

Policy Failures of the Federal Reserve System and a Proposed Competitive Money System

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Between 1995 and 2001, the U.S. economy experienced a wrenching boom-bust cycle spawned in part by the Federal Reserve System. This paper briefly reviews the actions of the Fed that led to the boom-bust cycle, utilizing Austrian business cycle theory. Next, this paper sets forth an approach that would introduce a private competitive money system based upon a concept suggested by F.A. Hayek.

Key Words: Federal Reserve, competitive money, boom-bust cycle, Austrian economics.

The Fed and the Boom-Bust Cycle

The Federal Reserve (Fed) set off the most recent boom-bust cycle in 1995 by accelerating the creation of “high-powered” money (the monetary base) from a rate of increase of about 2% annually to a peak of over 15% annually by the end of 1999. The monetary base is called high-powered money because it is the basis for bank reserves that are used to create loans or investments in government bonds. Whenever the Fed increases bank reserves through open market purchases of Treasury securities, the nation’s money supply is increased. For instance, the monetary base increased at an average annual rate of over 7% between 1997 and 2000.

During this period the broad measure of money increased dramatically to 11% annual rate for MZM (readily spendable money); and narrowly defined money (M1) increased at 7% annually, matching the growth rate of the money base. What the U.S. economy experienced during this period was a financial-market inflationary bubble, in which the stock market soared to astronomical heights. This sparked a surge in consumer spending and a resulting capital investment boom. Then in March 2001 there was a sharp downturn in the growth of economic

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activity, leading to a decline in business investing. (Anderson, et al, 2003)

Austrian economic theory provides the explanation of this boom-bust cycle. Simply stated, the theory describes how attempts by the Fed to artificially stimulate monetary growth through money and credit creation leads to unsustainable increase in investment spending by businesses. Eventually, this malinvestment becomes unstable and the subsequent bust occurs.

Ludwig von Mises in *Human Action*, summarizes the inflation-induced boom-bust cycle, stating:

“The boom is called good business, prosperity and upswing. Its unavoidable aftermath, the readjustment of conditions to the real data of the market, is called crisis, slump, bad business, depression. People rebel against the . . . malinvestment and the over consumption of the boom period.” Mises (1966)

Murray Rothbard in his *Man, Economy, and State* anticipates the destructive nature of the boom-bust cycle, stating:

“Because of the malinvestment . . . the boom always leads to general impoverishment, i.e. reduces the standard of living below what it would have been in the absence of the boom.” Rothbard (1993)

Rothbard correctly anticipated the devastation of wealth that occurred in the U.S. economy during 2001 – 2002.

Competitive Money Proposal

There is a growing body of literature related to the increased international monetary instability and rising monetary competition. (See Dornbusch, 2001 and Rogoff, 2001) In a book titled *The Geography of Money* (1998), the author discusses the eventual disappearance of national currencies and emergence of regional currencies. (Cohen, 1998).

One of the roots of the idea of competitive money stems from F.A. Hayek in a little known paper published in 1976. Hayek argued that history indicates that the control of the supply of money by government has eventually ended in inflation. Therefore, Hayek advocates:

“. . . the development of national and international monetary system based on gold and other devices designed to remove from government

the powers it invariably abused.” Hayek (1976)

Hayek sets forth a novel idea of allowing free competitive note issue by commercial banks. This idea was discussed in an open forum during the 1978 Mont Pelerin Society meeting in St. Andrews, Scotland.

Free competitive money would allow private note issue by, say, large international banks. The notes would initially circulate along with official national monies. This situation would not be unlike the so-called free banking era in America during the nineteenth century. Although, this period has been characterized as chaotic by most accounts, there were some islands of extremely sound currencies, as under the Suffolk Bank reserve system operating in New England during 1825 to 1857.

The Suffolk Bank reserve system existed during the 100-year period when the U.S. was on the Gold-Coin Standard along with the leading nations of the time. Although any bank could print and issue currency, it had to stand ready to redeem the paper in 100 percent gold on demand. The Suffolk Bank, acting basically for profit-seeking reasons, engineered a bank note clearing and redemption system that kept all bank notes in New England on par with gold. In a monograph about the Suffolk Bank, this author concluded the following.

“Furthermore, the systems’ requirement that reserves be deposited in a central depository (Suffolk Bank), and its effective provision for clearing and redemption, demonstrates the feasibility of a private gold-related banking system which might well eliminate the necessity for a government-operated central bank”. Trivoli (1979)

Hayek’s proposal is to allow banks to issue their own currency. He maintains that sound privately issued monies would prevail over the continually debased official government money if they were to circulate freely. In addition, the competitive monies would tend to restrict note over-issue by banks by constantly driving the inflated currencies to a discount relative to other

sound money units. These contentions are supported by both theoretical and empirical evidence. See Savings (1976) and Klein (1974).

Major criticisms that can be levied at Hayek’s competitive money proposal fall into two categories: first, gaining general acceptability; and second, the lack of a central coordinating entity (central bank).

Regarding general acceptability, Hayek readily agrees that it may take years before privately issued notes would gain wide acceptability, but he maintains that as governments continually debase the official monies the process would accelerate.

However, there are some practical barriers to overcome in gaining general acceptability of the privately issued notes. Moreover, there are problems with banks' relearning the business of note issue; and with the high probability of counterfeiting that would make people leery of accepting the notes. Finally, there is the simple fact that banks and businesses are moving away from use of currency.

Proposal for a Private Money Card

A proposal originally set forth by this writer in a leading Germany banking journal is for a modification of the presently existing major credit/debit cards, such as American Express, Carte Blanc, and Citibank Card, into actual independent money units. The existing widely used and internationally accepted credit cards could be easily transformed into competing international monies. Each money card would have its own unit of value based, as are all currencies, on its relative purchasing power vis-à-vis all other monies.(Trivoli, 1974)

The major credit card companies, which already conduct many functions of multinational banks, would be transformed into independent money-issuing entities. Individuals, businesses, and governments using their monies would have to maintain accounts with these entities much as card holders do with present credit card companies.

Under the new system the card holders would maintain deposits with however many money card companies they desire, receiving interest on funds held in the account. At the end of, say, a month, if the money-card holder overspends (borrows against) his account, the account will show a debit balance. Money-card holders could have their paychecks directly deposited into their money card account; much as is done currently with banks and financial institutions.

All transactions could take place with the new money cards, much as items are charged with present credit/debit cards. The technology is already in existence for store registers to handle credit or debit cards.

Individual money-card companies would have the following as their major assets: loans to customers, investments in short-term earning assets, deposits with other money card companies for clearing purposes, and gold or other suitable valuable commodities commonly accepted for their relatively stable value. The major liabilities of money card companies are, of course, the deposits of the card holders.

If a money-card company engages in over-expansion of credit by either extending too much credit to holders of existing cards, and/or accepting deposits from less credit worthy sources; the value of its card would tend to be discounted relative to the competing money cards. Stores and businesses would display the various money cards accepted and the discounts relative to other cards accepted by vendors. A customer paying for an item would know that its price was, say, 10% higher if they pay using money-card “Z” as opposed to money cards “A” or “C”.

A problem of individual money cards is, of course, gaining governments’ acceptance of the system of privately issued money cards. However, under the current monetary system, a major segment of the money supply is privately issued through bank loans. Likewise, under the present system the largest segment of the money supply is already composed of private money – that is, demand deposits. Of course, the checkbook money is denominated in U.S. dollars.

A subsidiary problem related to competing money card monies is that everyone who has a money card must qualify for a card with a private card issuer. What happens to a poor person who may not qualify either because of lack of adequate credit information or unemployment? Both problems, lack of government currency and possible inaccessibility of money cards to some people, can be easily handled by an official government issued “social services” card. This government money card would simply replace the present social security card.

Government’s Money – Social Services Card

The government money, say in “dollars,” would be in the form of a social services card (SS-card) issued to everyone just as is the present social security cards used in the U.S. These SS- cards would be similar to the privately issued money card; *i.e.*, accepted as money by all registers

in stores. The government would maintain accounts for all SS-card holders just as in the case of the private money-card companies. The accounts would show credits accumulated in the form of social security benefits, unemployment benefits, food stamp credits, etc. The SS-card holders would use the government money just as private card holders use their money cards. Therefore, all members of society would have access to the new money system no matter what their individual economic status.

One would expect that most SS-card holders who did not otherwise possess a private money card would try to qualify for one in order to broaden their economic horizons. Another, perhaps more compelling, incentive would be the likely depreciation of the government's SS-card vis-à-vis the private money cards. For instance, welfare recipients would see the government's inflationary policies immediately by a continual discounting of the SS-card's value by stores. The depreciation of the value of the SS-card would not directly affect the private monies, except to the extent that the private money card companies accept SS-card credit in substantial amounts.

Inflation, therefore, would not be generalized as it is under the present U.S. monetary system with only one official monetary unit controlled by the Fed. Instead, over issue of money would tend to be localized in some private money cards and possibly the government's SS-card. The value of these cards would decline relative to the other money cards once people got wind of the over expansion of credit to card holders by specific money-card companies.. The discipline of the competitive monies could possibly serve as a restraint upon government deficit spending to pay for various government programs and welfare benefits to the SS-card holders.

In general, a summary of benefits from the proposed private competitive money-card system includes:

- 1) Presently, internationally used credit/debit cards and technology are already in use. Thus, the rudiments of the system are already in general international use, making acceptability almost automatic.
- 2) The system eliminates need for government official note issue, or interference with foreign exchange.

- 3) There would be less opportunity for the value of a nation's money cards getting out of equilibrium vis-à-vis other nations' money cards.
- 4) The system would tend to reduce transaction costs existing under the present system of foreign exchange transfers and fluctuations. Governments would be able to interfere only in the value of the government services cards. Private money card companies could choose to completely avoid acceptance of the government's money.
- 5) The money cards may tend to reduce petty theft, since there would be no currency other than perhaps coins. The major form of theft would be stolen cards, which could easily be policed by programming registers to void stolen cards used in transactions. Of course, computer theft would still be a factor as it is currently, but new encryption techniques are being developed all the time.
- 6) The major benefits would be achieved by returning money back to private hands and providing individuals some degree of protection from continual debasement of official government monies through over extension of credit.

The Role of the Fed

What would be the role of the Fed under a privatized competitive money system? This question goes back to the second criticism of Hayek's original competitive money proposal – that is, the lack of a central coordinating entity (central bank).

The Fed would still exist and have important functions more akin to the originally conceived Federal Reserve System in 1913. That is, power would revert back to the twelve regional Federal Reserve banks. The Fed would carry out national clearinghouse operations in both the government SS-card money and the various private money cards. The bulk of the clearing activities of the private money cards would be carried out by private bank local and regional clearing houses, much as is done currently.

The Fed Board in Washington D.C. could, under Congressional mandate, lose most of its monetary policy powers. Instead of open market operations conducted in short-term U.S. Treasury securities, Congress may decide that the main monetary tool would be the discount

rate. In conducting open market operations the Fed Board might be limited to trading in Treasury repurchase agreements instead of buying or selling Treasury securities outright. The Fed Board could oversee the international clearing function of both the government SS-card and the private money cards. Competition between the private money cards and the SS-card would contribute to many of the conditions necessary to maintain an efficient and orderly private money system.

Summary

More research remains to be conducted to fully examine the benefits and costs of the proposed private money card system. This system maintains all the inherent benefits of the competitive money system proposed by Hayek while avoiding a number of serious practical pitfalls of the Hayek competitive money system. Moreover, the proposed private money card system is certainly within present technological capabilities. More importantly, the new system fits the apparent trends toward greater use of credit/debit cards in lieu of currency and demand deposits. Finally, the money-card fits the banking system's move towards a checkless banking system.

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