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## PREPARING FOR THE POST-VOLCKER ERA AT THE FED

David I. Fand  
John M. Olin Fellow

### INTRODUCTION

The U.S. seems to have licked inflation--or has it? In testimony before the Joint Economic Committee of Congress recently, Council of Economic Advisors Chairman Beryl Sprinkel warned that the money supply has been growing at more than a 13 percent rate this year and poses a "serious risk to inflation control." Sprinkel pressed the Federal Reserve Board to "pursue a risk-minimizing policy path" to avoid the danger of economic suspicion caused by erratic monetary policy.

Sprinkel's testimony raised once again the question that haunts policy makers: Will monetary policy torpedo U.S. economic expansion? The answer could turn on the policies of Paul Volcker, Chairman of the Board of Governors of the Federal Reserve.

Volcker's term as chairman will end in two years, and there are some expectations that he will step down before then.

If Volcker leaves the Fed, Ronald Reagan will have the opportunity to nominate a new chairman to the Board of Governors of the Federal Reserve system. This is a very significant appointment. The Fed Chairman is viewed by many experts as the second most important economic policy maker in the country. From almost any monetary policy perspective, the Fed chairman plays an extremely important role in shaping U.S. economic policy. As such, the choice of a new chairman should be preceded by a thorough assessment of monetary strategy and a frank appraisal of the Volcker tenure. Such a review indicates strongly that recent reductions in the rate of inflation mask years of dangerous monetary drift that must be ended. Without a change of course at the Fed, the U.S. economy could be headed for a severe crisis.

## THE VOLCKER YEARS

Paul Volcker was appointed Chairman of the Federal Reserve Board in 1979 by President Jimmy Carter.

Inflation was rising at an 8.6 percent rate in 1979, at a 3.8 percent rate in 1984, and at a 3.7 percent rate for the four quarters ending on June 30, 1985. Productivity was declining at a 1.2 percent rate in 1979. It grew at a 3.2 percent rate in 1984, and has moved down to a mere 0.1 percent rate in 1985. The unemployment rate was 5.8 percent in 1979, 7.2 percent in 1984, and it is running at approximately 7.5 percent for 1985.

There has been a significant rise in the value of the dollar since 1979. It averaged 1.83 West German marks in 1979, 2.85 in 1984, and 3.2 in 1985, and rose from an average of 1.66 Swiss francs in 1979 to 2.70 by 1985. This extraordinary increase in the dollar's value since 1979 is dramatic evidence of the growing confidence of foreigners in the American economy.

Such figures point to an excellent performance on inflation but mixed results for the productivity and employment variables. And the extreme contrast between the GNP and productivity results for 1984 and for 1985 illustrate the extraordinary economic variability in the Volcker years. These fluctuations can be traced in part to Fed policies that have contributed to economic instability.

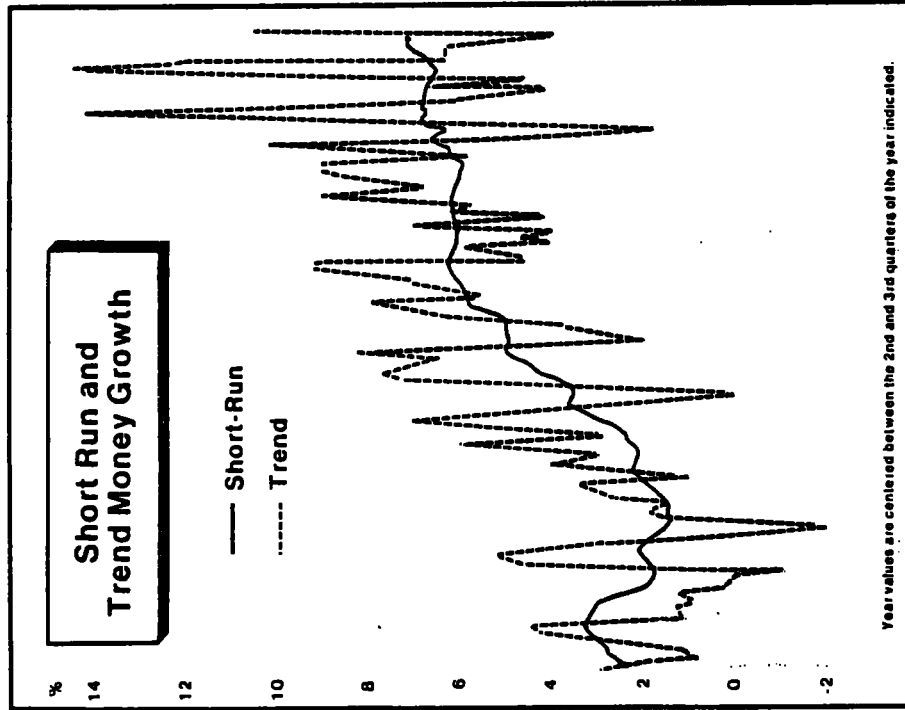
## MONEY GROWTH AND INTEREST RATE VARIABILITY

The money growth rate in the Volcker years has averaged 7.9 percent annually--somewhat above the 6.7 percent average for the preceding six-year period. Yet the variability of money growth around that average (as measured by the standard deviation) has been almost twice as high as the next highest period, which was during the 1940s.

To illustrate the extreme money growth variability since 1979, Chart I compares the money growth rate on a six-month basis with the five-year trend of the money growth rate. As the chart demonstrates, money growth variability under Volcker has been far higher than under previous Fed chairmen.

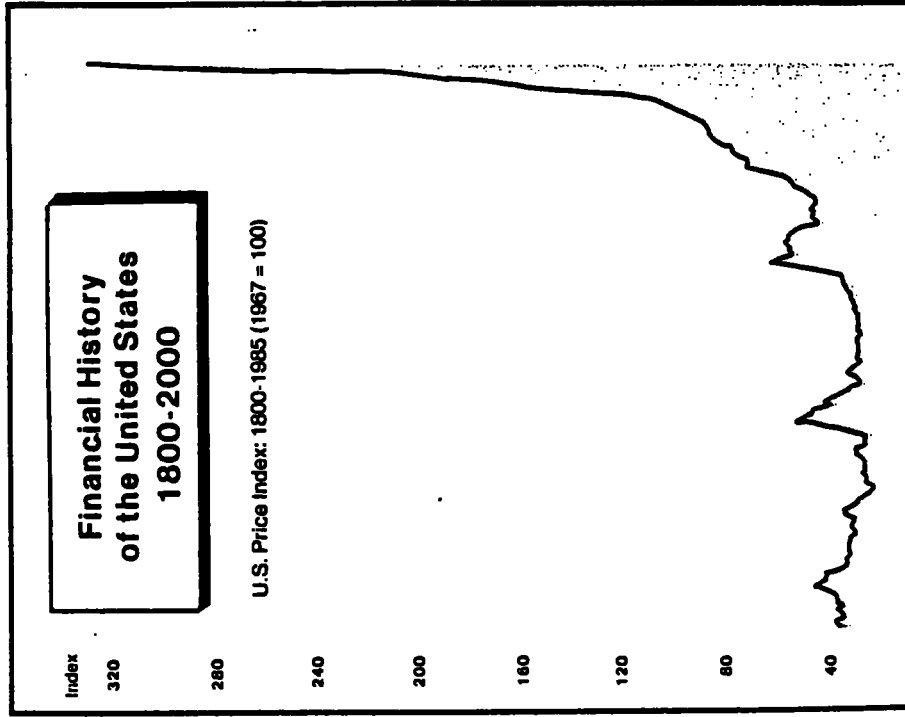
Given this money growth volatility and the link between money and the tangible economy, it is no surprise that output and employment have also swung wildly during the Volcker years. The unemployment rate moved up almost 5 full points in three years, from a 5.7 percent rate in 1979 (second quarters) to a 10.6 percent rate in 1982 (fourth quarters). GNP growth and productivity, as noted earlier, have also experienced wide fluctuations under Volcker. In two years, the U.S. moved from a famine 3 percent decline in real GNP between 1981 to 1982 (third quarters) to a superfeast 8 percent growth between 1983 and 1984 (first

CHART I



Source: Jack Falam, Assistant Vice President, Federal Reserve Bank of St. Louis

CHART II



Graphs by Karen Fortik for Policy Review.

Source: Manhattan Report 1994, Vol. 4 #3

quarters). Only in 1958 to 1959 (second quarters) was there a higher yearly growth rate of 8.4 percent; and in 1974 to 1975 (first quarters), the oil shock period, GNP declined at a 3.9 percent rate. The only recent period that can be compared to the fluctuations in real GNP growth rate for the five-year period 1980 to 1985 (first quarters) was the 1970 to 1975 period, when the first oil shocks occurred.

## MONEY AND THE PERFORMANCE OF THE ECONOMY

While this correlation between monetary volatility and economic instability cannot be disputed, many would argue that it is by no means clear that there is a causal connection. They point out, correctly, that logically some other factor may be responsible for both phenomena. Yet examining relationships in the economy leads to an inescapable conclusion. The extreme variability in money growth in the Volcker years led to very sharp movements in interest rates, employment, and real GNP, imposing a severe and costly burden on the private sector and reducing output and employment.

To reach this conclusion, it is helpful to examine the following developments: the large budget deficit; the addiction of policy makers to fine tuning and crisis management; and the change to fiat money in 1971.

### Deficits and the Economy

The current federal deficit of approximately \$200 billion is a little more than 5 percent of the GNP. This is very high by historical standards. As shown in Table I, during the past 65 years deficits typically have averaged about 1 percent of the GNP. Yet many of the predicted negative economic effects of large budget deficits have simply not materialized. Deficits were expected to increase inflation; in fact, inflation has been reduced by about two-thirds since 1980. Deficits were expected to increase interest rates; in fact, interest rates are now less than half of their peak level since 1981. And deficits were expected to weaken investment and thereby weaken the recovery; in fact, real business investment in the current recovery has been stronger than in the average recovery.

Despite the widespread and longstanding concern about the magnitude of the federal budget deficit, its effects on the economy have been surprisingly difficult to observe. The deficit is certainly a serious problem. It increases future interest payments that must be financed by reducing future noninterest expenditures or increasing taxes. And it may have other undesirable effects. But it seems not to be a fatal disease. Perhaps too much attention has been given the deficit by Volcker and others compared with two other, far more serious problems that threaten to undermine this monetary system.

Table I

Federal Expenditures, Receipts, and Deficits as  
a Share of the GNP  
Selected Years, 1929-1984

Years	In Percentages of GNP		
	Expenditures	Receipts	Deficits
1929	2.5	3.7	-1.2
1939	9.8	7.4	2.4
1949	16.0	15.0	1.0
1959	18.6	18.4	0.2
1969	20.0	20.9	-0.9
1979	21.1	20.4	0.7
1984	24.0	19.2	4.8

Source: Economic Report of the President for 1985, p. 66.

Crisis Management and Fine Tuning: Highly Variable, Volatile,  
and Uncertain Monetary Policies

During the Volcker years, quarterly money growth moved 21 percentage points in 1980 (from -4 percent to 17 percent), 14 percentage points in 1982 (from 3 percent to 17 percent) and 15 percentage points in 1983-1984 (from 18 percent to 3 percent). In contrast, in the six years before Volcker, the swing from the lowest quarterly money growth rate to the highest was 8 percentage points. Money growth has been more volatile since 1979 than in the previous 27 years.

What are the implications of such monetary seesawing? Theory and evidence indicate that sharp swings in money growth affect output and employment in the short run. Interest rates also are linked to money growth because a rise in money growth variability has a significant and positive relation to interest rate variability.<sup>1</sup> Recent studies suggest that the increase in variability of money and interest rates in the early 1980s, which

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<sup>1</sup> John A. Tatom, "Interest Rate Variability: Its Link to the Variability of Money Growth and Economic Performance," Federal Reserve Bank of St. Louis Review, November 1984; Z. Bodie, A. Kane, R. McDonald, "Why Are Interest Rates So High?," NBER Working Paper No. 1141, June 1983; M. Gertler and Earl Grinois, "Monetary Randomness and Investment," Journal of Monetary Economics, September 1982.

exacerbated monetary uncertainty, reduced output and employment and first raised, then lowered, the rate of inflation.<sup>2</sup>

The interest rate variability during the Volcker years helps explain the severity of the 1981-1982 recession and the swings in inflation from 1980 to 1983. Inflation was first pushed up temporarily in 1980-1981, then down in 1982-1983, due to the volatility of changes in interest rates.

Federal Reserve policy in the Volcker years has developed into an addiction to money growth variability and to fine tuning--concentrating almost exclusively on immediate problems to the relative neglect of overall future policy. Moreover, the roller-coaster Fed policy has become an additional source of uncertainty for business managers--many businesses hire "Fed watchers" at substantial salaries to interpret what the Fed is doing. This prompts business executives to worry not only about their competitors and their customers, but also about what the Fed may do next. This wastes valuable resources and dampens business confidence by introducing an additional risk. Needed instead is a monetary system that provides a stable monetary framework and stable prices, so that monetary policy ceases to be an additional significant source of instability and uncertainty.

#### Fiat Money Since 1971

Inflation started to turn upward almost two decades ago, and it accelerated sharply starting in 1971. It rose from a 1.6 percent rate in 1953-1965 to a 4.1 percent rate in 1965-1971, and then accelerated to an average 7.5 percent rate in the period 1971-1985, with many years in the double digit range.

Before 1971, the dollar and most other currencies were backed by gold or silver. Money stock growth was limited by law or other conventions. In 1971, however, the United States adopted inconvertible or "fiat" money, meaning that the major currencies in the international monetary system were no longer backed by anything tangible.

This lack of an anchor for currency makes the outlook for the long-term price level extremely uncertain. Already the era of fiat money has had a profound effect on prices. The 1939 price level in Great Britain, for instance, was essentially the

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<sup>2</sup> Paul Evans, "The Effect on Output of Money Growth and Interest Rate Variability in the United States," Journal of Political Economy, April 1984; John A. Tatom, "Interest Rate Variability and Output, Further Evidence," Federal Reserve Bank of St. Louis, Working Paper No. 84-016; A. Vevany and Thomas Saving, "The Economics of Quality," Journal of Political Economy, December 1983; and A. Mascaro and A. H. Meltzer, "Long and Short Term Interest Rates in a Risky World," Journal of Monetary Economics, November 1983.

same as it was in 1739. As Chart II indicates, the 1939 price level in the United States was very similar to that in 1800. But from 1939 to 1985, the price level rose by a factor of 8 in the United States, and it leaped 20-fold in Great Britain. Such a dramatic and sustained increase in the price level has not been seen for 200 years; it is a very drastic change in the world's monetary environment.<sup>3</sup>

The acceleration in inflation since 1971 demonstrates the need for an anchor restricting money growth if the U.S. is to achieve a stable monetary framework, and with it stable long-term prices. If there are no restraints on money growth price stability and predictability will remain uncertain. It is not at all clear that fiat money can achieve stability; the historical evidence is not reassuring.

Even the recent decline in inflation does not inspire confidence. This success has come in the face of the step-up in money growth during the Volcker years. Accordingly, it is quite possible that the country's recent disinflation merely reflects the strong dollar, the drop in oil prices, the deceleration in the velocity of circulation, and other favorable factors which temporarily are keeping inflation below what it may become later. There is little reason to assume that inflation has been licked. Indeed, a 4.5 percent inflation rate is not low; it is historically very high. It would produce an 8-fold increase in prices in 45 years, the same that occurred between 1940 and 1985.

The U.S. economy needs some system, arrangement, or device that will limit the quantity of money that governments can issue to keep inflation well under control. This problem is even more serious now that America faces \$200 billion budget deficits. The government may be tempted to monetize the deficit by an "inflation tax" on cash balances, by reducing the real value of outstanding government debt, or by reinstating bracket creep into the income tax.

#### APPROACHES TO MONETARY POLICY

Two basic philosophic approaches characterize the debate over strategies for monetary policy. One approach emphasizes the constitutional limits of monetary policy, while the other concentrates on short-term managerial aspects. The first highlights the rules and guidelines to determine monetary policy; the other, the authorities and their powers to manage policy.

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<sup>3</sup> See Milton Friedman, "Resource Costs of an Irredeemable Currency," forthcoming in the Journal of Political Economy.

## Rules Rather Than Authorities

In a famous 1936 essay, "Rules vs. Authorities in Monetary Policy," University of Chicago economist Henry Simons, founder of the Chicago School, discussed the threats to a market economy. He focused particularly on the danger of substituting authorities for rules in monetary policy. Wrote Simons:

An enterprise system cannot function effectively in the face of extreme uncertainty as to the action of monetary authorities or, for that matter, as to monetary legislation. We must avoid a situation where every business venture becomes largely a speculation on the future of monetary policy. In our search for solutions to this problem, however, we seem largely to have lost sight of this essential point, namely, that definite, stable, legislative rules of the game as to money are of paramount importance to the survival of a system based on freedom of enterprise.<sup>4</sup>

In this essay, Simons favored a monetary system based on constitutional rules to eliminate managerial discretion, fine tuning, crisis management, and the resultant uncertainty.<sup>5</sup> A growing number of economists today would agree that the health and long-run viability of a market economy require a constitutional approach to money.

## The Random Walk Monetary Standard

In sharp contrast to the constitutional monetary regime favored by Simons is the managerial approach, based on discretion, fine tuning, and crisis management. This approach leads to a monetary regime that UCLA economist Axel Leijonhufvud calls the "random walk monetary standard." He writes:

Under this standard the authorities, that is the monetary authorities, decide one period at a time whether to accelerate or to keep constant or to decelerate the rate of money growth. Only current economic conditions and immediate political pressures enter into this decision. Future money growth rates are left to the future. Nobody thinks about them today. Whoever will be in charge when the time comes will accelerate or decelerate as he or they see fit. The only rule that governs this process is that in each point in time, those who are in charge choose what seems to be the

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<sup>4</sup> "Rules vs. Authorities in Monetary Policy," Journal of Political Economy, 1936.

<sup>5</sup> Henry Simons favored a monetary regime that eliminated fractional reserve banking. He argued that a banking system based on 100 percent reserves would prevent sharp and erratic changes in the money stock.



most convenient and expedient thing to do at that point.... There is no scientific or rational way for the private sector to forecast future price levels in this system that we have allowed to develop.

Yet in an economy, a market economy such as ours, people are forced to bet on the price level ten years hence, all the time, whether or not there is a rational way to forecast it.<sup>6</sup>

Experience shows that a monetary regime based on the rule of authorities and operating under the random walk monetary standard will undermine the market economy, which is based on contractual arrangements, and lead to monetary anarchy.

#### WHY THE RANDOM WALK MONETARY STANDARD MEANS ANARCHY

The Federal Reserve's propensity for fine tuning and crisis management, together with the change to fiat money in 1971, has left the U.S. with volatile and highly variable money growth, high inflation, and super high interest rates. It has had a destructive impact on U.S. institutions and attitudes.

First, rampant uncertainty means that markets for long-term financial instruments tend to disappear. It is difficult to allocate resources efficiently during inflationary periods. The result is that productivity and capital accumulation suffer.

Second, economic success depends more on the ability to forecast and hedge against inflation than on efficiency and competitiveness. Guessing inflation correctly becomes the road to success for many Americans. An entire population, of course, cannot all improve their living standards by playing this inflation game.

Third, contracting ceases to be a reliable mechanism for reducing the risks of long-term ventures in such an inflationary environment. Political lobbying often becomes a substitute strategy, as some seek to attain by public compulsion what private cooperation has failed to achieve. Because inflation and fluctuations make outcomes less equitable, legislators are swamped by demands to control prices and rents, to regulate business, to tax some and to subsidize others. Ultimately, the political system loses legitimacy, and constitutional constraints on government will be demanded to end the monetary anarchy.

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<sup>6</sup> Axel Leijonhufvud, "Constitutional Constraints on the Monetary Powers of Government," in Richard B. McKenzie, ed., Constitutional Economics (Lexington, Massachusetts: D. C. Heath and Co., 1984).

## A CONSTITUTIONAL APPROACH TO MONETARY POLICY

A number of economic schools of thought reinforce the notion that it would be desirable to change the emphasis in U.S. monetary policy from a managerial to a constitutional approach.<sup>7</sup> The theory of "public choice," developed under the leadership of George Mason University professors James Buchanan, Gordon Tullock, and others, views civil servants and legislators as pursuing their own interests. While these perceived interests may, of course, include concern for the public interest, as well as the needs of their agency, public choice research on the determinants of government behavior suggests that the existing incentive structure does not adequately protect the public interest. Not surprisingly, public choice theory strongly favors a constitutional approach to money.<sup>8</sup>

The "rational expectations" school of academic economists, however, concludes that the public quickly learns what effects a government policy will have and takes action to anticipate it. Thus the public is seen to make rational decisions according to its expectations of the future. This school stresses the importance of a monetary rule that stabilizes expectations associated with monetary policy.<sup>9</sup>

The Austrian school, especially F. A. Hayek and Ludwig von Mises, raises very serious doubts as to whether the government is ever likely to play a constructive role in managing fiat money. The Austrians favor an automatic commodity standard such as gold or a monetary system that relies on a competitive privately produced money.

Empirical evidence supports the conclusions of these theories. America's experience with relying on the Fed to pursue monetary targets lends support to a constitutional approach. In 1975, for instance, Congress required the Federal Reserve to specify monetary targets and to abide by them. But money growth has been more variable and more erratic in these ten years than it was in earlier periods when there was no such target. The divergence between the target and the actual growth in the U.S. is extraordinary when compared with experience in other countries. And it raises serious doubts as to whether the Federal Reserve Board, under its current leadership, will follow a monetary rule or even monetary guidelines.<sup>10</sup>

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<sup>7</sup> See Milton Friedman and Anna J. Schwartz, "Has Government Any Role in Money?" forthcoming in Journal of Monetary Economics.

<sup>8</sup> See J. Buchanan, R. Tollison and G. Tullock, "Theory of Public Choice," University of Michigan, 1984.

<sup>9</sup> Robert J. Barro, Macroeconomics (New York: John Wiley and Sons, 1985), pp. 459-486.

<sup>10</sup> David I. Fand, "The Monetary Policy of the Federal Reserve," in C. Campbell and W. Dugan, Alternative Monetary Systems, Johns Hopkins Press, forthcoming.

Finally, extensive financial deregulation, which has increased the complexity of the monetary system, also suggests a move toward a constitutional approach. Some financial innovations are due to technological advances, while others are due to a looser regulatory environment. To accommodate such changes, the economy needs a monetary regime that can deal constructively with new technologies.

There is growing interest now in seeking ways of changing America's highly volatile and highly inflationary monetary system to one that is more compatible with stable prices and long-term price predictability. Support for a constitutional approach to money is growing. Restructuring the system according to such a model would be a desirable and constructive change in America's monetary system.<sup>11</sup>

#### IS A CONSTITUTIONAL APPROACH VIABLE? A COMPARISON OF FOUR COUNTRIES

To assess the prospects for a constitutional approach in the United States, it is helpful to compare actual money growth in the United States to that of West Germany, Japan, and Switzerland for the period 1978 to 1984, as measured against the money growth targets set by the central bank in each case. These three countries have committed themselves to constrain monetary growth to conform to the money targets.

For the U.S., the record is poor. As shown in Table II, the Fed missed its targets in five of the six years. In four of those five years, the growth in the money, or M1,<sup>12</sup> was considerably above the target. Indeed, M1 growth in one period was three points above the upper range of the target. The Fed missed the target in every single year during the period, except the last.

The West German record is quite different. Except for one period, the West Germans hit their target each year. And in the one period where they missed the target, 1980 to 1981 (fourth quarters), the actual rate of 3.1 percent was only slightly lower than the lower range of 4 percent.

The Japanese record is the most impressive--all the more because the Japanese do not target a range, but set an exact number. They have come very close to these precise targets. The

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<sup>11</sup> See Carl Christ, "Rules Versus Disgression in Monetary Policy," The Cato Journal, Spring 1983; Milton Friedman, "Monetary Policy in a Fiat World," Monetary and Economic Studies, Bank of Japan, forthcoming; and Friedman and Schwartz, op. cit.

<sup>12</sup> The monetary stock in the United States is defined as the sum of currency held by the nonbank public, demand deposits, other checkable deposits, and travelers checks.

Table II  
Rate of Money Growth in Four Countries (in percentages)

Dates (in quarters)	U.S. M1 Target	U.S. M1 Actual	Denmark Target	Denmark Actual	Japan M2 Target	Japan M2 Actual	Swiss Monetary Base Target	Swiss Monetar Base Actual
78(4)-79(4)	3-6	7.5	6-9	5.6	11	11	--	6.8
79(4)-80(4)	M1B 4-6.5	7.3	5-8	5.6	10	7.8	4	-7.0
80(4)-81(4)	M1B 6-8.5	5	4-7	3.1	10	10.4	4	-0.5
81(4)-82(4)	2.5-5.5	8.5	4-7	5.9	8	7.8	3	2.6
82(4)-83(4)	5-9	10.4	4-7	6.8	7	7.5	3	3.6
83(4)-84(4)	4-8	5.2	4-6	4.6	8	7.7	3	2.6

Source: IMF Statistics

only period where there was a considerable gap was in 1979 to 1981 (fourth quarters), when the target was 10 percent growth, and the central bank achieved a 7.8 growth rate. In almost every other period, the actual rate is almost exactly or very close to the targeted number.<sup>13</sup>

In the Swiss case, the actual money growth rates have been close to the targeted numbers since 1981. Before then, the Swiss were attempting to stabilize the value of the Swiss franc relative to other currencies, causing Swiss money growth rates to fluctuate widely. Since 1981, however, money growth rates have been very close to the targets.

This record suggests that in Japan, West Germany, and Switzerland, the central banks take their money growth targets seriously and are able to achieve their targets, while in the U.S., the Fed consistently misses its targets and by wide margins. If other countries can hit their money growth targets, the Fed should be able to do so as well. This would require a clear commitment by the Fed.

<sup>13</sup> A. H. Meltzer, "Variability of Prices, Output and Money, under Fixed and Fluctuating Exchange Rates: An Empirical Study of Monetary Regimes in Japan and the U.S.," in Bank of Japan Monetary and Economic Studies, forthcoming.

## REFORMING U.S. MONETARY POLICY

Economic performance during the Volcker years has been mixed. The output, employment, and productivity results are spotty and uneven; the inflation results--thus far--are good.

There is little dispute that Volcker has proved to be an extremely able crisis manager. The manner in which he dealt with the Hunt Silver Crisis, the Penn Square collapse, the Mexico debt problem, the Continental Bank problem, and the recent Ohio and Maryland savings and loan difficulties has been impressive--at least for the time being. But the basic function of the Federal Reserve System is to provide the U.S. with a stable currency, a stable value of money, and long-term price predictability. Judged against this objective, the Federal Reserve System under Volcker must be considered a failure.

The inflationary developments in the last two decades, and especially in the last 15 years, go beyond anything seen in the prior two or three centuries. Institutions built up during those years of relative price stability are beginning to crumble and erode. And Americans who no longer can depend on long-term contracts have sought increasingly to resort to the political process instead for economic security.

The U.S. was facing very serious problems before Volcker came to office in 1979. But he has not devoted his great talents to fashion the stable monetary framework that would lead to stable money, stable prices, and stable expectations. Such a framework is critical to the structural health of the U.S. economic system.<sup>14</sup>

## RULES TO DETERMINE THE MONETARY BASE

A possible solution to the policy vacuum would be to move to a commodity money such as a gold standard. This would work effectively only if politicians, the public, and bankers were prepared to accept the necessary discipline. An automatic monetary regime based on gold would remove the political elements from the monetary process. This is a very desirable objective. If the public proved ready to accept the constraints of an automatic commodity standard, it could provide the discipline currently lacking in monetary policy.<sup>15</sup>

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<sup>14</sup> See M. D. Bordo and A. J. Schwartz, "The Importance of Stable Money: Theory and Evidence," The Cato Journal, vol. 3, 1983.

<sup>15</sup> See Robert A. Mundell, A. Reynolds, J. Salerno, A. Kafka, et al. in The Cato Journal, vol. 3, 1983.

An alternative would be to freeze the monetary base after a transition period of several years.<sup>16</sup> This would mean that the sum of currency plus bank reserves would be held constant. Once the monetary base were frozen, the Federal Reserve no longer would be able to vary the quantity of reserves it supplied to the banking system, and there would be an end to volatile fluctuation in both money growth and interest rates.

The monetary base could be frozen in various ways. For example, the U.S. could freeze its monetary base and make no provision for any further increase in "hand-to-hand" currency (used for everyday purchases). Alternatively, the monetary base could be frozen, but banks might be permitted to issue bank notes redeemable in monetary base or in some valuable commodity, such as gold, or anything else that the public would accept. These bank notes would be used as hand-to-hand currency and serve as a means of payment. This would provide a fixed quantity of (government-produced) money as the base for a competitively produced supply of (privately produced) money that would meet the needs of business.<sup>17</sup>

If moving to a commodity standard or freezing the monetary base seemed too radical for policy makers to contemplate, they might consider other monetary regimes. They could introduce a monetary structure based on some other form of rule, such as a specific growth in the quantity of base money (a "quantity" rule) or a supply of money determined by the price movements of a specified commodity or group of commodities (a "price" rule).

The essential point in each of these options, however, is that monetary policy would be predictable, and it would conform to a rule--not to the discretion of the Fed.<sup>18</sup>

## CONCLUSION

The U.S. must free itself from the addiction to fine tuning and crisis management and limit the quantity of fiat money that can be printed. The country needs a monetary system that gives the public confidence in the future--especially that the Fed will

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<sup>16</sup> See Milton Friedman, "Monetary Policy for the 1980's," in J. H. Moore, ed., To Promote Prosperity (Stanford, California: Hoover Institution Press, 1984).

<sup>17</sup> See L. H. White, Free Banking in Britain (Cambridge, Massachusetts: Cambridge University Press, 1984); "Competitive Money Inside and Out," in The Cato Journal (previously cited), and L. B. Yeager, "Stable Money and Free Market Currencies," in The Cato Journal (previously cited).

<sup>19</sup> See Meltzer, "Monetary Reform...", op. cit.

not simply print money to cover burgeoning deficits. There is widespread agreement that the U.S. should pursue this goal, but it has not been translated into a general agreement on the appropriate monetary regime that should be constructed.

Accordingly, the Fed, the Congress, and the Administration should develop a "statement of intent" on the need for a more stable monetary framework. A monetary policy consistent with this statement should then be designed and implemented. Given the extreme volatility of recent years, a tough monetary rule has great appeal.<sup>19</sup> But it should be noted that Nobel economist Milton Friedman, who first proposed this 25 years ago, recently concluded that the Federal Reserve bureaucracy simply will not follow any rule that limits its ability to manipulate the quantity of money, if they have the power to vary the monetary base.<sup>20</sup> According to Friedman, it would be better to have a rigid freeze on the monetary base, despite the theoretical disadvantages of such a rule, than to entrust the Fed with any rule that involves changes in the monetary base.

If Friedman is correct, the Administration should begin to build support for a freeze. And it should do so quickly. Monetary policy has taken a back seat to taxes and spending in recent years. The evidence suggests that, unless it receives immediate attention, the economic future of the U.S. could be threatened.

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<sup>19</sup> See Milton Friedman, A Program for Monetary Stability (Fordham University Press, 1959).

<sup>20</sup> See Milton Friedman, "Monetary Policy in the 1980's," op. cit.