

Can Money Exist Outside of the
State? The virtues of monetary
rules and frameworks

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Introduction

What should we aim for as an appropriate framework for the operation of a monetary system in a free society? Would it be free banking, a truly independent central bank, a monetary constitution or some other form of monetary policy arrangement? What we can agree on is that, any type of arrangement should be taken out of the government's hands and a minimal amount of involvement by the state needs to be ensured. One does not need to argue this point only on philosophical grounds but mainly because discretion and distortion have been common features in monetary policy when the government has been involved generating unsound monetary policy. The following essay will discuss the role of government in a monetary system, both on the currency level issue and in the methods of monetary policy application. It will provide a brief description of examples of money outside of the state as well as discuss the need for a framework of monetary policy that would require rules rather than discretion.

The first section will discuss the relationship between money and the state. The second section will provide various types of examples of money outside of the state. The third section will discuss the need for a monetary framework. The fourth section will discuss what monetary policy can or cannot achieve and the fifth and last section will present the discussion on discretion vs. rules.

Money and the State

Carl Menger (1871), characterized money not as the product of an agreement or invention on part of economizing men or of legislative acts, but as a custom that evolved through each individual's economic interest and his need to have one set of commodities to exchange for others he desired. He presents the history of different types of money and how everywhere a phenomenon can be observed in which a certain number of goods, especially those that are most saleable in a specific time and place have become, through the powerful influence of custom, acceptable to everyone to trade and be capable of being given in exchange for other commodities. He specifically rejects the notion that money

is an invention of the state or a product of a legislative act. Even the sanction of political authority is not necessary for its existence.

Misses (1912) describes the role of government in the money market only as a participant and that it exchanges commodities and money on terms which are governed by the laws of price. However, it wields a big influence in monetary policy and the determination of a choice of a monetary commodity due to its own importance as an economic agent in society and its share of dealing in the market. This has also been enhanced by its role as controller of the mint and its influence in changing the character of the money-substitute in circulation. Nevertheless, it is the common practice of every agent in the market which leads to the creation money and not the state itself.

Hayek (1976) traces the involvement of governments in money since about 2,000 years. This was done through their prerogative on their exclusive right of supplying money by a monopoly of minting coins of gold, silver or copper. As coinage spread, governments came to discover that the exclusive right of coinage was a most important instrument of power as well as an attractive source of gain. He goes on to state that from the beginning the prerogative was neither claimed nor conceded on the ground that it was for the general good but simply as an essential element of governmental power. Hayek describes the story of money as a government monopoly and discretion on its issue, regulation and manipulation. The government's role in money began only as a certification process of the weight and fineness of the materials that universally served as money. Afterwards, in the middle ages, the role was distorted to be seen as a government's obligation to confer the value upon the money. Seignorage aggravated the state's intervention in money as it became to be seen as a profitable source of revenue.¹ In this sense we can see that the government was not in charge of selecting the type of currency to be used but was only a certifier of such currency.

In recent years and after many centuries into the evolution of money, Brennan and Buchanan (1981) suggest that the government's involvement in money also occurs due to the fact that markets fail in the money market, a point which can be debated in and of itself. However, they claim that in the absence of some view of how the political-governmental process works, "market failure" provides no grounds for the delegation of money creation authority to government.²

¹ Hayek. F (1976) "The Denationalisation of Money", Institute of Economic Affairs, pp. 23

² Brennan G., Buchanan J. (1981), "Monopoly in Money and Inflation", Hobart Paper 88, Pp. 19., Institute of Economic Affairs.

Also, due to the supposition that money directly relates to employment and income, the government's role in money has been seen to be justified due to these goals. This is an issue that can be directly traced to the status quo of monetary policy. If one examines the monetary policy objectives set forth by the Federal Reserve Act of the United States, it states that the Federal Reserve and the Federal Open Market Committee "shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates".³

James Buchanan characterized the state as having two roles, a protective state and a productive state. He referred to the protective state as the enforcing agency at the constitutional stage, which has the only responsibility of enforcing agreed-on rights and claims along with contracts which involve voluntarily negotiated exchanges of such claims. The productive state refers to the agency through which individuals provide themselves with public goods in post constitutional contract. Here, collective action is viewed as a complex exchange process with participation among all members of the community.⁴ He suggests that when these two roles are confused the state taken upon a wide array of functions that expand the scope of government intervention, which is an issue that can be traced to the monetary policy arena.

Can money exist outside of the state?

The first answer that comes to mind is yes. Throughout history money has existed outside of the state. As the theories presented above suggest, money was not created by the state. It has been an evolutionary process and the choice of commodity to be used has always been left to the individuals. Throughout the years, the state influenced the monetary system and has developed a monopoly in the issue of money. However, this was not always the case and there are episodes of money outside of the state that are worth mentioning.

Selgin and White (1994) demonstrate how competing currencies provide stability in a monetary system and how free banking has functioned properly in many countries. Free Banking or a Laissez Faire monetary system involve no governmental control of the quantity of exchange media, no state sponsored central bank, no legal barriers to the entry, branching, or exit of commercial banks among its main features. Dowd (1992) supports this type of system and presents evidence for the Australian case.

³ Board of Governors of the Federal Reserve System (2009), Federal Reserve Act, Section 2a. Monetary Policy Objectives.

⁴ Buchanan, J. (1975) "The Limits of Liberty", The University of Chicago Press, pp.88-89

Fellow authors, White and Schuler among others, present the case of free banking in the Scottish and Canadian experiences respectively.⁵

In the United States, Rolnick and Weber (1982) support the evidence that the failure of free banking was over exaggerated. They present a detailed analysis of four states. They show how the outcomes of the Free Banking system varied by states and although there were banking problems it need not be attributed to an overall failure of Laissez-Faire banking . They present different results for different states and how many of the banks that operated in those states did not go out of business or at least redeemed their notes at par after going out of business. Also, many banks were in business for more than a year suggesting that it wasn't an overall issue of wildcat banking.

Dwyer (1996) supports this claim and documents several episodes of free banking in the United States in the 19th century and concludes that although free banking was not problem free it did not disappear because there was an apparent dissatisfaction voiced by citizens of free banking states. It was actually taxed out of existence by the federal government.

Discussing other monetary policy arrangement, an experience worth mentioning is the bank of England. Central Banking can be debated as an efficient institution to direct a monetary system, however, the bank of England had evolved as a private bank throughout its history before being nationalized in 1946, although it was granted a government monopoly. It started as a private bank that served as the government's bank and later on became a lender of last resort for all banks becoming one of the first central banks in history.⁶This experience suggests that at least a private independent central bank can exist, although it remains to be seen which system would provide more stability in monetary policy, if a central bank guided system or free banking.

Another experience of money outside of the state at least regarding direct policy application are recent efforts in inflation targets as seen in countries like Germany, New Zealand and England among others. These countries have restricted or reduced the influence of the state in monetary policy. Governments still play a big part of the monetary framework and have the ability to infringe upon the central bank's independence so this cannot be viewed as a definite experience of money existing outside of the state but it could be thought of as a first step in getting the government out of the monetary system.

⁵ Chapters 3,4,9 in The Experience of Free Banking, Dowd (1992).

⁶Bank of England (2009), About the Bank of England: History, <http://www.bankofengland.co.uk/about/history/timeline.htm>

A Framework of Monetary Policy

What is lacking throughout the years in the discussion about monetary policy is a framework in which it can operate. It is conceivable that throughout the years the discussion of how should monetary policy be carried out and who should direct it has been a discussion of actions within a set of given rules and no discussion regarding the rules themselves. Rules should be the ones restricting the monetary system and how much discretion should be allowed as well as defining what system would be more adequate to direct monetary policy under a framework of clearly defined rules of the games. As Brennan and Buchanan suggest, economists have made proposals of monetary policy systems that totally ignore the working of politics, with the result that the ones finally adopted have often become perverted versions of the original suggestions.⁷ The authors mainly point to the Keynesian approach that has prevailed throughout the 20th century although it can also be said that it goes further than just an ideology. It can be asserted by the treatment of monetary policy as a whole by either taking government as a benevolent actor in the process of money creation and monetary policy as well as by not acknowledging the influence that it exerts in the system.

Meltzer (2003) also comments on this issue by evaluating monetary policy in a framework of government intervention in money. He suggests that institutions both shape the society of which they are part and adapt to the dominant views in that society. In his analysis of the early years of the Federal Reserve he suggest that although it was independent of the day to day political process, the public, acting through its representatives, could insist on structural changes or even without formally changing structures it could demand that the Federal Reserve undertake new responsibilities or give up old ones. The main conclusion he draws is that no institution can be independent of this pressure for change.

The importance of frameworks when dealing with government can be traced back to Madison (1788). He states that "In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself. A dependence on the people is, no doubt, the primary control on the government; but experience has taught mankind the necessity of auxiliary precautions"⁸. In this sense,

⁷ Brennan G., Buchanan J. (1981), "Monopoly in Money and Inflation", Hobart Paper 88, Pp. 19., Institute of Economic Affairs.

⁸ Madison J., The Federalist No. 51 The Structure of the Government Must Furnish the Proper Checks and Balances Between the Different Departments

monetary policy is one of the most important government interventions which in this sense require clearly defined rules in a constitutional setting, in which government would be constrained so as to exert minimal discretion or influence, if any, over monetary policy.

In the Constitution of Liberty, Hayek also raises the need for a monetary framework. He stated that some mechanical rule which aims at what is desirable in the long run and ties the hands of the authority in its short term decisions is likely to produce a better monetary policy than principles which give to the authorities more power and discretion and thereby makes them more subject to both political pressure and their own inclination to overestimate the urgency of the circumstances of the moment.

Milton Friedman⁹ also makes the case for a monetary framework suggesting that it should be implemented by the government and that it should operate under the rule of law rather than the discretionary authority of administrators. Although the former issue is a big source of debate, the latter provides the essence of the argument that monetary policy should be conducted under a clearly defined set of rules, what Buchanan would refer to as a monetary constitution.

Buchanan (1962) suggests that the most meaningful criterion for monetary policy, regardless of the level of discussion, is predictability in the value of the monetary unit or in the absolute level of prices. He goes on to emphasize that attainment of predictability, under any monetary framework, is more important than the means through which the goal is accomplished. He argues for a framework that would produce predictability in the value of money. A monetary system that would allow the “individual decision-maker, whether he be consumer, entrepreneur, seller of productive services, or speculator, to remove from his calculus uncertainty about the future course of the absolute price level”¹⁰. The result desired would be in terms of the value of money, or the absolute price level. The decision maker will still face uncertainty in his efforts to predict the future course of relative prices.

Instead of stability in monetary policy as suggested by Friedman’s k rule or the Taylor rule, Buchanan argues that “predictability instead of stability allows us to isolate problems and issues relating to the monetary constitution from those which introduce problems and issues concerned with the

⁹ Friedman M. (1948), A monetary and Fiscal Framework for Economic Stability.

¹⁰ Predictability: The Criterion of Monetary Constitutions. From In Search of a Monetary Constitution, ed. Yeager L. ,pp. 155-183. Cambridge: Harvard University Press.

efficacy of monetary policy in producing specific effects on the so-called macroeconomic variables.”¹¹ He goes on to argue that if predictability was ensured by a monetary framework or constitution, there wouldn’t be that big of a difference among alternative patterns of performance. He states that “there should be relatively little difference in the social costs of organizing a monetary system that would, for example, produce stability in the product price level, and a system that would produce a gradual increase, provided that the predictability was equivalent in the several cases.”¹²

Discretion VS. Policy rules

The need for a monetary framework stems from the important discussion in monetary policy on how the government’s role could be constrained or even dismissed. This has been a big problem in monetary policy as governments have used discretion instead of rule like behavior in managing money and have created many episodes of monetary crisis such as the great depression in the US or the history of hyperinflations encountered in different cultures and environments such as Europe, Africa and South America showing the true and definite impact of monetary policy in an economy. This section will present the discussion on monetary policy rules, their importance, and why they are preferable to discretion.

Why do we need rules in monetary policy? Buchanan and Brennan (1985) provide a clear argument for a general need of rules. “We require rules for living together for the simple reason that without them we would surely fight. We would fight because the object of desire of one individual would be claimed by another. Rules define the private spaces within each of us can carry on our own activities.”¹³ This is not different for monetary policy. Rules in monetary policy need to be clearly defined as to avoid discretionary policies that could ultimately infringe upon a person’s liberty to carry out his own activities. This infringement can come about in the form of higher inflation or higher taxes, both of which greatly constrain the activities that people carry out and are very much influenced by government policy. The following authors bring to the table a clear understanding to the debate of rules vs. discretion in the context of monetary policy.

One of the most compelling arguments for rules is put forth by Kydland and Prescott (1977). They assert that with the precondition of understanding the business cycle, the implication of their analysis is

¹¹ Predictability: The Criterion of Monetary Constitutions. “In Search of a Monetary Constitution”, ed. Yeager L. ,pp. 155-183. Cambridge: Harvard University Press.

¹² Ibid.

¹³ The Reason of Rules, pp.5

that policy makers would follow rules rather than discretion. The reason for this is that discretion implies selecting the decision which is best, given the current situation. Such behavior would result in suboptimal planning or economic instability due to the dynamic nature of economic systems and the weight that economic agents put in their future expectations of policy actions and not only on past and current actions. Given that issue, which policy should be optimally selected? Kydland and Prescott propose that economic theory be used to evaluate alternative policy rules and that one with good operating characteristics be selected. Rules are preferred to be simple and easily understood, so that it's clear when a policymaker gets off track. Institutional arrangements can be made to change policy rules although the authors state it might be costly. However, in the context of this paper they propose that one possible arrangement would be "for Congress to legislate monetary and fiscal policy rules and these rules to become effective only after a 2-year delay. This would make discretionary policy all but impossible".(Kydland and Prescott, 1977)

Following this logic Taylor (1993) states that time inconsistency demonstrates that policy rules are superior to discretion. Hence, it is important to preserve the concept of a policy rule even in an environment where it is practically impossible to follow mechanically the algebraic formulas economists write down to describe their preferred policy rules. According to Taylor (1993) a policy rule is a contingency plan that lasts forever unless there is an explicit cancellation clause. The important thing to have in mind is that if a policy rule is to have any meaning, it must be in place for a reasonably long period of time even though it might not last forever. It is important for policymakers to make a long commitment to stay with the rule if they are to gain the advantages of credibility associated with a rule. Credibility and transparency have long been associated with predictability in monetary policy (Blattner et.al, 2008). Taylor states that "if economic analysis is to predict how the economy will perform with a policy rule, some durability of the rule is obviously required"¹⁴.

Henry Simons (1936) once said that the problem is "that of defining an adequate monetary system based on simple rules and of finding the way toward such a system."¹⁵ He went on to elaborate that monetary rules must be compatible with the reasonably smooth working of the system and that it is essential that enterprisers and investors have a minimal level of uncertainty regarding monetary conditions in the future. This relates to what Buchanan refers to as predictability which was explained in the first part of this paper. Simons also states that "the most important objective of a sound liberal

¹⁴ Discretion versus Policy Rules in practice, pp 199

¹⁵ Rules versus authorities in monetary policy, pp 4

policy..... should be that of securing a monetary system governed by definite rule” and although he favors a money growth rule rather than a price index rule he acknowledges that a monetary rule of maintaining a constant price index seems to provide an escape from present monetary chaos and uncertainties. He was referring to the monetary context in his own time, however, this statement could apply to the current economic context in which monetary policy is not being conducted soundly.

Barro (1986) studies the developments in rules versus discretion. He discusses rules in monetary policy as “regimes where the policymaker can and does make commitments about future monetary growth and inflation”¹⁶. He states that if the commitment is credible then people would anticipate low inflation. The result he finds when discussing these types of rules would support according to him a form of 'constant-growth-rate rule', although he would rather see it applied to prices rather than to the quantity of money. Barro says that the enforcement power behind the low-inflation rule is crucial and that a mechanism for binding the policymaker's hands in advance should be put in place. In this way, high inflation cannot be generated later, even if such a choice looks good to everyone ex post. This directly relates to the essence of an inflation contract in the context of inflation targeting, binding the monetary authority's hands to the inflation announcement, an aspect which also reduces the government's ability to influence the monetary system. Barro makes an emphasis in noting that the rationale for the 'binding of hands' “applies even though (or actually especially if) the policymaker is well-meaning”.¹⁷This notion directly relates to Madison (1776) and the necessity of rules, specifically because men are not angels and there is a need to oblige the authority to control itself.

For reasons already suggested in previous sections of this paper Buchanan's (1962) suggestion is a monetary constitution which entails a constitutional rule that will be able to provide predictability, making it a long term commitment which entails a bigger time horizon constraining discretionary measures. A monetary constitution is of the essence to bind the monetary authority's hands and more importantly to this paper, to restrict or diminish the influence of the government in the monetary system.

¹⁶ Recent Developments in the theory of rules versus discretion, pp 27

¹⁷ Recent Developments in the theory of rules versus discretion, pp 27

What monetary policy can and can't do

In defining the relationship between money and the state there is a need to define exactly what it is that monetary policy can or cannot achieve to better understand the role that the state could have in it, if any. Friedman (1968) defines the role of monetary policy in two terms. The things that monetary policy can achieve and the things it cannot. The things that he suggests monetary policy cannot do are first, peg the interest rates for more than very limited periods and second, cannot peg the rate of unemployment for more than very limited periods. Friedman goes into explaining why these variables cannot be influenced by monetary policy on longer periods of time, but this does not fall into the scope of this paper. The important issue to discuss is that this substantially limits the role that a central bank or any other monetary institution for that matter, should have in the economy. Thus, Friedman provides the two aspects of what monetary policy can do. First, monetary policy “can prevent money itself from being a major source of economic disturbance.”¹⁸ This serves as to prevent mistakes by the monetary authorities. Friedman refers to episodes in monetary history in which this aspect has played a major role. A second subject monetary policy can influence, which is more relevant to the present discussion, is to provide a stable background for the economy. He goes on to say that “Our economic system will work best when producers and consumers, employers and employees, can proceed with full confidence that the average level of prices will behave in a known way in the future-preferably that it will be highly stable.”¹⁹ This aspect of stability can be seen more of a call for predictability in which stability will later follow. Extending the analysis, a monetary constitution could provide the conditions under which predictability and stability are carried out in monetary policy. These roles reduce the scope in which monetary policy needs to operate.

¹⁸ The Role of Monetary Policy, pp.12

¹⁹ The Role of Monetary Policy, pp.13

Conclusion

When discussing the influence of the Bank of England, Bagehot (1893) proclaimed that a monetary system and framework that is so engrained in the habits of men cannot be altered just because theorists disapprove of it and books are written against it. A significant reform that requires a vast reconstruction cannot be found adequate, so it is therefore useless proposing it. A dependence on such a banking system, would not allow for any big reforms.

It has become clear throughout this essay the money can exist out of state and that the state is one of the main contributors to the instability of the system, though ironically it's the one that advocates more economic stability. This paper presented the relationship between money and the state, the role that the government should have in monetary policy as well as proposing more of a rule like behavior in a monetary framework. The question now becomes if money outside of the state will ever exist? Is it possible to make significant reforms to the system which will allow monetary policy to become more predictable and less discretionary? Is the future of monetary policy research going to be able to prove Bagehot wrong and significant changes will occur? Only time will tell, for now, I will close this essay by offering some words of hope from James Buchanan:

“.....persons are neither bees in hives, carnivorous beasts in a jungle, nor angels in God's heaven. They are independent units of consciousness, capable of assigning values to alternatives, and capable of choosing and acting in accordance with these values. It is both physically necessary and beneficial that they live together, in many and varying associations and communities. But to do so, they must live by rules that they can also choose”²⁰.

²⁰ The Domain of Constitutional Economics, The Logical Foundations of Constitutional Liberty, p.395

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