that prerogative, ought to be scrapped as well.