

# Avoiding and Resolving Financial Crises: *The Rule of Law or the Rule of Central Bankers?*

Keynote address to the 2009 Economic Freedom Network Asia International Conference Siem Reap, Cambodia, 9 October 2009. Copyright reserved by the author; posted here by permission.

LAWRENCE H. WHITE

*Professor of Economics, George Mason University, Fairfax, VA 22030 USA*  
*lwhite11@gmu.edu*

Your excellency, distinguished guests, ladies and gentlemen:

I am delighted to join you at this wonderful setting to discuss whether the principle of “the rule of law” might help us to overcome global economic and financial crises. Can applying “the rule of law” help us in resolving the extraordinary situation we have been in for the past two years or so? Can it help us to avoid future crises?

What refreshing questions! The approach of our fiscal and monetary authorities through this crisis has been to consider every possible remedy *but* applying the rule of law.

In my home country of the United States, the chairman of the Federal Reserve System, Ben Bernanke, seems to have explicitly discarded commitments to principles of any kind – at least until the crisis ends. At a strategy meeting with other Fed and Treasury officials early in the crisis Bernanke reportedly declared: “There are no atheists in foxholes and no ideologues in financial crises.”<sup>1</sup>

Over at the US Treasury, an official named Neel Kashkari, the Treasury's chief bailout administrator under Secretary Hank Paulson, was asked by a reporter how the Treasury would spend the \$700 billion in bailout money that Congress had provided essentially without instructions. Kashkari replied that nothing was ruled out: "We are looking at everything," he said. "We are trying to figure out what will provide the most benefit to the financial system."<sup>2</sup>

Allow me to unpack Bernanke's and Kashkari's messages: "When we in authority say that it is time to be pragmatic, then we must be pragmatic. There are no durable principles, no constitutional constraints, limiting what we in government may do once we declare an emergency. The hope of avoiding a deeper crisis authorizes us to make it up as we go along, to do whatever seems expedient at any given moment. Once we raise the prospect of a possible 'financial meltdown,' we over-rule any concern about a constitutional meltdown."

Such sentiments are not surprising from men held responsible for the health of the economy – which by the way is an absurd assignment for any government to give, an absurd assignment for anyone to accept, and an absurd assignment for the rest of us to take seriously. Such men understandably want to avoid being seen as doing too little. Had Ben Bernanke stood on principle, he probably would not have been reappointed as Fed chairman by President Obama (as Bernanke recently *was*), and someone more flexible would have taken his place. What is surprising and disappointing is how many

ostensibly free-market economists and limited-government commentators have echoed these sentiments.

Against this background of a widespread retreat from principled approaches to economic policy, I salute the conference organizers for re-injecting the classical liberal principle of “the rule of law” into the debate.

My own academic specialty is monetary and financial institutions, where references to “the rule of law” are few – for reasons we will shortly discuss. Bear with me as I try to unpack what the concept means and how it might apply to money and finance.

**The concept of “the rule of law” in jurisprudence and political philosophy** has several dimensions. This will no doubt give us much to discuss today and tomorrow. But at the core of the “rule of law” concept, as I understand it, is the liberal principle of *non-discretionary governance* that stands in contrast to *the arbitrary or discretionary rule of men in authority*. In shorthand, a political community faces a choice: either “the rule of law” or “the rule of men”. When I hear or read the simple phrase *the rule of law*, I find that I can usually clarify its meaning by adding “and not of discretionary authorities”.

Friedrich Hayek in his classic work *The Road to Serfdom* contrasted “a country under arbitrary government” from a free country that observes “the great principle known as the Rule of Law. Stripped of all technicalities,” he continued, “this means that government in all its actions is bound by rules fixed and announced beforehand — rules which make it

possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge."<sup>3</sup>

In other words: Under the rule of law, executive agencies of government do nothing but faithfully enforce statutes already on the books. Under the rule of men, those in positions of executive authority have the discretion to make up substantive new decrees as they go along, and to forego enforcing the statutes on the books.

Some complain that this distinction is empty because, after all, laws are always executed by men. To clarify the distinction, consider the following common analogy. We also know that the referees in a football match will be men. But they can be men who impartially enforce the rules of the sport as they were known at the outset of the match, i.e. follow the rule of law, or they can be men who arbitrarily enforce rules against one team but not the other, or (even worse) penalize a team for infractions of novel "rules" that they have made up in mid-match.

The "rule of law" concept has deep historical roots. Hayek elsewhere quotes David Hume's *History of England* – written two centuries earlier – on the value of establishing the rule of law in place of the unconstrained discretion of government officials. Wrote Hume, celebrating the "Glorious Revolution" of 1688:

No government ... is perhaps to be found in the records of any history, which subsisted without the mixture of some arbitrary authority, committed to some magistrate; ... with no other control, than the general and rigid maxims of law and equity. But the parliament justly thought,

that the King was too eminent a magistrate to be trusted with discretionary power, which he might so easily turn to the destruction of liberty. And in the event it has been found, that, though some inconveniences arise from the maxim of adhering strictly to law, yet the advantages so much overbalance them, as should render the English forever grateful to the memory of their ancestors, who, after repeated contests, at last established that noble principle.<sup>4</sup>

In this passage Hume acknowledges that it is not always *convenient* in the short run to forego *ad hoc* measures – “some inconveniences arise from the maxim of adhering strictly to law” – but affirms the lesson of history that in the long run we *are better off* from adhering to the rule of law: “it has been found, that ... the advantages so much overbalance” the inconveniences.

The contrast between *the rule of law* and *the rule of men* is sometimes traced still further back to Plato’s dialogue entitled *Laws*. In that work (§ 715d) the Athenian Stranger declares that a city will enjoy safety and other benefits of the gods where the law “is despot over the rulers, and the rulers are slaves of the law”. In other words, government officials are to be the *servants* and not the *masters* of society.

The rule of law is vitally important because it allows a society to combine freedom, justice, and a thriving economic order. (On this theme I recommend Randy Barnett’s book *The Structure of Liberty*.) When legal rules are known and government actions are predictable, free people can confidently plan their lives and businesses, and can

coordinate their plans with one another through the market economy. Citizens need not fear arbitrary confiscation of their possessions or nullification of their contracts.

Entrepreneurs know that if they succeed in turning lower-valued bundles of inputs into higher-valued products, they get to keep the rewards. If they fail, they fail, and they bear the losses.

To be sure, the procedural principle of non-discretionary and non-arbitrary law enforcement is not sufficient for ensuring a free society. The *form* and *content* of the laws being enforced are also important. Regarding form, the legal theorist Lon Fuller has famously listed eight ways that *a system of legal rules* can fail to meet *formal standards of legality*: it can be empty, secret, retroactive, incomprehensible, or self-contradictory; it can require the impossible, change too often, or fail to be administered as announced.

The *content* of laws is of course also crucial for a free economy. Laws that meet the formal standards of legality, and are applied universally in non-discretionary fashion, might still prohibit what in justice ought to be allowed. In particular, in a fully free economy the law does not restrict the scope of honest voluntary exchanges among rightful owners, what the philosopher Robert Nozick has called “capitalist acts between consenting adults”.<sup>5</sup>

### **What does all this have to do with avoiding and resolving financial crises?**

The rule of law clearly does *not* prevail in our current monetary and financial systems.

We do not have, to use Hayek’s words, “government in all its actions ... bound by rules

fixed and announced beforehand”. Not when participants in financial markets hang on every word from the lips of the central banker, trying to guess his future policy actions.

Central bankers today are discretionary rulers over the economy’s monetary and financial institutions. Defenders of the rule of law, who in general decry the arbitrary rule of men, should specifically decry *the rule of central bankers*. Central bankers today are *not* “slaves of the law” but exercise wide discretion in monetary policy and regulatory rule-making under the legislation that created and empowered the central bank.

Could it be otherwise? In a few minutes I will consider

- 1) whether it is possible to have a central bank *without* discretion and consistent with the rule of law, and if not
- 2) whether it is desirable to do without a central bank.

For now that I want to emphasize that discretion in monetary policy and financial regulatory policy does not give us better results. It is today well understood that inflation is inadvertently fostered by the discretionary policies of central banks, where “discretion” means the absence of pre-commitment to any fixed policy rule.<sup>6</sup> The same is true of financial crises, because discretionary central bank policy tends to create asset price bubbles. And just as inflating central bankers like to pose as inflation *fighters*, the current mess in the aftermath of the bubble’s collapse is being addressed – in *highly* discretionary fashion – by central bankers posing as *stabilizers* of financial markets. All too often central bankers set fires (unintentionally no doubt), discover them, and then don

the apparel of fire fighters. All too often they trip over their fire hoses or end up throwing gasoline on the fire.

Look into the histories of central banks. Vera Smith's *The Rationale of Central Banking* is a good place to start.<sup>7</sup> Some central banks were given discretionary powers quite deliberately, for example the United States' Federal Reserve System. Others, for example the Bank of England, gained their discretionary powers as the unintended consequence of legislated privileges, accompanied by the legislature's inattention or acquiescence.

The creators of the Federal Reserve System in 1913 thought that they were creating an institution to save the economy from the recurrence of financial crises like the Panic of 1907. The Fed was to be a discretionary "lender of last resort," provider of "elasticity" to the currency, and preventer of crises. But by instituting the rule of men rather than of law, they sowed the seeds for even larger future crises. The Roaring Twenties boom that collapsed into the 1929-32 debacle is well known. 2007-09 is the latest episode. I needn't go into the details of the evidence that the Federal Reserve inflated the housing bubble that preceded the crash. But I do want to note that when Alan Greenspan held interest rates so low that the *real* short-term rate (the nominal rate minus the contemporary inflation rate) was negative for 2 and a half years, he was exercising discretion, not faithfully executing any rule on the books.

In their policies for addressing the current crisis, central bankers have not limited themselves to the "orthodox" crisis policies of injecting reserves into the banking system in the aggregate and making short-term last-resort loans to particularly illiquid

commercial banks, policies that are already disturbingly discretionary. They and Treasury ministers have been unorthodox and undeniably arbitrary, bestowing favors on some firms and burdens on others. Let me count the ways in the case of the Federal Reserve System and the Treasury of the United States. Forgive my focus on the United States, but it is where the global crisis started, and it is the case I know best.

- 1) The Bernanke Fed – normally I wouldn't personalize the Fed, but here we're talking about actions that exhibit rule of man rather than rule of law – the Bernanke Fed has without precedent created “facilities” for lending to certain classes of *non*-banks and for buying their illiquid or toxic assets. It has decreed and printed up so many hundreds of billions of dollars for lending at below-market rates to brokerage houses, so many hundreds of billions for buying assets from mutual funds, so many hundreds of billions for buying mortgage-backed securities, so many hundreds of billions for buying commercial paper.
- 2) Through the Federal Reserve Bank of New York, then headed by Timothy Geithner, the Bernanke Fed set up a special subsidiary (called “Maiden Lane LLC”) to sweeten an acquisition deal to protect the bondholders of the investment house Bear Stearns. It did not do the same for the investment house Lehman Brothers. It has set up other subsidiaries (Maiden Lane II, Maiden Lane III) to buy and hold bad assets from a single failed insurance company, AIG.
- 3) The Paulson Treasury forced an arbitrary set of nine major banks to issue and sell new preferred shares to the Fed. I say “forced” because, although some banks wanted to make the deal, others didn't. \$125 billion of taxpayer money was crammed into Citigroup, Bank of America, Wells Fargo, JPMorgan Chase, Bank

of New York Mellon, State Street Bank, Merrill Lynch, Morgan Stanley, and Goldman Sachs. The last three were newly converted investment banks, given commercial bank status just in time to qualify for the infusion. Goldman Sachs is the former investment bank once headed by Treasury Secretary Paulson. From the nine banks, the Treasury took “preferred shares” with fixed 5 percent dividends (increasing to 9 percent if the shares have not been repurchased in five years). The Treasury explained that it did not make participation *voluntary* because it did not want to stigmatize as weak the banks that chose to participate. The same treatment was later extended to other banks.

- 4) The Fed arbitrarily jammed the failed investment bank Merrill Lynch down the throat of a major commercial bank, Bank of America. The Fed had decided that Merrill Lynch needed to be immediately acquired rather than liquidated. The Bank of America’s CEO Ken Lewis initially agreed that BOA would be the acquirer, then changed his mind. An acquiring firm has every right to back out when its due diligence reveals (as it did in this case) that the target firm’s are more toxic than previously suspected. In one journalist’s account, here’s what happened next:

“[A]ccording to Lewis' testimony, confirmed both by Paulson and by official minutes of meetings, Paulson and Bernanke pressured Lewis into violating his own legal fiduciary duty to his shareholders, who had to approve the deal based on accurate information. Relying on no legal authority whatsoever, the Fed and Treasury threatened to remove the

board and management of Bank of America if they refused to go forward and demanded that Lewis not divulge the conversation.”<sup>8</sup>

As Hayek warned in *The Road to Serfdom*, giving an executive agency (or legislature) the discretion to bestow benefits and burdens on known recipients is a recipe for partiality:

Where the precise effects of government policy on particular people are known, where the government aims directly at such particular effects, it cannot help knowing these effects, and therefore cannot be impartial. It must, of necessity, take sides, imposing its valuations upon people and, instead of assisting them in the advancement of their own ends, choose the ends for them.<sup>9</sup>

The eagerness of Ben Bernanke and Hank Paulson – and now Timothy Geithner – to substitute their own judgment for the dispersed judgments of a freely competitive financial market may reflect simple intellectual error. Or, less innocently in the case of Hank Paulson, former CEO of the investment bank Goldman Sachs, it may be error compounded with partiality.

There is a serious question as to whether all of the Fed’s actions have been technically legal under the Federal Reserve Act. The Federal Reserve’s statutory authority is overly broad, but even so may not be broad enough to cover all of the Fed’s non-traditional actions in the crisis. Experts are doubtful. A leading legal historian of the Federal Reserve Act is Walker Todd, formerly an attorney on the staffs of the Federal Reserve

Banks of New York and Cleveland, now a fellow of the American Institute of Economic Research. Todd has commented:

All the recent lending activity has altered the composition of the Fed's balance sheet in ways difficult to comprehend even for long-time Fed watchers. Also, *much less of that lending is based on clear statutory authority than one might prefer if one cared about the rule of law and the potential for tyrannical government.*<sup>10</sup>

Since the spring of 2008 the Fed in its press releases has repeatedly claimed authority under the emergency provisions of section 13(3) of the Federal Reserve Act. The section was added in 1932, and subsequently amended in 1935 and 1991.<sup>11</sup> The current language of the section authorizes the Fed's Board of Governors, "in unusual and exigent circumstances," which prevail "during such periods as the said board may determine" by a vote, to "discount ... notes, drafts, and bills of exchange" for any individuals or firms it chooses (not just for commercial banks). In place of the older rule that the Fed may only discount (that is, buy) specific types of paper that are eligible by dint of being highly secured, the 1991 amendment allows the Fed to discount notes, etc., that are "secured to the satisfaction of the Federal Reserve bank". In place of the formerly constraining rule, the Fed has discretion to buy notes, etc. from whomever it wants, whenever it deems that the circumstances warrant, backed by whatever security it deems good enough.

The Fed today interprets 13(3) as essentially giving it *carte blanche*. Even as amended, however, you have to read between the lines and off the edge of the page to find authority for the Fed to purchase assets that are not “notes, drafts, and bills of exchange,” or authority to set up of special subsidiaries with *carte blanche* to do so.

Economist Edward Kane states bluntly that the Fed in the last 18 months “has exercised discretion it was never given.”<sup>12</sup>

**Whatever the extent of its statutory authority, the Fed flouts the rule of law** by its repeated use of 13(3) since April 2008 as a blanket authority for its huge new “loan facilities” and “funding facilities” and “limited liability company” subsidiaries, programs of lending to and buying assets from financial firms that are not commercial banks (but rather investment houses, brokerage houses, insurance companies, and mutual funds). Under the cover of emergency, the essentially *fiscal* operations of subsidizing certain classes of firms at taxpayer expense are being undertaken by an agency that finances its operations without an appropriation from the legislature, simply by “printing up” the funds it spends (thereby taxing holders of dollars). As Todd notes:

This stands the entire Federal Reserve Act on its head. The exceptional rule--the emergency power--has now become the regular way of doing things and the quantitatively dominant method of extending credit for the Fed.<sup>13</sup>

If the statute law allows the central bank an *indefinitely wide* range of actions, practically without constraint, then we have not the rule of law but the rule of central bankers.

Hayek explained the difference in *The Road to Serfdom*,

The fact that someone has full legal authority to act in the way he does gives no answer to the question whether the law gives him power to act arbitrarily or whether the law prescribes unequivocally how he has to act. ... If the law says that such a board or authority may do what it pleases, anything that board or authority does is legal – but its actions are certainly not subject to the Rule of Law. By giving the government unlimited powers, the most arbitrary rule can be made legal; and in this way a democracy may set up the most complete despotism imaginable.<sup>14</sup>

The Bank of England and the UK Financial Services Authority have likewise violated the rule of law in their attempts to address the crisis, Tim Congdon finds in *Central Banking in a Free Society*, his recent book published by the Institute of Economic Affairs. The British government bought “large equity stakes” in three banks “at prices beneath asset value per share, implying massive dilution of existing shareholders’ assets. The government’s actions may have been legal, but they challenged private property rights and insulted the rule of law.”<sup>15</sup>

Similar stories might be told about other central banks. You will know the details in your own country better than I do.

## **What is the alternative?**

What does the rule of law tell monetary and regulatory authorities to do when large financial firms are insolvent?

It says: Do *not* practice discretionary forbearance, turning a blind eye in the vain hope that a failing firm's red ink will happily turn to black, that a zombie institution will come back to life, that toxic assets will detoxify themselves. Do *not* arbitrarily rescue or bail out an insolvent firm at taxpayer expense. Instead, resolve the firm. If nobody wants to buy it as a going concern at a non-negative price, follow bankruptcy law. If a special bankruptcy law applies to financial institutions, follow that. In the United States, the FDIC Improvement Act of 1991 mandates that the FDIC (Federal Deposit Insurance Corporation) resolve banks on the edge of insolvency swiftly and at least cost to taxpayers. In the last eighteen months the authorities have been ignoring this statutory mandate. (Instead, the Fed "injected capital" into failing banks when it forcibly purchased preferred shares.)

Enacting a "prepackaged bankruptcy" law to swiftly resolve future failures of non-bank financial institutions would be a good idea, but in its absence follow the laws that are on the books.

The rule of law in bankruptcy means not only making shareholders accept that they have been wiped out, but also making *creditors and counterparty institutions* take the losses that are theirs. The creditors divide up the remaining assets without discretionary authorities sheltering them from losses with taxpayer funds. One thing the Bush administration did right was to allow Lehman Brothers to enter resolution. Yes, it was a great shock to the financial market. Paul Krugman wrote: “The chaos after Lehman Brothers failed showed that letting major financial institutions collapse can be very bad for the economy’s health.”<sup>16</sup> Yes, but an economist should ask: what’s the alternative? The only alternative to leaving the losses with Lehman’s stakeholders was shifting the losses onto taxpayers. This implies either (a) loss-covering handouts to those who deliberately took great risks of loss to enjoy the upside of great gains, or (b) nationalization. As a rule (and government should be following a rule, not snap judgments made in the heat of the moment), both are worse than resolving major financial institutions that have reached insolvency. Both are inconsistent with the rule of law, because they cannot possibly be applied consistently. Not *every* failed business in a country can be bailed out and kept on life support indefinitely – there isn’t enough money in the Treasury. Not *every* firm can be nationalized – the economy will cease to function, as Lenin found out when he tried it in the Soviet economy around 1920.

The shock was great in Lehman’s case because the Bush administration had previously, by rescuing Bear Stearns, led everyone to think that Lehman’s creditors and counterparties would be protected from Lehman’s imprudence. In the days after the Lehman failure everyone exposed to firms like Lehman had to re-evaluate their

exposures. Credit shrank to financial firms that could not demonstrate their solvency. Consistently enforcing the rules requiring insolvent firms to exit the market promptly would remove that kind of uncertainty and provide greater clarity to financial markets. It was inconsistency on this front – from abrogation of the rule of law – that created the situation where the authorities faced the choice between an ugly Lehman failure and the even uglier options of nationalization or open-ended bailouts.

**Bailouts and other favoritism, in violation of the rule of law, create moral hazard.**

We now know, having learned from hard experience, that letting only shareholders bear losses, while protecting creditor and counterparties at taxpayer expense, as was done in the case of Bear Stearns, isn't enough to control moral hazard. After Bear Stearns was rescued, Lehman Brothers *increased* its leverage and *increased* its exposure to risky mortgage assets. If creditors and counterparties think that they can count on government protection, they will be willing to lend copiously and cheaply, enabling a borrowing firm like Lehman to hold a highly leveraged portfolio of risky assets. From the point of view of shareholders, the higher return from “leveraging up” – relying heavily on borrowed funds – makes it a profitable strategy when lenders supply funds with very low risk premia. From the point of view of the taxpayers now on the hook, the firm takes on an *overly* leveraged portfolio of *overly* risky assets. The most stunning examples of this over-leveraging phenomenon were Fannie Mae and Freddie Mac, but investment houses like Lehman and Bear Stearns exhibited it as well.

If everyone knows that the rule of law will be followed, such that nobody gets bailed out, the incentive for imprudence disappears along with the hook into taxpayers. I don't mean that no financial firm will ever act imprudently, but that there won't be a *system-wide* malincentive producing an *epidemic* of imprudence. If it is known that nobody is "too big to fail", or too well connected to fail, then lenders will not *let* financial firms leverage up cheaply in the belief that they will be protected. The potential for failure of a hedge fund, investment bank, or other financial institution is therefore no rationale for new legal restrictions on them, like arbitrary limits on firm size or imposed capital ratios or executive compensation ceilings. Without the malincentives of implicit or explicit guarantees, their shareholders and those who lend to them can and should determine how much capital is adequate.

The Fed's new activities deserve to be called a bailout program because they seek to channel credit selectively at below-market interest rates, or purchase assets at above-market prices, in hopes of rescuing, or enhancing profits for, favored sets of financial institutions. The Fed's new lending facilities are not derived from a central bank's traditional "lender of last resort" role. They have nothing to do with replenishing the reserves of the banking system or preventing contraction in the stock of money. The Fed's activities seem rather to aim at protecting financial institutions from the consequences of imprudent portfolio decisions.

The rule-of-law approach promptly moves failed banks and other financial firms into resolution (sale or liquidation) and thereby removes the bad apples to make room for

better-managed firms expand their market shares. A capitalism in which Freddie Mac and AIG are never wound up is like an American Idol contest in which the worst singers never leave the stage to make room for the more talented.

Bankruptcy does not make assets disappear. They only change hands. When an airline goes bankrupt, the planes and pilots don't disappear. They are reallocated to other airlines with better plans for using those resources. Likewise when a bank is resolved the brick and mortar, the assets (what is left of their value), and the financial talent don't disappear. They go to other banks with sounder strategies.

It cannot be denied that with consistent resolution of insolvent firms, in Hume's words, "some inconveniences arise". But the advantages "much overbalance" the inconveniences, for the good reason that pulling the plug on failed firms is consistent with the logic of the market economy: those who stand to gain when they succeed must also stand to lose when they fail. Nationalization and bailouts are failed policies, for the good reasons that they are inconsistent with the logic of a market economy.

### **Can there be a central bank consistent with the rule of law?**

Yes, but only in a limited sense. The *useful* functions that central banks now play were originally played in historical banking systems by spontaneously emerged private clearinghouse associations. These were private self-governing membership clubs of banks. The problem of arbitrary government did not arise because they were not the

creatures of legislation. We find private clearinghouse associations in a competitive banking systems historically performing three key roles now pre-empted by central banks: they served as bankers' banks for clearing and settlement, they regulated the solvency and liquidity of their member banks, and in rare cases they acted as lenders of last resort.<sup>17</sup>

Clearinghouse associations did not monopolize the issue of currency nor use that monopoly to pursue a monetary policy in pursuit of macroeconomic goals. (A gold or silver standard controlled the quantity of money without the need for a monetary policy.) No one has yet devised a plan for making these last two functions, and thus government central banks as we know them today, compatible with the rule of law.

A fellow economist, when I told him that I would be speaking on "rule of law versus rule of central bankers," commented: "if rule of law means rule by the legislature, I'd prefer the rule of central bankers." Many economists favor "independence" for central bankers over monetary policy dictated by the legislature. Parliamentary backseat-driving of discretionary monetary policy is indeed not an attractive prospect. But those are not the only two alternatives. The rule of law in monetary institutions does not mean putting legislature's whims in place of the central bankers' whims.

The independence of Federal Reserve policy in 2001-07, as already noted, did not deliver stability, but fueled an unsustainable path in mortgage volumes and housing prices. The

key to stability is not the independence but the restraint of central bank money creation. Because central bankers have little interest in self-restraint, external restraint is needed.

What kind of restraint? This is a much-debated topic that I can only skim over. There is much to be said for a gold or silver standard as a constraint, but do note that the classical gold standard worked more automatically and better in countries *without* central banks, like Canada and Australia before 1935.

Milton Friedman long called for a “quantity rule” reform that would replace the central bank’s discretion in monetary policy with a non-discretionary algorithm for money growth (e.g. every day expand the monetary base such that M2 grows at 4% per year). He sometimes described his proposal as one to replace the central bank’s monetary policy committee with a robot. Another quantitative type of rule, Hayek’s proposal of 1931, would direct the central bank to target nominal national income (GDP).

After more than twenty years of seeing his advice ignored, Friedman in the early 1980s began to realize that the central bank would not adopt such a proposal because it had no incentive to tie its own hands. Central bankers sincerely believe, despite the evidence, that they can achieve net benefits by their wise use of discretionary powers. For the same reason, the central bankers appointed to carry out an “automatic” monetary policy would find every pretext for re-establishing their discretion. To eliminate the problem they must be sent home completely. Our best hope for eliminating central bank discretion, then, is to eliminate the central bank. In 1984 Friedman proposed abolishing the central bank’s

monetary policy committee, freezing the stock of fiat reserve money, and allowing commercial banks to again issue banknotes in order to satisfy any growth in the demand to hold currency.<sup>18</sup> Freezing the stock of national fiat money is a way of eliminating discretion in monetary policy that it relatively easy to monitor and enforce.

Friedrich Hayek in 1976 began calling for the “denationalization of money”. He imagined unbacked or fiat-type banknotes and deposits provided by competing private issuers. Moving money-issue to the private sector, at least in countries where contract law is honored, removes it from the realm of state action where we must worry about holding the money-issuer to the rule of law.

My own preference is for a third way of eliminating central bank discretion, proposed by classical liberals from Adam Smith to Ludwig von Mises: free banking on a gold or silver standard. The redeemability of banknotes and deposits imposes a “rule” on money-issuers by private contract rather than by legislation. Policy-makers in developing countries should especially note that in the economic history of the West private note-issue aided economic development.<sup>19</sup>

For a small open economy, tying itself to an external monetary standard through a currency board (as in Hong Kong, tied to the US dollar, or Estonia, tied to the Euro) or official dollarization (as in Panama) provides a discipline analogous to a gold standard. These arrangements are compatible with the rule of law if they are “orthodox,” that is, set up so as to be immune to discretionary tinkering. Their chief drawback today is that they

require relying on the good behavior of the external central bank whose currency provides the standard.

### **Can the Monetary System Regulate Itself?**

Our current system – discretionary fiat money issued by central banks – cannot regulate itself, and I have my doubts about Hayek’s imagined private fiat-type system. But a free banking system on a gold or silver standard has shown that it can regulate itself. In a nutshell, gold or silver redeemability for banknotes and deposits in a competitive banking system sets a strict limit on the volume of money and credit created. A gold or silver standard, without a government central bank to loosen its constraints, will automatically stop the banking system from following a path that inflates a bubble in asset prices.

Ludwig von Mises explained this in his *Theory of Money and Credit*.<sup>20</sup> Hayek was unfortunately not always so clear, before 1976, on the benefits of free banking over central banking. During a lecture tour promoting *The Road to Serfdom* in 1945, pointedly cross-examined by two academics on a radio program, Hayek said that the creation of the Federal Reserve System was *not* a step along the “road to serfdom,” and added: “That the monetary system must be under central control has never, to my mind, been denied by any sensible person.”<sup>21</sup> Hayek was certainly wrong on the second claim, if we may count Adam Smith and his own mentor Mises as sensible persons. It increasingly looks like he may have been wrong on the first claim.

As if intending to make the idea of “no central banking” look moderate, a few economists propose to avoid credit bubbles by completely outlawing *commercial* banking as we know it. Some propose that currency notes and checkable accounts should not be issued by banks, i.e. institutions that intermediate these liabilities into loans, but only by warehouses holding 100% backing. Others propose to make the financial system safer by outlawing *all* intermediation funded by debt, i.e. outlaw ordinary banks, thrift institutions, investment houses, finance companies, and insurance companies. The only intermediaries they would allow are mutual funds, where all customers are shareholders. I’m happy to see that the financial crisis has widened the scope of debate over monetary and banking reform. But these proposals – pardon the cliché – would throw the baby out with the bathwater.

Are proposals for doing without a national central bank “radical”? This label should not scare us. Since the bubble collapsed in 2007, we live in a period when to prefer merely the *slightest* reduction in government intervention is considered “radical”. Doing without a central bank is certainly not a radical idea in areas that already operate without a central bank, such as Panama or Hong Kong or Estonia. Private note-issue is certainly not radical where it already exists, namely Scotland, Northern Ireland, and Hong Kong.

Are these ideas “utopian”? Perhaps. But I agree with Hayek that classical liberals need the courage to think “utopian” thoughts about first-best institutional arrangements if we are to capture the imaginations of young intellectuals in the way that socialists captured them in the mid-twentieth century.<sup>22</sup>

In closing, I hope that some future historian, paraphrasing the passage from David Hume's *History of England* that I quoted earlier, will be able to write the following:

“No *central bank* ... is perhaps to be found in the records of any history, which [has] subsisted without the mixture of some arbitrary authority, committed to some *officials*; ... with no other control, than the general and rigid maxims of law and equity. But the people justly thought, that the *head of the central bank* was too eminent *an official* to be trusted with discretionary power, which he might so easily turn, despite the best of intentions, to the destruction of monetary and financial stability. And in the event it has been found, that, though some inconveniences arise from the maxim of adhering strictly to law, yet the advantages so much overbalance them, as should render the *people* forever grateful to the memory of their ancestors, who, after repeated contests, at last established that noble principle by establishing *the principle of no government intervention into money or banking*.”

---

<sup>1</sup> Peter Baker, “A Professor and a Banker Bury Old Dogma on Markets,” *The New York Times* (20 September 2008),

<http://www.nytimes.com/2008/09/21/business/21paulson.html>.

<sup>2</sup> David Ellis, “Kashkari: Bank bailout just beginning,” CNNMoney.com (7 November 2008),

[http://money.cnn.com/2008/11/07/news/companies/kashkari\\_tarp/index.htm?postversion=2008110715](http://money.cnn.com/2008/11/07/news/companies/kashkari_tarp/index.htm?postversion=2008110715)

<sup>3</sup> Friedrich A. Hayek, *The Road to Serfdom*, The Definitive Edition, ed. Bruce Caldwell, vol. 2 of *The Collected Works of F. A. Hayek* (Chicago: University of Chicago Press, 2007), p. 112. Originally published 1944.

<sup>4</sup> Quoted in F. A. Hayek, *Studies in Philosophy, Politics and Economics* (New York: Simon and Schuster, 1969), p. 118.

<sup>5</sup> Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974).

---

<sup>6</sup> See Finn E. Kydland and Edward C. Prescott, "Rules Rather than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy* 85 (June 1977), pp. 473-91.

<sup>7</sup> Vera C. Smith, *The Rationale of Central Banking* (Indianapolis: Liberty Fund, 1990). Originally published 1936.

<sup>8</sup> Robert Kuttner, "Betting the Fed," *The American Prospect* (1 June 2009) [http://www.prospect.org/cs/articles?article=betting\\_the\\_fed](http://www.prospect.org/cs/articles?article=betting_the_fed)

<sup>9</sup> Hayek, *The Road to Serfdom*, op. cit., p. 115.

<sup>10</sup> Emphasis mine. Walker Todd, "The Tyranny of the Fed," *American Institute for Economic Research Commentaries* (03 APRIL 2008) <http://www.aier.org/research/commentaries/167-the-tyranny-of-the-fed>

<sup>11</sup> For the text of the Act see <http://www.federalreserve.gov/aboutthefed/section13.htm>. For its citation as authority for the creation of the Maiden Lane LLC's and such, see the footnotes to the Fed's latest statement of Factors Affecting Reserve Balances, <http://www.federalreserve.gov/releases/h41/Current/>. On the 1991 amendments, see Walker F. Todd, "FDICIA's Emergency Liquidity Provisions," *Federal Reserve Bank of Cleveland Economic Review* (Fall 1993), pp. 16-23.

<sup>12</sup> Bill Bergman, "**How the Federal Reserve Contributes to Crises**: Interview with Ed Kane, Martin Mayer & Walker Todd".

<http://www.globalresearch.ca/index.php?context=va&aid=15094>

<sup>13</sup> Ibid.

<sup>14</sup> Hayek, *The Road to Serfdom*, op. cit., p. 119.

<sup>15</sup> Tim Congdon, *Central Banking in a Free Society* (London: Institute of Economic Affairs, 2009), p.

<sup>16</sup> Paul Krugman, "Bailouts for Bunglers," *New York Times* (1 Feb. 2009), <http://www.nytimes.com/2009/02/02/opinion/02krugman.html>

<sup>17</sup> Richard H. Timberlake, Jr., "The Central Banking Roles of Clearinghouse Associations," *Journal of Money, Credit, and Banking* 16 (February 1984), pp. 1-15.

<sup>18</sup> Milton Friedman, "Monetary Policy: Theory and Practice," *Journal of Money, Credit, and Banking* 14 (Feb. 1982), pp. 98-118; Friedman, "Monetary Policy for the 1980s" in John H. Moore, ed., *To Promote Prosperity* (Stanford, CA: Hoover Institution Press, 1984), pp. 23-60.

<sup>19</sup> See Rondo Cameron et al., *Banking in the Early Stages of Industrialization* (New York: Oxford University Press, 1976); also Lawrence H. White, "Money and Capital in Economic Development: A Retrospective Assessment," in Steve Hanke and Alan A. Walters, eds., *Capital Markets and Development* (San Francisco: ICS Press, 1991): 65-99.

<sup>20</sup> Ludwig von Mises, *The Theory of Money and Credit* (Indianapolis: Liberty Press, 1980).

<sup>21</sup> F. A. Hayek, *Hayek on Hayek: An Autobiographical Dialogue*, ed. Stephen Kresge and Leif Wenar (Chicago: University of Chicago Press, 1994), p. 116.

<sup>22</sup> Hayek, "The Intellectuals and Socialism," in Hayek, *Studies in Philosophy, Politics and Economics*, op. cit., pp. 178-194.