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Euro Imbalances and Adjustment: A Comparative Analysis

Leszek Balcerowicz

This article deals with the main problems and proposed solutions with respect to the euro. I start with what I perceive to be confusion in the debate on the euro. The next section shows a large variation in the growth performance in the eurozone, and more broadly in the European Union (EU). This should make us skeptical when hearing about the crisis of the euro, or of Europe. I then proceed to discuss what the problem countries in the eurozone suffer from. The next section deals with a more difficult question: What are the links between the euro architecture and the accumulation of these problems—that is, the imbalances and structural barriers to economic growth in some members of the eurozone? I then proceed to discuss the adjustment under the euro after 2008, focusing on the weaknesses of the policies of the crisis management. The article ends with a critical discussion of the problems and solutions put forward in the debate on the euro.

Against this background and based on the previous diagnosis, I sketch what I consider to be the right approach to solving the problems of the eurozone. Throughout the article I discuss the euro as a monetary arrangement, the weaknesses of which have to be identified by taking a comparative perspective—namely, that of other currency unions.

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Confusion in the Debate on the Euro

There is a lot of confusion in the debate on the euro. First, problems that have appeared in the eurozone are often confused with those caused by the euro. As a result, the euro is blamed for almost everything bad that emerged after the introduction of the Economic and Monetary Union (EMU). In discussing the impact on the euro, little effort is usually dedicated to spelling out what would have been the developments in the eurozone under alternative monetary arrangements—that is, if EMU had not been introduced.

Second, more general issues are mixed up with those specific to the eurozone, often without a clear separation between the two categories. The first group includes discussions on hard (fixed) pegs versus free floats and on the causes of the financial crises. It also includes some newer issues like the proper fiscal policy during a financial crisis and the consequences of unconventional monetary policy. Obviously, one cannot avoid considering general issues in discussing the problems in the eurozone. However, general arguments are not enough for the proper diagnosis and the proper therapy with respect to the euro. In addition, one must isolate and analyze the specificities of the eurozone—for example, why differences in risk premiums between such different countries as Greece and Germany were so small until recently, and why fiscal constraints in the member countries of the eurozone have proven so weak. Moreover, to isolate and discuss these specificities, one must compare the EMU with other types of hard-peg arrangements.

Third, there is a lot of verbiage in the debate on the necessary solutions to the euro's problems, exemplified by such popular, but unclear, expressions as "fiscal union" or "political union." That rhetoric, used by the proponents of the further centralistic integration in the eurozone, reflects, I think, wishful thinking and an unreflective belief that a monetary union necessarily requires a political union.

Finally, there are excessive generalizations in the discussions on the euro which mask a huge variation in the economic performance of the member countries, especially since 2008. (The same goes for the rest of the EU.) Not every member has turned out to be a problem country. The division into the center and the periphery has emerged.

The Variation in GDP Growth in the EU, 2008–13

Table 1 shows the large variation in the growth performance in the EU during 2008–13. The cumulative growth in the eurozone over 2008–13 ranged from 5.2 percent in Slovakia to −23.6 percent in Greece; among the non-euro EU members, it ranged from 12.5 percent in Poland to −4.1 percent in Britain. It is interesting to compare economic growth in the respective EU countries with that in the United States over the same period. As one can see, nine countries have outperformed the United States in terms of GDP per capita, and three of them (Poland, Slovakia, and Sweden) in aggregate GDP growth. The nine best performers included free floaters (Poland and Sweden), countries with hard pegs, that is, members of the euro (Germany and Malta), and four countries with euro-based currency boards (Bulgaria, Estonia, Latvia, Lithuania—known as the BELL).

The worst performers included the problem countries in the eurozone (Portugal, Italy, Ireland, Greece, and Spain—known as the PIIGS), along with Cyprus and Slovenia. However, the free floaters (Britain and Hungary) did not fare very well either. An interesting contrast is visible between the growth performance of the BELL and the PIIGS as well as other problem countries in the eurozone. The example of the BELL shows that a hard peg (i.e., not being able to use the nominal devaluation of the domestic currency) does not necessarily prevent a country from having a relatively good growth performance. The contrast between the BELL and the PIIGS is even more interesting because all of the BELL and most of the PIIGS (Greece, Ireland, Spain) developed the credit booms that went bust, and the boom-bust episodes in the BELL were more intense than among the PIIGS. This raises the question of what had allowed the BELL to outperform the PIIGS by such a wide margin. I will discuss that issue shortly.

What Problems Do the Problem Countries in the Eurozone Suffer From?

In this section I will discuss the types of problems that appeared in the PIIGS. As those problems are not specific to the PIIGS, I will also touch upon some broader issues.

The problems that appeared in the PIIGS were (1) the financial booms that resulted in large imbalances and declining price

TABLE 1
Cumulative Changes in GDP per Capita

	2008–13	2008 Trough	2013 Trough
Group 1			
Poland	12.5%	1.6%	10.8%
Slovakia	5.2%	−5.1%	10.9%
Lithuania	5.2%	−14.0%	22.2%
Bulgaria	3.6%	−5.0%	9.0%
Sweden	3.4%	−5.8%	9.8%
Germany	3.0%	−4.8%	8.2%
Malta	2.7%	−3.0%	5.9%
Estonia	2.5%	−14.0%	19.3%
Latvia	1.6%	−16.4%	21.5%
United States	1.2%	−4.0%	5.4%
Group 2			
Austria	0.3%	−4.1%	4.6%
Romania	−2.5%	−7.3%	5.2%
France	−2.6%	−3.7%	1.1%
EU-27	−2.6%	−4.6%	2.1%
Belgium	−2.7%	−3.5%	0.9%
Czech Republic	−2.8%	−5.1%	2.4%
Euro area -17	−3.5%	−4.7%	1.3%
United Kingdom	−4.1%	−4.6%	0.5%
Hungary	−4.4%	−6.6%	2.4%
Denmark	−4.8%	−6.2%	1.4%
Finland	−5.0%	−9.0%	4.3%
Netherlands	−5.1%	−4.2%	−1.0%
Ireland	−5.7%	−7.5%	1.9%
Spain	−7.4%	−5.1%	−2.4%
Portugal	−7.5%	−3.0%	−4.6%
Luxembourg	−8.1%	−5.8%	−2.5%
Italy	−9.0%	−6.1%	−3.1%
Slovenia	−11.8%	−8.7%	−3.4%
Cyprus	−20.6%		
Greece	−23.6%		
Other			
Korea 1997	22.1%	−6.4%	30.5%
Turkey 2000	17.1%	−7.0%	25.9%
Sweden 1990	2.4%	−4.4%	7.1%
Finland 1990	−5.3%	−11.4%	−5.3%
Chile 1981	−11.7%	−18.7%	8.6%

Note: the figures for 2013 are based on the European Commission's spring forecast. Trough = 2009, if not stated otherwise.

Source: European Commission Annual Macroeconomic Database (AMECO).

competitiveness of the affected economies, and (2) the accumulations of microeconomic distortions, which together with chronically stressed public finance, have acted as a break on economic growth.

Let me start with the boom-bust episodes. A sustained accelerated spending fuelled by credit and foreign capital inflows produced booms that tended to go bust. There is no bust without a previous boom.

The booms differed in their intensity and structure depending on the extent to which the accelerated spending was financed by domestic or foreign sources, and in the composition of funding—that is, in the share of FDI, portfolio investment, and debt finance. Finally, the booms differed depending on the sectors the extra spending was directed to—for example, the stock market, real estate and housing, consumer durables, fixed investment outside housing, and the fiscal sector. Differences in the intensity, structure, and location of the booms influenced the probability they would go bust and determined the consequences of such busts for subsequent economic growth, especially in the long run. This is an important and largely unexplored subject that I must leave aside here.

Among the PIIGS, Greece, Ireland, and Spain developed intensive booms that were largely financed by foreign portfolio and debt capital, mostly coming from more advanced eurozone economies (Ebner 2013). In addition, Greece accumulated massive microeconomic distortions.

One can distinguish two types of boom-bust episodes that appeared in the eurozone (and more broadly): (1) fiscal to financial and (2) financial to fiscal. Those episodes differ in their sequence and root causes (Balcerowicz 2012b).

The fiscal-to-financial crisis is dramatically exemplified by Greece. It typically starts with a sustained budgetary overspending that spills over to the financial sector, as financial institutions are big buyers of government bonds. Moreover, domestic financial firms often own a disproportionally large part of their country's sovereign debt—witness the problems of the Greek banks. This "home bias" has been due to official regulations such as the Basle risk-weighted capital requirements and to the informal links between the government and the banks. It is, of course, especially strong when the banks are stated-owned (Gonzales-Garcia and Grigoli 2013).

The fundamental question that goes beyond Greece and the eurozone is: What are the root causes of the tendency of modern

political systems to systematically overspend, which results in fiscal-to-financial crises or in chronically ill public finances that act as a brake on economic growth? This hugely important issue belongs to public choice and cannot be discussed here at greater length. I can only point to the interaction of the destructive political competition (i.e., competing for votes with spending promises) and the weak, if any, fiscal constraints.[1] The solutions consist, therefore, in making political competition fiscally more responsible and strengthening the fiscal constraints on governments. On the first issue, there is ultimately no good substitute for more active and effective engagement of those members of society who understand that freedom and economic growth require keeping the size of government in check. On the second issue, constitutional constraints on the budget may be of help. However, in order to introduce and maintain them, a strong participation of civil society is again required. This is especially important in the larger EU countries, as they are less susceptible than the smaller ones to European pressures; indeed, they are largely behind them. The European rhetoric should not mask the realpolitik in the EU. The story of emasculating of the Stability and Growth Pact by Germany and France in 2005 is a case in point.

The financial-to-fiscal crisis in the eurozone had occurred in Ireland and Spain. The spending boom in the housing sector fuelled the growth of their economies and created a deceptively positive picture of their fiscal stance. Once the housing boom stopped and reversed, the economy went into a deep recession, the situation in the banks sharply deteriorated, and large budget deficits appeared.

There is little doubt that fiscal-to-financial crises have political roots. In contrast, there has been a heated debate about the underlying reasons for the financial-to-fiscal boom-bust episodes. Much of the mainstream literature superficially blames "unregulated" financial markets and financial institutions. In the same vein, conventional analysts point to "market failures," without mentioning that the markets that they blame for various failures have been distorted by various government interventions. More careful researchers stress the inherent fragility of the traditional fractional reserve banks and the

[1]I do not mean to suggest that the right solution is to abolish open political competition (i.e., democracy). Rulers in nondemocratic regimes also tend to pacify their societies by increasing budgetary spending, and political power in most of those regimes is less constrained than in most democracies.

pro-cyclicality of financial systems. These are empirically relevant observations. However, the invariant features they refer to cannot explain huge differences in the incidence and depth of the financial crises over time and across countries. Rather, as Calomiris (2009) has noted, the important contributing factors to the financial crises are bad policies—both macroeconomic policies, strictly speaking, and those that result in bad laws, regulations, and organizations that distort market price signals.

While serious errors were committed by private financial firms, an especially high share of wrong decisions were made by government sponsored enterprise—for example, cajas in Spain, Länderbanken in Germany, and Fannie Mae and Freddie Mac in the United States. In Slovenia, one of the worst performers in the eurozone, state-owned banks accounted for 70 percent of overall banking assets and led to a politicized misallocation of credit. These are examples of "enclaves of socialism" in capitalistic economies—and capitalism is often blamed for the operation and outcomes of these enclaves. Vast experience shows that direct politicization of firms, both financial and nonfinancial, distorts incentives and leads to bad decisions, corruption, and waste. Thus, any serious reform that aims at reducing the risk of financial crises should include the elimination of the organizational enclaves of socialism from the financial sector.

Many laws and regulations contributed to the recent financial crisis by encouraging private investors to take excessive risks and by distorting the operation of financial markets. These laws and regulations included: perverse credit weights in the Basle capital accords that encouraged domestic banks to lend to their sovereigns; tax regulations that favored debt relative to equity financing; subsidized mortgages that encouraged excessive borrowing; federal deposit insurance that eliminated an important source of market discipline; and bailout policies that resulted in the "too big to fail" syndrome—that is, the flagrant distortion of financial markets (Balcerowicz 2012a). Most of these policies are still in place.

Finally, the monetary policy of the leading central banks deserves a special mention. The contribution of Federal Reserve policy to the U. S. housing boom and, indirectly, to the global financial crisis has been shown in many articles (e.g., Taylor 2013).[2] The same goes for

[2]For an early warning, see Niskanen (2006).

the monetary policy of the ECB (Taylor 2009). However, the post-crisis official discussion on how to prevent another serious financial crisis has focused on regulations, with little time dedicated to the contributory role of monetary policy. The typical framing of the debate on central banks is how they can prevent the buildup of serious financial crises facing inherently fragile and unstable financial markets, while the relevant question is how to prevent central banks from occasionally "leaning with the wind," thus fuelling asset bubbles and destabilizing financial markets. This is all the more important because, in response to the crisis they contributed to, the central banks of the largest OECD economies have shifted to unprecedented policies of ultra-low interest rates and massive interventions in financial markets. By heavily influencing the expectations, and thus operations of those markets, these policies amount to a massive macroeconomic statism—to be distinguished from the microeconomic statism of direct politicization of firms and anti-market regulations.

These remarks point to more fundamental issues of an institutional nature—namely, (1) the present fiat money regime and the related large role of central banks), and (2) the fractional reserve banks with the related official regulations and the reduced role of market discipline. There are many important problems regarding each of these two institutional systems and their potential alternatives. For example:

- What is the relative role of the various kinds of monetary and financial systems in producing booms that often result in crises?
- What are the interactions between these two systems in generating instability?
- Can one effectively constrain the monetary policy of the central banks of large countries while preserving fiat money?[3]
- And, if not, what would be the best alternative, assuming that it could be introduced and sustained?

These questions are fundamentally important but go beyond the scope of this article. I would only like to note here that while

[3]The smaller countries can go for dollarization, euroization, introduce currency boards, or enter monetary unions. The main problem is with the large countries, especially the United States, as the Fed's policies heavily influence the monetary policy and economy of all other countries.

working on them, one should not lose sight of the potential improvement within the framework of the present monetary and financial paradigm. A large variation in the incidence and magnitude of financial crises (and inflation) within this framework seems to suggest that this is not necessarily a hopeless task. But I grant that in observing the unprecedented expansion of the central banks' activity during recent years, one does not get very optimistic about improving monetary policy under fiat money.

Finally, returning to the problems of countries in the eurozone, I would like to mention Italy, Portugal, and France—all of which have been growth laggards during 2008–13 (and Italy also much earlier). However, as distinct from Greece, Italy, and Spain, these countries did not suffer from acute boom-bust episodes after the introduction of the euro. Their slow economic growth resulted instead from the accumulation of regulatory distortions, lack of market reforms, and chronically stressed public finances. The question is whether those policies have anything to do with the introduction of the euro.

The Euro and Problems in the Eurozone

The previous section described the boom-bust episodes and bad structural and fiscal policies that appeared in some member countries of the eurozone. In this section I will discuss a more difficult question: whether the euro has contributed to these problems, and if yes–then how?

Speaking about the euro I have two things in mind: the original design of the EMU and its actual implementation. It matters whether problems can be linked to some features of the original design that have been implemented or whether they have been due to the fact that some design features remained on paper. The first case raises the question of what would be the better arrangements. For example, how can one change the modus operandi of the ECB to avoid an excessive suppression of the risk premiums across the eurozone countries? The second problem (persistent deviations of actual policies from the original design) raises the issue of whether this was just an accident of bad politics, which could be remedied thanks to the accumulated experience and increased pressure from more enlightened and powerful peers, or whether it has been unrealistic from the very beginning to expect that a given constraint could be respected. In the latter case, the arrangement in question would

suffer from incentive incompatibility and should be replaced by, or complemented with, some other mechanism. A candidate in this category is the Stability and Growth Pact whereby the European Commission and governments of the member countries (the actual or potential fiscal sinners) have been entrusted by all the members with enforcing budget discipline.

In searching for the links between the euro and the problems in some countries of the eurozone, one has to show through what channels the specific features of the euro might have contributed to these problems. And in doing this, it is not enough, of course, to show what has actually happened under the euro. In addition, one has to show what would have happened under some alternative monetary arrangements. This comparative scenario analysis is not easy and partly speculative.[4] Therefore, what I can do in this short article is to put forth some hypotheses and ask certain questions.

Let me turn to the boom-bust episodes, which occurred in Greece, Ireland, and Spain after the introduction of the euro. Ample literature shows that financial crises have occurred under different monetary arrangements (see, e.g., Reinhart and Rogoff 2009). Recent history includes crises under fixed or hard pegs (Asian countries in 1998, Sweden and Finland in 1990, and the Baltics after 2008) as well as under freely floating exchange rates (Britain and the United States during the global financial crisis). However, this list shows only that no monetary regime is able to make a country immune to financial crises. It does not shed much light on a more important question: What explains differences in the incidence and depth of financial crises across time and space? Moreover, as a special case of this broad issue, one should ask: What features of the euro might have contributed to the booms and busts in some eurozone countries?

There is one feature I have already mentioned, and which deserves special attention in this respect, namely, the extreme suppression of credit spreads among eurozone members with very different fundamentals. Until 2008, the narrow interest-rate spreads had been widely welcomed as a sign of success of the eurozone being

[4]For example, Hellwig (2011) claims that if not for the introduction of euro and the ECB, the independence of the Bundesbank in Germany would have been undermined because of the constellation of political forces that had appeared in Germany in the 1990s.

a “true” monetary union. Only a few economists regarded this extreme suppression of the spreads as a reason to worry.

There are three questions related to the extremely suppressed credit spreads in the eurozone until 2008:

1. Why and how might they have contributed to the booms in some eurozone countries and to the ensuing problems? And why in these countries and not in other member states?
2. What were the reasons for these spreads and, more specifically, what features of the euro itself might have contributed to their suppression?
3. To what counterfactual monetary arrangements were the spreads in the eurozone especially low?

The first question is easy to respond to: The acute booms occurred in eurozone countries that had the largest declines in their credit spreads (ECB 2012). In discussing the consequences of this change in interest rates, we must return to the distinction between fiscal-to-financial versus financial-to-fiscal crises.

In the case of Greece, it was mostly the government that benefited from the narrowing of interest-rate spreads. Governments differ in their fiscal behavior depending on their socio-political system. However, one may safely assume that in the modern world governments tend to spend any windfall gains, unless there are sufficiently strong institutional or socio-political constraints.[5] Such constraints did exist in many Western countries in the 19th century due to a belief in balanced budgets and the strong position of fiscally conservative voters among the electorate. This belief has been severely weakened by macroeconomic statism (Keynesianism) and the related changes in the composition of the electorate. Given the looming fiscal challenges in most Western economies, the key question has been how to restore the mechanisms of fiscal responsibility. In the eurozone, fiscal constraints turned out to be much weaker than envisioned, and led to an acute fiscal-financial crisis in Greece where the

[5]The windfall gains obtained by some countries in the eurozone were a special case of a broad category of the availability of easy money to the governments. Other examples include aid to the poorer countries and new funds derived from the discovery of natural resources (Fernandez-Villaverde, Garciano, and Santos 2013). Research suggests that the distortive impact of various kinds of windfall gains on politicians’ behavior depends on how strong the institutions are that constrain the government.

balance between fiscal populism and fiscal constraints was especially unfavorable. Looking forward, one must face the question of what changes in the eurozone countries, or at the level of the whole group, would permanently strengthen fiscal discipline.

A different mechanism—of the Wicksellian type—was present in the case of financial-to-fiscal booms in Ireland and Spain that led to radically lower interest rates. In this case, the gap between market (financial) rates and natural rates developed, fuelling a surge in the demand for credit by firms and households (Hellwig 2011). The borrowing spree was strengthened by policies that subsidized mortgage credit, making it even cheaper.

Many observers worried about the possible lack of fiscal discipline as a danger to the smooth functioning of the euro. However, it is puzzling that few, if any, warned against the danger of financial-to-fiscal booms, which turned out to be a serious problem in the euro area. Speculating about the reasons for this neglect, one can perhaps mention the popular conviction in the economics profession (until recently) that financial crises have been relegated to the less developed world. Another mistaken belief, specific to the eurozone, is the tendency to view the EMU as being immune to internal balance of payments problems (Merler and Pisani-Ferry 2012).

Further research should explain why among the countries that obtained the largest reductions in credit spreads, Greece developed the fiscal-to-financial boom-bust episode while Ireland and Spain suffered from the financial-to-fiscal crisis. In searching for the response to this question, one would have to look to cross-country differences in housing cycles, financial sectors, and political preferences of the ruling parties.

There is much more controversy and much less research regarding the second question: Why have credit spreads (until recently) been so drastically suppressed across the eurozone countries? Some observers regard this as just another instance of market failure. However, the behavior of market participants is shaped by many factors, and in the case of financial markets those factors prominently include actual and expected actions of policymakers. True, lenders in financial markets were late in recognizing the looming boom-bust problems in the eurozone, but they were still quicker than official monitoring agencies, including the IMF (Tran 2013). Indeed, even the most ardent proponents of rational expectations do not ascribe to markets the gift of perfect foresight. Rather, they only

claim that market participants do not make *systematic* errors in their forecasts.[6] Lenders in the financial markets may have underestimated the risks that the booms they financed would turn into busts, or they may have been skeptical about the realism of the no-bailout clauses that were an important part of the euro's institutional framework. If the latter was the case, developments in the eurozone have largely proven lenders right (the Greek exception notwithstanding). The assistance given to the problem countries, especially Ireland, was in fact a bailout of the creditors from the assisting countries, especially from Germany and France—and, in the case of Ireland, also from the United States. Therefore, in contrast to the United States in 1870, when the insolvent states were not bailed out by the federal government, the eurozone did not enforce its no-bailout constraint.

Two other factors are mentioned in the literature as having contributed to the extreme suppression of the credit spreads across the eurozone and the resulting boom in some member countries. The first one clearly constitutes a feature of the euro design and practice—namely, the modus operandi of the ECB. Buiter and Siebert (2005) were to my knowledge the first to point it out. As Harold James (2013) notes, "When the EC Committee of Central Bank Governors began to draft the ECB statue, it took the principle of invisibility and centralization of monetary policy as given. But this was not really justified either historically or in terms of economic fundamentals." George Soros (2011) is more specific:

> The European Central Bank treated the sovereign debt of all members as riskless and accepted them at its discount window on equal terms. Banks that were obligated to hold riskless assets to meet their liquidity requirements were induced to load up on the sovereign debt of the weaker countries to earn a few extra points. This lowered interest rates in Portugal, Ireland, Greece, Italy and Spain and generated housing bubbles.

A similar point was made by Steinmeier and Steinbrück (2010). Gill and de Souza (2013) pointedly remark that "by treating all sovereign debt equally, the ECB sent markets the wrong signal."

[6]However, it is an interesting question to what extent macroeconomic beliefs of major players in the financial markets are shaped by conventional macroeconomic doctrines.

Both nominal and real interest rates were suppressed in the future problem countries in the eurozone, thus fuelling the demand for credit. Until 2008 the PIIGS displayed persistently higher inflation than the core members of the eurozone (ECB 2012). This resulted from the boom and the various distortions in the PIIGS that hampered the single market and the tendency for the prices of tradeables to be equalized across the members of the currency union. Therefore, in considering the question of how to reduce the risk of serious boom-bust episodes in the eurozone, one must look at the causes of the extreme suppression of nominal credit spreads across the eurozone and the structural reforms necessary to complete the single market. Those reforms are also important for other reasons, especially for strengthening longer-term growth in the eurozone countries.

Let me finally discuss the third question: Whether the propensity to generate boom-bust episodes was especially strong in the eurozone compared to other hard-peg arrangements. If the main channel behind this tendency had been the radically suppressed credit spreads in the eurozone, then one should compare them with those under other hard-peg systems (e.g., in the large federal states, dollarized economies, currency board countries, and former Deutsche mark bloc under the gold standard) while taking account of differences in economic fundamentals among the members of the respective hard-peg areas.

There is no space here for such a comprehensive comparison. However, even a glimpse at the available literature strongly suggests that the credit spreads in the eurozone were extremely suppressed. First, "between 2004 and 2007 when European sovereign bond spreads were nearly eliminated, the average spreads between Aaa and Bbb state bonds . . . were in the range of 58 to 46 basis points" (Henning and Keesler 2012: 16). Second, Dellas and Tavlas (2013: 509) stress that under the gold standard "spreads were fairly large—in the range of 100 to 400 bp despite the small external and fiscal imbalances of the participating countries." If we do not want to assume that lenders in 19th century were much more rational than those at present, we must conclude that special factors in the eurozone led to an extreme suppression of credit risks and the related financial crises in some member countries. Those special factors included the ECB's treatment of debt of the various

eurozone governments and distortions that produced persistent inflation differentials.[7]

Finally let me consider the question whether there has been any link between the euro and the fact that many members of the eurozone have made little progress on structural reforms, and some of them accumulated anti-market distortions and delayed the necessary institutional improvements of their economies—especially Greece, Portugal, Italy, and France. The pace of institutional change results from the interplay of many factors, among which the political ones play a prominent role. The question is then: Has the euro influenced them and, thus, the quality of the institutional systems, in at least some members of the eurozone? The original expectation of the proponents of the EMU was that the euro would remove the easy way of coping with economic problems (i.e., nominal devaluation) so that their governments would be forced to use harder but more productive methods (i.e., structural reforms).[8] This expectation has not been fulfilled. The pace of structural reforms in the member countries turned out to be very disappointing, except perhaps for Germany (Whyte 2010). The main reason for this state of affairs was that the introduction of the euro did not remove the easy ways of coping (or rather pretending to cope) with the countries' economic problems. True, the option of nominal devaluation has been eliminated, but another easy way of tolerating distortions and delaying reforms was created: cheap credit and capital inflows, especially to the future problem countries. Those inflows not only fuelled financial crises in some member countries but also made bad structural policies more financeable.

Policies and Adjustment under the Euro

I have already shown the types of problems that appeared in some members of the eurozone: boom-bust episodes and bad structural and fiscal policies. I have also discussed the links between these problems and some features of the EMU, especially the ECB's

[7]In thinking about further research, I would note that the BELL developed an intense credit boom, even though they did not participate in the eurozone monetary system. One reason could have been their very small size, which made it easy to overwhelm them with external capital inflows.

[8]See Fernandez-Villaverde, Garciano, and Santos (2013).

modus operandi that contributed to the extremely suppressed credit spreads across the eurozone, and, thus, via the financial booms to the financial crises and bad structural and fiscal policies. These tendencies were strengthened by the ECB's easy monetary policy, international and domestic regulations that encouraged risky behavior of lenders and borrowers in the financial markets, and neglect of the agreed fiscal constraints by eurozone governments. As a result, the eurozone during the first 10 years of its existence did not have a mechanism for smoothly dealing with the emerging fiscal, financial, and structural problems. Rather, it had a mechanism for accumulating them and postponing their resolution. This is clearly visible when one compares the eurozone with the gold standard (see Dellas and Tavlas 2013).

Given the problems in the eurozone since 2008, what policies have aimed at dealing with them? We now turn to that question.

A huge literature has emerged on the post-2008 policies in the eurozone. Here I can deal only with a few selected issues. First, one should distinguish between policies designed to cope with a crisis (crisis management) and those intended to reduce the risk of a future crisis (structural reforms). The latter would make eurozone countries better able to cope with future shocks and strengthen economic growth. Both kinds of policies have been present at two levels: that of the eurozone and in the respective countries. I will focus on crisis management in this section. In the next section, I will discuss the actual and proposed structural reforms in the eurozone.

The practice and rhetoric with respect to the policies at the eurozone level have been dominated by what I would call a "bailout bias." It is not specific to the eurozone; one can see it in the policy and policy debates in the United States, Britain, and Japan. Bailout bias results from the perceived benefits of some parties and the beliefs of others. As to the former, it is easy to understand why creditors prefer bailouts to debt reduction. Many politicians welcome official crisis lending as a way to ease market pressure. The media, meanwhile, thrive on news of incoming catastrophe, which they assume can only be prevented by governments and central banks.

The beliefs behind the bailout bias are expressed by the uninhibited use of metaphors like "contagion" or "domino effect." The message is that once financial markets become disturbed, they become violent and undiscriminating. So that once investors lose confidence in one country, it is assumed that all other countries are in danger.

Consequently, it is taken as conventional wisdom that only a formidable countervailing power—a "big bazooka"—can break this presumed vicious dynamics of financial markets (Balcerowicz 2012a). But financial markets, even when distributed, are not blind. They do distinguish, however imperfectly and belatedly, between the macroeconomic situation of various countries. And when they are especially late in their assessment, one should look to some official interventions, as has been the case with the ECB's policies that have contributed to the suppression of interest rates across the eurozone.

Another related fallacy is that reforms can generate benefits only in the longer run. It is assumed that bailouts are the only way affected governments can reduce sharply increased yields. However, well-structured and credibly implemented reforms produce both long-term and short-term benefits. The former include enhanced growth potential and increased resilience of the economy. The latter—call them "confidence effects"—consist in the lower interest rates a country's agents have to pay. Financial markets do react to differences in reforms—even before they bear their longer-term benefits—provided the structure of reforms is correct and their implementation credible. This prediction has been illustrated by the divergent dynamics of government bond yields across the PIIGS and by differences between the PIIGS and the BELL.

In discussing the consequences of the official bailouts, one should consider the potential conflict between the availability and scale of official lending and crisis prevention. There is a huge literature on this topic with respect to IMF lending, but the problem exists in any kind of official bailout. Indeed, the very prospect of crisis lending can make countries less prudent (the moral hazard problem), thus increasing the number of policy-induced crises and bailouts. The realization that such a danger exists led to the non-bailout practice in the United States in the relation between the federal government and the states, and to the insertion of the non-bailout clause in the formal architecture of the euro. The problem is that this clause, as well as the earlier Stability and Growth Pact, largely have been ignored. These facts pose questions regarding how the eurozone's institutional arrangements can be improved to prevent serious imbalances in member countries and, if they arise, how to deal with them in a better way.

Finally, the easy availability of official bailouts may prolong a crisis by reducing politicians' incentives to engage in politically unpleasant

but economically necessary reform. Even if a country is blessed with a reformist leader who is immune to this danger, his political base may not be. The easy availability of crisis lending can therefore weaken political support for reformist leaders and delay the necessary adjustment policies, thus increasing their costs. We can see this effect when one compares policies and outcomes in the BELL and the PIIGS, and also among the PIIGS themselves.

Let me now turn to the practice of the bailouts in the eurozone. Much attention has been dedicated to the creation of the temporary, and then permanent, official assistance fund in the eurozone—the European Stability Mechanism (ESM). However, here I will only note that the issues that have been raised with respect to the IMF also apply to ESM. Moreover, the larger the financial capacity of the ESM, the more acute the moral hazard, the quality of the conditions demanded from the borrowers, and the ESM capacity to enforce them.

There have been two other related bailout mechanisms in the eurozone that turned out to be more important and more controversial than anticipated—namely, the policies of the ECB and the operation of the Target 2 payments system since 2008. The first is a special case of a broader problem: the unconventional monetary policy (UMP) of the central banks of major OECD economies, especially the U.S. Federal Reserve. Therefore, I can't help but mention some broader issues as well.

UMP is a huge and unprecedented experiment in monetary policy, possible only under a fiat money regime. Its proponents have been very vocal and have been using three main devices in the debate—the first two of purely rhetorical nature and the third more technical.

First, they presented the alternative to the UMP as a "catastrophe" or a "meltdown" of the financial system. However, whatever power this argument may have had in the beginning, it has sharply declined with the time. And the main problem is with a *sustained* UMP.

Second, they have stretched the concept of "lender of last resort" as though the central bank provision of liquidity to commercial banks was the same as its funding of governments via money creation.

Third, the proponents of continued UMP, especially in the central banks themselves, point to the models they use and claim that the UMP has produced positive net effects—not only for the countries

where it has been practiced but also for other economies. In other words, in their view, the net spillovers have been positive. However, the problem is that these models are fatally flawed: they tend to overestimate the positive effects of UMP and ignore the negative ones (see Cizkowicz and Rzonca 2012).[9] And as the potential benefits of UMP are short term while its costs are a growing function of time, the net negative effect of UMP is likely to be reached rather early and to grow with time. Most of the omitted channels negatively affect the supply side of the economy. For example, the continued UMP creates uncertainty and, therefore, is likely to reduce investment in the fixed assets and the related "embodied" innovations. It may encourage forbearance in bank lending and thus slow the pace of restructuring in the economy. It is likely, as already mentioned, to weaken the politicians' incentives for early reforms. In addition, prolonged UMP creates exit problems and reduces the value of information supplied by financial markets.[10]

The UMP pursued by the ECB has been very expansionary by historical standards, but not as expansionary as that of the Fed (Balcerowicz et al. 2013: 50–52). However, the UMP as implemented by the ECB produces some problems that are specific to the eurozone. First, this policy, especially buying up the bonds of the distressed governments, is akin to regional policies. To justify such measures in terms of monetary policy—that is, claiming that its purpose is to repair the broken transmission channels of the monetary policy—is not convincing, as one can justify in these terms any bailout financed by the ECB. And, of course, it begs the question of what formal and professional competence any central bank has in deciding which risk spreads are unacceptable and, thus, justify the bailout of the affected country financed by money creation. Second, the selective country bailouts are not compatible with the ECB's

[9]These models and the conclusions they give rise to, remind me of the debate about the efficiency of socialism versus capitalism, where Oskar Lange was the main protagonist on the socialist side, while von Mises and Hayek claimed that socialism cannot be as efficient as capitalism. Lange was declared a victor in the debate in the mainstream literature in the West. However, he achieved his victory by using an analytical scheme that ignored all the weaknesses of socialism (Balcerowicz 1995).

[10]For more on the negative effects of UMP, see Phelps (2009), Shirakawa (2011), Hannoun (2012), White (2012), BIS (2012), Cochrane (2012), Rajan (2013), Taylor (2009, 2013), and Feldstein (2013).

mandate to maintain price stability. Undertaking such measures may be perceived as further undermining formally accepted treaties in a situation when restoring confidence in the rules of the game is crucial.

In the above discussion of the ECB's unconventional policies, I have focused on its purchases of the PIIGS' government bonds. However, there have been other elements of these policies, especially all of the refinancing operations with respect to the eurozone banks. These policies have helped or even encouraged banks in the problem countries to buy the bonds of their national governments. Therefore, even though they are officially presented as belonging to the traditional domain of central bank operations as a lender of a last resort with respect to the commercial banks, in fact they amounted to money creation that indirectly financed fiscally distressed governments. This applies especially to the ECB's Long-term Refinancing Operation (LTRO) launched at the end of 2011. Italian and Spanish banks have used the cheap credits from the ECB to buy massive quantities of their governments' bonds.

The changes in refinancing consisted in radically lowering collateral requirements since 2008, and moving to a full allotment regime. In addition, the Emerging Liquidity Assistance (ELA) has been introduced, whereby the national central banks have been authorized to create money in order to extend credit to commercial banks in their countries when the banks face a shortage of collateral acceptable by the ECB. The ELA has been extensively used by the PIIGS, especially Ireland and Greece (Merler and Pisani-Ferry 2012).

These changes, especially the first two, have been accompanied by massive expansion in refinancing credit flowing to commercial banks in the PIIGS and the massive expansion in the Target 2 balances owned by Germany, the Netherlands, and Finland that are kept at the ECB.[11] The latter change, first highlighted and analyzed by Sinn and Wollmershauser (2011), has sparked a heated debate about what have been the underlying causes of these processes, whether the Target 2 has contributed to the accumulation of these imbalances,

[11]Target 2 is the eurosystem's operational tool whereby national central banks of the eurozone provide payment and settlement services for trade and capital transactions. There is no limit to the transactions that can be processed by the system and, therefore, the size of the Target 2 position (Merler and Pisani-Ferry 2012: 3–5).

and how to deal with them (Mayer 2011, 2012; Sinn 2012; Merler and Pisani-Ferry 2012; Auer 2012).

The most concise summary of this discussion would be the following: First, there is a basic agreement that the expansion of the refinancing credit and the related rapid accumulation of Target 2 balances have been related to a sudden stop, and then partial reversal, of the private capital flows to the PIIGS, which had previously funded the expansion of current account imbalances in these countries. The flows that declined the most and were strongly negatively correlated with the growth of Target 2 imbalances were changes in the cross-border positions of the national banking systems (i.e., interbank market) and the reductions of the banks' holding of foreign government debt (Auer 2012). To put it simply, banks from the center of the eurozone, especially Germany and France, reduced their exposure to the banks and governments of the PIIGS.

Second, the discussants agree that the expansion of the refinancing credit flowing to the PIIGS had been made possible by the radical relaxation of the refinancing standards by the ECB. Some of them point out that an additional reason for that expansion was the fact that there has been no limit on the Target 2 balances. Correspondingly, the proponents of this view suggest that a limit should be placed on them (see Sinn, 2012).

Third, it is difficult to deny that the flows of official funds to the PIIGS, reflected in the accumulation of Target 2 imbalances, were filling in the gaps created by the declines in the flows of private capital and as a result delayed the reduction of the current account deficits in these countries. However, there has been sharp disagreement in the assessment of the eurosystem's policies that produced these compensatory flows. Proponents of the UMP (e.g., Merler and Pisani-Ferry 2012) claim that these policies have been necessary in order to avoid the collapse of the banking sectors and maintain demand in the distressed eurozone economies. Meanwhile, the skeptics (e.g., Mayer 2011, 2012; Sinn 2012) stress that even if the extraordinary refinancing operations made sense early on during the global financial crisis, the ECB should have started to phase them out. This is the typical controversy between those who focus on aggregate demand and those who concentrate on the dynamics of market supply and demand.

Be it as it may, it is clear that the ECB's extraordinary refinancing operations have substantially delayed the reduction in previously

inflated current account deficits in the PIIGS, a point granted even by some proponents of these operations (e.g., Merler and Pisani-Ferry 2012).

We have shown that the actual operational architecture of the euro enabled the accumulation of large imbalances in some eurozone countries. Moreover, the UMP policies pursued by the ECB provided ample extra financing to the PIIGS and delayed the reduction of these imbalances. The latter tendency is in sharp contrast to the adjustment mechanisms under some other types of hard-peg arrangements, such as the dollarized economies, currency boards, and the classical gold standard. In all these cases, there are no flows of official funds compensating for declining net inflows of private capital. Rather, these arrangements provide for automatic adjustment via changes in the quantity of money, and they strengthen policymakers' incentives to improve conditions favorable to keeping and attracting private capital. It is doubtful these market-based mechanisms can be improved on by the peer pressure and official monitoring performed by such bodies as the IMF, European Commission, and European Systemic Risk Board. Those bodies suffer from informational and enforcement problems that are difficult to resolve.

Finally, let me take a brief look at the pattern of adjustment among the PIIGS relative to the BELL, which rely on euro-based currency boards. I have already mentioned that during 2008–13 the BELL belonged to the growth leaders in the EU in terms of cumulative growth in GDP per capita, while the PIIGS were at the bottom of this league. The question is whether this striking difference in performance had anything to do with differences in crisis management policies.[12] One cannot help but notice such a link as reflected in the different time pattern of adjustment. In the BELL, the reduction in the current account deficit started earlier and was faster than among the PIIGS (except for Ireland). Both groups finally achieved a similar extent of external adjustment, but in the PIIGS it had been accompanied by a much deeper cumulative decline in GDP per capita. The BELL also achieved faster reduction in unit labor costs and inflation than the PIIGS.

Early radical adjustment by the BELL was rewarded by a faster decline in interest rates. It is hard to reject the hypothesis that this

[12]In discussing this issue, I have drawn on Balcerowicz et al. (2013).

pattern of adjustment in the BELL was causally related to the fact that—as distinct from the PIIGS—they were not subject to the ECB's unconventional monetary policy, including its hugely expanded refinancing operations. Financial flows that weaken policymakers' incentives to launch proper policies are likely to be harmful, both during the stage of accumulating the imbalances and the stage of dealing with them. Striking differences also emerged in the pace and structure of fiscal consolidation between the BELL and the PIIGS, which may be partly linked to the fact that the BELL have been outside the eurosystem. They launched an early and radical fiscal adjustment largely based on reducing budgetary spending. Meanwhile, most of the PIIGS delayed fiscal consolidation and (except for Ireland) mostly relied on tax increases—a strategy more detrimental to growth than expenditure-based fiscal adjustments.

Euro: The Main Problems and Solutions

Two main objections are raised against the euro. The first is expressed in a popular statement "One monetary policy can't fit all." This implies that countries, especially larger ones, should have their own currencies and floating exchange rates. The second objection is contained in another popular saying, "Monetary union requires fiscal (political) union." I will discuss these two objections and then present my own view as to what the main weaknesses of the euro architecture are and what should be done.

The first criticism harks back to the old discussion of fixed versus flexible exchange rates. The main protagonists in this debate—Milton Friedman and Robert Mundell (2001)—were much more nuanced than most of the proponents of monetary nationalism and free floats. Indeed, there is no shortage of criticism of the deficiencies of floating rates (e.g., see Dornbush 1976, 2001). National monetary policy can be very bad, as it was in many future members of the eurozone before they started their transition to the euro. Thus, while criticizing the deficiencies of the euro's architecture one should not take it for granted that the counterfactual was bound to have been much better. Most importantly, a general comparison of fixed versus flexible rates is not very useful in addressing the specific problems of the eurozone. In addition, one does not start from scratch but from a situation in which the euro already exists. Therefore, any assessment of any proposed radical change would have to include the cost of

transition from the present arrangement to the new monetary regime.[13]

Nominal devaluation as an adjustment device is certainly no panacea, even though it is usually politically easier than the internal one—namely, reducing the rate of growth of wages and prices relative to those in other countries of the hard peg area. But this fact must have been obvious before the euro was launched. What was not considered to a sufficient extent were the reforms necessary to remove the rigidities of wages and prices in the eurozone countries, and to make the internal devaluation quicker and less costly. Finally, the internal devaluation advanced in the PIIGS, and the comparison of their external adjustment with that of the BELL highlights the importance of wage-price flexibility and making the adjustment quickly (Balcerowicz and Łaszek 2013).

Greece, Spain, Portugal, and to some extent Italy have introduced reforms that made their labor and product markets more flexible (Balcerowicz et al. 2013). Such reforms would have been less likely if these countries stuck to their own currencies and allowed them to float. Therefore, the assessment of the euro should not be limited to deploring the crises it contributed to. Rather, we also should consider the longer-term consequences of these crises in terms of improved policies.

Let me now turn to the second criticism of the EMU—that it is a monetary union without fiscal/political union. This implies that to save the euro one must turn the eurozone into a fiscal/political union. In commenting on this criticism, let me first note that the crucial terms "fiscal union" and "political union" are not clear. Fiscal union could mean the existence of effective fiscal constraints on members of the monetary union, but it could also mean large cross-regional fiscal transfers—or it could mean both of these. Meanwhile, it is unclear if political union is synonymous with fiscal union, and if it is, in what sense of the word? Or does political union by definition include fiscal union in addition to something else? And what is this addition?

It appears to me that behind the described rhetoric there are two different proposals. In the first case, fiscal and political union are code words for centralistic arrangements in the eurozone that would

[13]For more on these costs, see Euro Intelligence (2009), Åslund (2012), and Blejer and Ortiz (2012).

ensure fiscal discipline in member states. This was the original intention of the Stability and Growth Pact. This is also the intention of the newly introduced initiatives, like the "Six Pack" and Fiscal Treaty. However, can these top-down fiscal constraints be more effective than the Stability and Growth Pact, especially after the non-bailout clause has been violated? I doubt it. Indeed, I believe nothing can well substitute for increased monitoring of governments by financial markets and for increased civic pressure coming from fiscally conservative voters in the respective countries. Even in the United States, where the position of the federal government vis-à-vis the states is much stronger than that of the center of the eurozone with respect to the member states, certain states are persistently fiscally ill-disciplined—and the non-bailout clause allows pressure coming from the financial markets to bear upon them. The same has been recently true of Australia (Ergas 2011).

In the second case, fiscal or political union are code words for a federal state, with more emphasis on increased cross-country fiscal transfers and less focus on fiscal discipline. This position arises from a belief that the only guiding model for the eurozone is "one currency-one state." There are two critical objections to this model: (1) it is not necessary to solve the euro's problems, and (2) it is not politically feasible.[14]

Even a brief look at developments in the eurozone after the introduction of the EMU demonstrates that it was not the lack of larger fiscal transfers that caused the problems in the PIIGS. The analysis in the previous sections shows that the true reasons were completely different:

- Some elements of the original euro architecture generated—via easy money—financial booms and the financing of bad fiscal policies.
- After the consequences of those accumulated problems came to the surface, some policies, including those of the ECB, delayed adjustment, making it more costly.

It is these weaknesses that have to be removed through well-conceived and targeted reforms.

[14]One can add that the existence of a single federal state does not guarantee a good currency—witness the monetary history of Argentina.

Not only is the model of a federal state in the eurozone not a proper solution to the euro's problems, but also it is not politically feasible (Issing 2013). Any attempt to rush it would be politically very risky—witness the heated debate about the EU budget (which hovers around 1 percent of the EU's GDP) or political tensions generated by inter-regional fiscal transfers in Italy, Belgium, and Spain.

To see what are the proper solutions to the eurozone problems one must break with the idea that the only model for the eurozone is a federal state model and look to other types of hard-peg areas (or currency unions in a broader sense), including the classical gold standard and currency boards.[15] The purpose of such an analysis is not to replicate them in the present eurozone but to see what have been the specific weaknesses of the euro architecture so far and how to eliminate them. In such a way, one arrives at the euro problems and the reforms one should aim at.

A more detailed discussion of these reforms is beyond the scope of this article.[16] They have to address the two crucial weaknesses of the euro architecture discussed in this article. Regarding the first, the excessive suppression of the credit spreads across countries with different fundamentals, one has to consider changes in the modus operandi of the ECB. In addition, if the exit option from the euro is introduced as an ultimate sanction, as put forward by the prime minister and finance minister of the Netherlands, risk premiums need to better correspond to underlying risks (Rutte and de Jager 2011).[17] Furthermore, as I have already stressed, increased fiscal discipline requires stronger monitoring from fiscally conservative voters; it cannot be imposed from outside, especially in the larger countries. Finally, to reduce the risk of serious financial-to-fiscal crises, one has to eliminate perverse regulations and prevent central banks from fuelling the booms. These are politically difficult tasks that go well beyond the eurozone.

The same is true of the central banks' unconventional monetary policies, which are even more risky in the eurozone than in the United States. The previous discussion suggests that a generous refinancing credit offered by the ECB to the PIIGS, together with the

[15]For an early analysis of this type, see Hanke (1998).

[16]I discussed them at length elsewhere (Balcerowicz 2012a, 2012b).

[17]Various bail-in schemes could also be used.

deficient strategy of delayed and improperly structured fiscal consolidation and delayed structural reforms (especially in Greece), have postponed the external adjustment in the PIIGS and increased its costs. However, the crises in these countries have spurred labor and product market liberalization, which have improved their capacity to deal, when necessary, with negative shocks through internal devaluation.

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Lessons from China's Great Famine

Mao Yushi

While the Great Famine (1959–61) is one of many famines throughout China's history, this does not undermine its significance in China's modern history. Unlike other tragic famines in the past, the Great Famine was caused by avoidable human mistakes—not by inevitable natural disasters.

There has been a great deal of scholarship in the West on the Great Famine, where it is known as the "Great Leap Forward." Several excellent books, such as Jasper Becker's *Hungry Ghosts* (1997), Frank Dikötter's *Mao's Great Famine* (2010), and Ralph Thaxton's *Catastrophe and Contention in Rural China* (2008), have explored the catastrophe from many angles, including the political decisions made by Beijing and local governments. Yet there had been comparatively little work coming from China. Now, thanks to the work of Chinese reporters, scholars, and especially Yang Jisheng's in-depth work *Tombstone* (2012), we have a more complete picture of this dark time in China's recent past.

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Personal Reflections

I was in my early 30s when the Great Famine took place. Labeled as a "rightest," I was persecuted along with thousands of others. At that time, many rightists were removed from their posts and sent to the countryside for re-education. During the Great Famine, many did not survive as they succumbed to hunger and disease. I was reduced to the lowest human form by the end of the Great Famine, constantly stalked by the nightmare that I could never shake: hunger. As a survivor with firsthand experience, I know that scores died during the Great Famine. As an economist and a concerned citizen, I felt an obligation to find out exactly how many people died during this catastrophe.

Calculating the True Number of Deaths

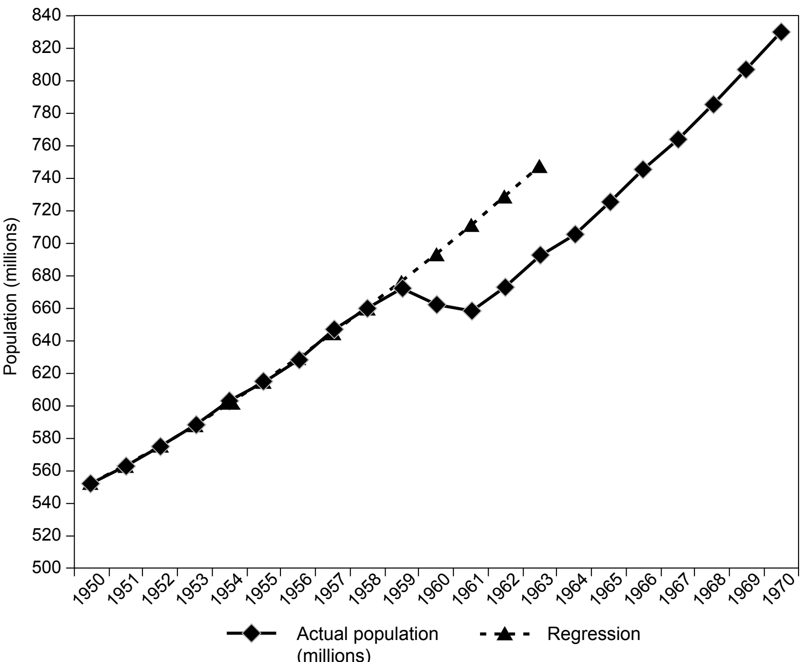
The causes of the Great Famine may be open to questions and debate, but the number of the deceased during this period must not be overshadowed by the necessity to be attuned to political sensitivities. It is the duty of survivors like me to determine the exact number of the deceased during the famine so that they can be remembered and a lesson for the nation can be learned.[1]

As shown in Figure 1, the vertical axis represents population and the horizontal axis the period from 1950 to 1970. According to the government's statistical yearbook, the population of China grew continuously until the end of 1958. However, between 1959 and 1961, the population plummeted. In 1962, the population resumed its growth. The solid black line represents the actual population during this period in millions. According to the trend line of the previous years, using the method of quadratic regression, the population would have been 711.18 million by 1962, as shown by the dashed line after 1959.[2] Compared with the real population of 658.59 million in 1961, the difference is 52 million individuals. What does 52 million mean in this context? It represents those who would have been born as well as those who would not have experienced abnormal deaths.

[1]Editor's note: Most of the calculations in this article are from Mao Yushi's "Method for Calculating Deaths in the Great Famine" (2011).

[2]The fitted value (10 million) $= 54.074 + 1.0684N + 0.02933N^2$. Where $N = 1$ when year $= 1950$.

FIGURE 1
The Impact of the Great Famine on China's Population



Two factors contributed to this loss of 52 million individuals. The first is those females who did not give birth, while the other factor is death by starvation.[3] If we subtract the would-be newborns, we will have the number of deceased from hunger, or the victims of the Great Famine. But we also need to ask: How many infants would have been born during this period? Taking into account the average mortality and fertility rates of the period, I concluded that 16 million babies should have been born between 1959 and 1961. The math behind this is relatively simple: 52 million minus 16 million gives us

[3]Editor's note: Frank Dikötter (2010), in his study of the famine, highlights the role of another factor in the death toll between 1959 and 1962: violence. Cadres would often resort to beatings when the desired results were not achieved by the peasants under their control.

36 million. We now have the number of unnatural deaths: 36 million. During the Great Famine, 16 million babies were not born who otherwise would have been, and 36 million individuals starved to death. The only problem with this calculation is the accuracy of the population statistics from the government. I have doubts about government statistics, which may affect the accuracy of this estimate.

What does 36 million mean? If we take a look at the casualties from WWII, we see that approximately 30 to 40 million died, including casualties in the European and Pacific theaters. This comparison shows the stunning fact that the Great Famine killed as many as the Second World War.

Considering the accuracy of this figure, I am sure it invites disagreement. Four hundred thousand Japanese died in Mainland China after the Lugouqiao Incident (also known as the Marco Polo Bridge Incident). This number is accurate as the names of those who perished during the invasion are listed at the Yasukuni Shrine in Tokyo. But one must ask: How many Chinese people died? We don't know for sure. Some say 29 million, which means that for each Japanese casualty in the war, 60 to 70 Chinese lost their lives. I find this figure hard to treat as true. According to my estimate, the number of Chinese casualties during the Second World War is less than 10 million.

This is just to show that we should have our own judgment about statistics. Thirty-six million is my own judgment of what happened in the past, and others may doubt the veracity of that figure. Yet there are no sources other than the government statistics bureau for such information, which is also one of the many impediments for our research.

There are 30 provincial capitals in China, and the 36 million deaths from the Great Famine are equal to a Nanjing Massacre in every capital five times over. The numbers are so large they become senseless, but what I see in these statistics are lives just like yours and mine. They deceased long ago, but they leave us an obligation to speak on their behalf and to always speak the truth. We can't allow people to cover the truth by saying they died not because of the Great Famine but due to their malnutrition or health problems. It's ruthless and inhuman to deny these facts.

Li Shengming of the Chinese Academy of Social Sciences published an article entitled "How Did the Lie of the Death of 30 Million Come into Being?" (2013) in the *China Social Sciences Journal.* I was

stunned and infuriated by his claim that the high number of casualties in the Great Famine was wrong and those who died had nobody but themselves to blame. It's beyond comprehension how people could even make such a claim.

This 36 million accounted for 5.5 percent of the total population of 660 million. There were 700 people in the small village where I stayed during this period, and roughly 80 to 90 died from hunger or related diseases. The casualties accounted for 10 percent of the population of that small village in Shandong. As Yang Jisheng (2012: 394) rightly points out, the death rate varied from province to province, with Anhui, Henan, Sichuan, Gansu, and Shandong being the most seriously affected. It's not how wealthy the province was or how developed agriculture was in a certain province that accounted for the variance in death rates. In certain provinces, relatively few people died even though agriculture was less developed. But many died from hunger in provinces like Henan and Sichuan where agriculture was rather developed.

I concluded before that the nationwide death rate of the Great Famine was 5.5 percent. I have extended that calculation to the average death rate for the three decades of Mao Zedong's rule, which was 1.1 percent. This means 11 people out of 1,000 died of diseases, earthquakes, and other reasons during Mao's rule. The average death rate in the three decades after the reform and opening up was 0.66 percent, a decrease of almost 50 percent. In addition, another 10 million people died for various reasons in political movements. Roughly estimated, about 3 to 4 million people died during the Cultural Revolution (1966–76). I've done extensive work to estimate the unnatural deaths during Mao's rule. But still I am not confident in my judgment, which is mostly based on common sense and information from the mass media. During the three decades under Mao's rule, 230 million died. Death due to political reasons amounted to 45 million to 50 million. For every four normal deaths, there was one abnormal death. After the reform and opening up in 1978, up to now, death due to political reasons decreased to about 200 to 300 thousand, which is a huge improvement. I think the most remarkable achievement of the reform is that deaths for political reasons have been greatly reduced, while during Mao's Zedong's rule one could only count on fate to die or survive.

According to the *China Statistical Yearbook* (1984: 397), China exported 4.15 million tons of food during the first year of the Great Famine, an amount that could feed 20 million people for a year with

each person consuming some 200 kg of food annually. This means most of the deaths during the famine could have been avoided if there were no food exports and the food was reasonably distributed. As a matter of fact, food was sufficient in the international market during this period, but Mao Zedong was too complacent and arrogant to decide to export food and instead acted as if "New China" was doing a good job of feeding its people. But what was the reality?

Holding Mao Zedong Responsible

Mao Zedong, along with some other people, should be held responsible for the death of so many people during peacetime. I am not accusing him of killing people intentionally. The Lushan Plenum was supposed to set the right track by correcting the problem of radicalness. But it took a shift as Mao targeted Peng Dehuai, which was purely Mao's responsibility. As Yang has written (2012: 389), 20 million people would not have perished if the Lushan Plenum were not held. What's more, the famine was reported to Chairman Mao continuously between 1959 and 1960, but he chose to ignore the disastrous news. Later, Mao sent PRC President Liu Shaoqi and Premier Zhou Enlai to deal with the famine, but to no avail. I doubt if Mao ever felt a sense of guilt, as he later persecuted Liu Shaoqi and other formerly close comrades. I think it is purely deluded and ill-informed to still uphold his flag in China. The Chinese people are a great people and they can't be blinded by Mao's mistakes.

Institutional Reasons for the Great Famine and Devastation

Yang (2012: 486) describes the institutional reasons for the great number of deaths during the Great Famine, which were caused by a system characterized by monopolies and food stamps. Starvation did not occur in urban areas on a scale even close to that in the countryside. The reason was simple: the urban population was guaranteed food stamps, which enabled them to obtain 15 kg of food per month. No matter exactly how much food one could obtain, starvation sounded like a far-fetched idea as one still had access to food anyway. People in rural areas, however, were not provided with food stamps. They grew their own crops, and after handing over a considerable proportion of the food they grew to the government, the remainder

was at their own disposal to either consume or sell on the market. If the government decided to collect more from the farmers, they were left with nothing to eat.

To take a step back, what is more reliable, food stamps or currency? If one loses one's food stamps, he cannot expect to gain additional stamps from his fellow citizens, as there are none to give. During the time of the famine, food stamps equaled life. Without food stamps, one did not eat. We should remember this lesson when we hear of new government programs to "help" us. For example, the current program to construct the *Baozhang fang* (保障房), or secure, housing might be treated with more skepticism after reviewing the history of similar projects. Perhaps a more realistic outcome is for the stock of affordable housing to shrink once the government project gets under way.

During the Great Famine, I was 30 years old and working at the Railway Research Institute. Our basketball court had been transformed into a field to grow wheat. The authorities asked the people not to waste our energy in order to save food. Not only was our basketball court turned into a field, but other research institutes experienced similar transformations.

Lester Brown, the American environmentalist and founder of Worldwatch, in his book *Who Will Feed China?* warned that the expanding number of golf courses in China is endangering the food supply (Brown 1995: 60). That claim is way below professional standards and judgments. Yet golf courses can only be developed if there is sufficient land. I can only speak for myself in saying that I have doubts about the professionalism and ethical standards of someone like Lester Brown. It is a shame that he is popular in China.

Conclusion

The Chinese government has been trying one way or another to ban talks and discussion on the Great Famine. This leads to a bigger concern of mine. How can a society be sustained when it is built on lies? Famine sounds like a far-fetched topic of the modern world, but the Great Famine along with the great toll is real. The lessons we learned are not in vain, and they should remain so even if my generation passes away. The current regime of China, be it under the rule of Jiang Zemin, Hu Jintao, Xi Jinping, or even Deng Xiaoping, should not hold itself accountable for the Great Famine. Deng Xiaoping

may still be involved one way or another, but this regime under President Xi Jinping should not associate itself with the one in the past. Therefore, it does not make any sense to cover the truth and stand by the guilt of Mao's rule as the legitimacy of the current regime is not dependent on Mao's rule but on the success of the reform and opening up.

I hope the Chinese people will not forget the Great Famine, and I believe the lessons learned from it will throw light upon the future.

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Equality, Justice, and Freedom: A Constitutional Perspective

James A. Dorn

The publication of Thomas Piketty's best-selling book *Capital in the Twenty-First Century* (2014) has raised awareness of the rising inequality of income and wealth. The author argues that such inequality threatens democratic values and should be reversed by imposing steeply progressive income and wealth taxes on the rich and near-rich. His policies, if implemented, would create more equal outcomes but undermine the principles of freedom and justice that are the essence of the U.S. Constitution.

The notion of equality is central to any discussion of the legitimacy of markets and government. This article investigates alternative meanings of equality, especially as the term applies to economic and political equality, derives the implications of each for the legitimacy of markets and government, and considers the role of the state in the maintenance of a free society. It will be seen that the legitimacy of the U.S. system of government is based on limiting the power of government to the protection of persons and property.

The roots of legitimacy for America's constitutional republic and for capitalism can be traced to what Corwin (1955) called "the 'higher law' background" of the Constitution. In the Framers' Constitution, majority preferences are bounded by constitutional principles—that is, higher-law principles or what Sir Edward Coke referred to as

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"common right and reason" (Corwin 1955: 44). The constitutional perspective sees natural rights to life, liberty, and property as being self-evident and prior to the institution of government.[1] In a rights-based approach to constitutional legitimacy, liberty trumps democracy. That view is in sharp contrast to Piketty's contention that "capitalism and markets should be the slave of democracy" (quoted in Schuessler 2014).

The constitutional perspective on equality—namely, equal rights and freedom under a rule of law—has been eroded as the redistributive state has grown. Equality has come to mean equal outcomes and "equal opportunity," in the sense of equal starting positions, rather than equal rights under a just rule of law. The trend toward what Anderson and Hill (1980) have called the "transfer society" has been encouraged by a complacent judiciary that has split the constitutional rights fabric in half, creating an artificial distinction between economic and noneconomic rights, with only the latter being afforded the status of fundamental rights (Dorn 1986). As Mayer (2011: 8) notes, "It is the creation of this double standard, under which economic liberty and property rights are devalued compared with more favored liberty rights, that improper judicial activism . . . can truly be found."

The loss of the constitutional perspective has given rise to what James M. Buchanan (1977: 296) has called "constitutional anarchy." More than a century earlier, Frederic Bastiat ([1850] 1964: 238–39) warned:

> If you make of the law the palladium of the freedom and the property rights of all citizens, and if it is nothing but the organization of their individual rights to legitimate self-defense, you will establish on a just foundation a rational, simple, economical government, understood by all, loved by all,

[1]The epistemological problems surrounding John Locke's natural rights theory have been exaggerated, according to Epstein (1985: 11–12), at least as they relate to constitutional theory. Likewise, Pilon (1981: 7) notes that although the Framers lacked modern epistemological tools, they "got it right, right as a matter of ethics." The important point is that the Framers did accept the conclusions of Locke's political philosophy even though his reasoning may have been flawed in part. Carl Becker (1958: 72) argues: "It was Locke's conclusion [regarding the inviolability of property] that seemed to the colonists sheer common sense, needing no argument at all."

> useful to all, supported by all, entrusted with a perfectly definite and very limited responsibility, and endowed with an unshakable solidarity.
>
> If, on the contrary, you make of the law an instrument of plunder for the benefit of particular individuals or classes, first everyone will try to make the law; then everyone will try to make it for his own profit. There will be tumult at the door of the legislative chamber; there will be an implacable struggle within it, intellectual confusion, the end of all morality, violence among the proponents of special interests, fierce electoral struggles, accusations, recriminations, jealousies, and inextinguishable hatreds; . . . government will be held responsible for everyone's existence and will bend under the weight of such a responsibility.

Those conflicting views of law and justice have as much relevance today as they did in Bastiat's time. Understanding their ramifications is essential for the maintenance of a free society.

In the modern redistributive state, equality of rights has been crowded out by equality of outcome; equal opportunity has been turned on its head; and limited government has given way to legislative activism. Cronyism and rent seeking have become the dominant features of democratic states as special interests seek to use the power of government for their own benefit. Consequently, the constitutional perspective—with its emphasis on ordered liberty, equal rights, and a just rule of law—has been seriously eroded.[2] Accordingly, the security of private property and freedom of contract have been jeopardized with a consequent rise in the uncertainty surrounding rights to property, liberty, and contract.

Equality of Rights and the Constitution of Liberty

From a constitutional perspective, equality means first and foremost the equality of rights under a just rule of law, with the basic right of every individual being the right to noninterference (Pilon

[2]The institution of slavery cast a big shadow on the Framers' Constitution, though the Civil War amendments helped to rectify that injustice. The "constitutional perspective" is one that recognizes fundamental rights and the importance of just rules that guide long-run behavior so that individual actions can be coordinated and result in economic and social harmony. That is why well-defined property rights are so important.

1979b, 1979c, 1981, 1983). That fundamental right stands at the center of what F. A. Hayek (1960) called the "constitution of liberty."

The basic principles inherent in the natural rights doctrine were stated in the Declaration of Independence and were used to justify the American Revolution. Their content is well-known: "All men are created equal . . . with certain unalienable Rights"; "to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed"; and "whenever any Form of Government becomes destructive of these ends, it is the Right of the People to alter or abolish it." The Constitution stands on those higher-law principles and is best viewed as a charter for limited government and individual freedom, not a blueprint for majority rule (see, e.g., Barnett 2004, Neily 2013).

The higher-law standing behind the written Constitution is what Cicero called "true law"—namely, "right reason, harmonious with nature, diffused among all, constant, eternal; a law which calls to duty by its commands and restrains from evil by its prohibitions" (Corwin 1955: 10). It encompasses the principles inherent in "the rule of law" regarded as "a meta-legal doctrine or a political ideal" (Hayek 1960: 206). Chief among those principles are the supremacy of private or common law, equality of the law, and priority of individual rights (Dicey [1915] 1982: 120–21). Those principles form a common web because equality, justice, and freedom are all central to the higher-law background of the Framers' Constitution.

At the heart of the English common or private law, and implicit in the U.S. Constitution, is what Hume ([1739–40] 1978: 526) called the "three fundamental laws of nature—that of the stability of possession, of its transference by consent, and of the performance of promises." Adam Smith ([1759] 1976: 163) referred to them as the "laws of justice," and F. A. Hayek (1982, vol. 2: 40) termed them the "rules of just conduct." Equality under the law requires equal treatment or due process and, at a more fundamental level, equal rights. Thus, the rule of law places substance above process.

James Madison, the chief architect of the Constitution and Bill of Rights, accepted John Locke's natural rights' position that "the *State of Nature* has a Law of Nature to govern it, which obliges every one. And Reason, which is that Law, teaches all Mankind . . . that being all equal and independent, no one ought to harm another in his Life, Health, Liberty, or Possessions" (Locke 1965: 311). He also accepted Locke's dictum that "The great and *chief end* . . . of Mens uniting into

Commonwealths, and putting themselves under Government, *is the Preservation of their Property,"* by which Locke meant their "Lives, Liberties, and Estates" (p. 395).

Madison, following in the Lockean natural rights tradition, placed property and equality of rights at the core of his constitutional system, a system in which both economic and noneconomic liberties were to be afforded equal protection under the law of the Constitution and enforced by a vigilant judiciary.[3] As Madison (1865: 51) wrote:

> It is sufficiently obvious, that persons and property are the two great subjects on which Governments are to act; and that the rights of persons, and the rights of property, are the objects, for the protection of which Government was instituted. These rights cannot well be separated. The personal right to acquire property, which is a natural right, gives to property, when acquired, a right to protection, as a social right.

In his famous essay "Property," which appeared in the *National Gazette* on March 29, 1793, Madison argued that "in its larger and juster meaning," property "embraces every thing to which a man may attach a value and have a right, and *which leaves to every one else the like advantage*." An individual thus has a property right in "his opinions and the free communication of them, . . . in the safety and liberty of his person, . . . [and] in the free use of his faculties and free choice of the objects on which to employ them." Justice requires that government safeguard "property of every sort." Consequently, Madison stated: "that alone is a *just* government, which *impartially* secures to every man, whatever is his *own*" (Hunt 1906: 101–2).

The idea that to be legitimate law must be impartially administered and protect property broadly conceived was self-evident to the Framers. Although those abstract principles were not fully realized in practice, they set a framework for future constitutional change, as evidenced by the Thirteenth and Fourteenth Amendments.

In establishing a constitutional republic, Madison's main concern was to limit the power of government and protect persons and

[3]For an in-depth account of the higher-law background of the Constitution and its influence on Madison, as well as his view of the judiciary, see Dorn (1988).

property. Writing to Thomas Jefferson in 1788, Madison noted: "In our Governments the real power lies in the majority of the Community, and the invasion of private rights is *chiefly* to be apprehended, not from acts of Government contrary to the sense of its Constituents, but from acts in which the Government is the mere instrument of the major number of the Constituents" (Padover 1953: 254).

By limiting the powers of government and reaffirming the rights of individuals, the Constitution and Bill of Rights set the basis for a free society—that is, a social and economic order characterized by equal rights and equal freedom. As Pilon (1983: 175) argues,

> The free society is a society of equal rights: stated most broadly, the right to be left alone in one's person and property, the right to pursue one's ends provided the equal rights of others are respected in the process, all of which is more precisely defined by reference to the property foundations of those rights and the basic proscription against taking that property. And the free society is also a society of equal freedom, at least insofar as that term connotes the freedom from interference that is described by our equal rights.

In the Madisonian, natural-rights view of the constitutional contract, there are no welfare rights entailing positive obligations on the part of the state to take private property from A, in the name of "social justice," and redistribute it to B without A's consent. The right to noninterference carries only the negative obligation to refrain from interfering with the equal rights of others to their property and freedom. As such, under the constitution of liberty, there is a consistent set of rights, all of which flow from the basic right to noninterference. In that "world of consistent rights, everyone can enjoy whichever of his rights he chooses to enjoy at the same time and in the same respect that everyone else does, and the negative obligations correlative to these rights can be satisfied by everyone at the same time and in the same respect that he enjoys his own rights by noninterference" (Pilon 1979c: 1340–41).

The Madisonian system of government, being one of equal freedom and justice, is in sharp contrast to the modern redistributive

state with its emphasis on forced transfers. As Bastiat ([1850] 1964: 65) stated:

> When law and force confine a man within the bounds of justice, they do not impose anything on him but a mere negation. They impose on him only the obligation to refrain from injuring others. They do not infringe on his personality or his liberty or his property. They merely safeguard the personality, the liberty, and the property of others. They stand on the defensive; they defend the equal rights of all. They fulfill a mission whose harmlessness is evident, whose utility is palpable, and whose legitimacy is uncontested.

When equality is viewed from a constitutional perspective, the emphasis is on equal rights and equal freedom, which are essential for legitimate constitutional choice—that is, a just constitutional order. In this respect, Madison (in Hunt 1906: 102) remarked:

> That is not a just government, nor is property secure under it, where the property which a man has in his personal safety and personal liberty, is violated by arbitrary seizures of one class of citizens for the service of the rest. . . . Nor is property secure . . . where arbitrary restrictions, exemptions, and monopolies deny to part of its citizens that free use of their faculties, and free choice of their occupations, which not only constitute their property in the general sense of the word, but are the means of acquiring property strictly so called.

Underlying the legitimacy of the Framers' Constitution, therefore, is what John O'Sullivan, editor of the *United States Magazine and Democratic Review*, referred to as the "voluntary principle." In 1837, he wrote: "The best government is that which governs least." Thus, legislation "should be confined to the administration of justice, for the protection of the natural equal rights of the citizen, and the preservation of the social order. In all respects, the voluntary principle, the principle of freedom . . . affords the true golden rule" (Vernier 1987: 12). From a constitutional perspective, then, equality refers to the equal rights of individuals to be free from interferences affecting their lives, liberties, and estates.

Buchanan and Tullock, in their classic *Calculus of Consent* (1962: 250), argue that when choosing the rules of the game (the

constitution) "full consensus . . . among all members of the social group seems . . . to be the only conceivable test of the 'rightness' of the choices made."[4] Indeed, it is the *voluntary* nature of any choice that justifies it under the process-driven model, but one must also ask if anyone's rights have been violated in the process. Hence, in determining the legitimacy of governments, "process will not carry the day; substance must" (Pilon 1985: 826). That is why the rights-driven model of constitutional legitimacy is a necessary complement to the unanimity rule. By accepting property, liberty, and contract as self-evident natural rights, the Framers' sought a system of government that would secure those rights.

In sum, individual rights to life, liberty, and property are justified by "right reason" not by majoritarianism, and the function of a just government is to protect both economic and noneconomic rights under the rubric of the property right. In this sense, Pilon (1985: 829) emphasizes that the "substantive element [in due process] is justified not because it reflects the will of the majority, not because it has been determined by some democratic process, but because it is derived from principles of reason."

Insofar as the judiciary safeguards those principles embodied in the higher-law background of the Constitution, individuals will be able to pursue their own interests provided they respect the equal rights of others. By limiting the range of political choice in the post-constitutional setting, the Framers wisely provided for a structure and function of government compatible with free markets and a political setting in which individual rights come first and majoritarianism second.

[4]Rutledge Vining, who influenced Buchanan and Tullock at the University of Virginia, recognized this aspect when he wrote:

> To be free to act as one chooses and at the same time to recognize the freedom of others to do likewise can only mean that all participate equally in setting the constraints upon individual action. For no one is free unless all abide by the rules of conduct which all can be brought to accept as approximate constraints upon individual action. . . . To require of each individual that he takes no action which impairs the freedom of any other individual is to accept the moral principle that no individual should treat another simply as a means to an end. Each individual chooses the rules and principles for the guidance of his conduct, but he does so under the general principle that no rule of action will be adopted which could not be universally adopted by all individuals [Vining 1956: 18–19].

Equality of Outcome and the Redistributive State

A change in the meaning of equality—from equality of rights to equality of outcome—transforms the function of government from one of protection to one of redistribution. As such, there is a shift away from the Framers' minimal state to the modern welfare state. In this shift, the concept of justice also undergoes a transformation, losing its classical connotation of equal freedom and taking on the connotation of "social justice," which is to be achieved by forced transfers and socioeconomic regulation. Thus, instead of a substantive theory of rights and justice consistent with a free-market process and a social compact theory of the state, the acceptance of equality of outcome as the basis for legitimacy leads to a purely consequentialist model of markets and government and to an end-state concept of justice.[5]

When viewed from the outcome-driven model of equality, the concepts of economic equality and political equality also take on new meanings. Economic equality, instead of meaning open competition and the protection of individual rights to private property and freedom of contract, is now defined in terms of distributive justice. The focal point thus shifts from rules to results and from freedom to coercion as the state attempts to impose some predetermined pattern of income and wealth distribution on the free-market process. The constitutional perspective is thereby distorted as judicial and legislative eyes turn toward what Hayek (1982, vol. 2) has called the "mirage of social justice." Similarly, political equality, when viewed outside the Framers' system of limited government, becomes more focused on the democratic process than on effectively constraining the powers of government and safeguarding individual freedom. The danger is that without effective constraints on majoritarian impulses to redistribute income and wealth, democracy will trump liberty—thus, politicizing economic life and slowing economic growth.

The demise of substantive protection of economic rights in the United States since the late 1930s has eroded the economic constitution and expanded the size and scope of government.[6] The Supreme

[5]On the difference between the process concept of justice and the end-state concept, see Nozick (1974: 153–60).

[6]In 1988, William Niskanen, then chairman of the Cato Institute, observed: "The erosion of the economic constitution and the pervasive growth of government are among the more important characteristics of our times" (Niskanen 1988: xiii). See also Dorn and Manne (1987), Epstein (1985), and Siegan (1980, 1984).

Court's reliance on the "rational basis" test has effectively eliminated judicial review in the field of economic liberties, leaving the door open to all sorts of legislative mischief. Commenting on this development, Epstein (1984: 28) wrote:

> Under present law, if any conceivable set of facts could establish a rational nexus between the means chosen and any legislative end of government, then the rational-basis test upholds the statute. In theory, the class of legitimate ends is both capacious and undefined, while the means used need have only a remote connection to the ends chosen. In practice, every statute meets the constitutional standard, no matter how powerful the arguments arrayed against it.

In sum, the movement from a rights-based view of equality toward an outcome-based view has turned the Framers' Constitution on its head. The safeguarding of persons and property, which Madison held as the primary function of a just government, has given way to the promotion of social justice via the redistributive state. Rent seeking has risen as the judiciary has abandoned substantive due process with respect to economic liberties.[7] The notions of economic and political equality have taken on new meanings that are inconsistent with the "voluntary principle." The linkage between moral and political legitimacy, therefore, has been severed (see Pilon 1982).

The Chameleon of Equal Opportunity

Equality is often interpreted as "equal opportunity," but that usage sometimes refers to equal rights and other times to equal starting conditions.[8] In the former sense, equal opportunity simply means equal freedom under what Bastiat ([1850] 1964: 94) called the "law of justice"—that is, the law of liberty or higher law underlying the

[7]Jan Tumlir (1985: 14) understood that "if we are to explain the rise of rent seeking to a dominant form of democratic politics, we must focus on the change in constitutional interpretation."

[8]See Pilon (1982: 37–39) and Friedman and Friedman (1980: chap. 5). Both Pilon and the Friedmans recognize that equality of opportunity—in the sense of equal freedom—is fully consistent with the Framers' Constitution. However, when viewed as equality of material starting conditions, equality of opportunity is at odds with the free society envisioned by the Framers.

Framers' Constitution. As such, equality of opportunity is perfectly consistent with the constitutional perspective on equality.

The chameleon nature of equal opportunity, however, becomes apparent when viewed in the second sense—namely, as equality of one's starting position or endowment. For here, the minimal state sheds its protective function to return as Leviathan, ready to redistribute property according to the preferences of organized interests or the will of the majority. In the process, the original and legitimate meaning of equal opportunity is lost sight of.

Just as equality of rights and equality of outcome are inconsistent usages, so too are the twin usages of equal opportunity just noted. Extending equal opportunity to everyone violates no one's rights when used in the sense of equal freedom. All individuals can jointly have rights to life, liberty, and property—in the sense that all are free to choose among competing alternatives in a world of scarcity. One person's right to noninterference in the use of his property does not preclude others from having the same right to their property. Whether the property right in question is the right to freedom of contract or freedom of speech, those rights are fundamental natural rights belonging to each individual on an equal basis. Thus, in the absence of any positive welfare rights, the set of rights stemming from the basic right to noninterference (which entails only negative obligations) is a world of consistent and equal rights, "a world in which we can at all times enjoy whichever exemplifications of our right to noninterference we choose to enjoy, subject only to the restrictions we incur as a result of our own actions" (Pilon 1979a: 148).

Having an equal right to noninterference or liberty, however, is not the same as having an equal power to exercise that right.[9] Under the First Amendment, all individuals have the right to free speech, but the exercise of that right will be affected by relative endowments and, thus, by the scarcity of resources. The same is true in the exercise of economic liberties such as the right to use and dispose of private property and the right to negotiate contracts so long as third-party rights are not violated.

[9]For a useful discussion of this distinction and the implications of the failure to perceive the difference between having general rights and exercising those rights, see Pilon (1979b: 1189–91).

The failure to understand the difference between having a right and exercising it has led to the fallacy of thinking that the state can legislate a right to equal opportunity—in the sense of equal starting conditions—without violating the right to noninterference. Yet, the incentive is for politicians to legislate free lunches, even though in a world of scarcity it is impossible to equalize material conditions without taking from those who produce income and wealth and redistributing it to those who do not. Thus, while it is possible for all individuals to have the right to private property and freedom of contract, it is patently absurd to think that all individuals can exercise that right without violating the very freedom the initial right conveys.

In sum, extending the right of equal opportunity—in the sense of equal freedom and equal justice under a rule of law—to everyone as a natural right entails no opportunity cost in terms of forgoing other legitimate rights and liberties.[10] As such, equal opportunity in this limited sense is a legitimate part of the constitutional perspective of equality. However, once equal opportunity is enlarged to mean equal endowments, the state necessarily moves from protecting property rights to redistributing them.

Constitutional Principle or Constitutional Anarchy?

A principled approach to equality requires an understanding of the higher-law background of the Constitution, wherein the Constitution is viewed as a charter of freedom. Insofar as equality of rights is replaced by equality of outcome or equality of opportunity in terms of equal starting conditions, the Framers' Constitution will fall prey to the redistributive state. The choice between a constitutional ethos of liberty and an ethos of social justice, therefore, is a choice between constitutional principle and what Buchanan (1977: 296) has called "constitutional anarchy."

A Constitutional Perspective of Equality and Order

In taking a constitutional perspective of equality and order, the focus is on the underlying rules necessary for coordinating individual interests so as to resolve conflicts in a socially and economically harmonious way with a minimum of government interference in the

[10]See Meckling and Jensen (1980) on the difference between what they call "scarce rights" and "non-scarce rights."

private domain. A constitutional perspective, therefore, encompasses both the problem of moral legitimacy and the problem of efficiency—that is, it deals with the ethical problem of determining the legitimacy of the rules underlying markets and government as well as the practical problem of determining how well the chosen rules operate to bring about a spontaneous social and economic order. It is only within a system of limited government safeguarding private property and freedom of contract that those two aspects of the constitutional perspective reinforce each other as justifications for a free society.

When addressing the question of how rule changes affect individual incentives and behavior, the constitutional perspective accepts the public choice view that individuals are self-interested in all aspects of their behavior involving scarce resources. The upshot of the self-interest postulate is not that individuals cannot be public spirited, but rather that each individual seeks to undertake those actions he expects will render him a net benefit—whether operating in the private or public sector. An individual's utility function can contain many different economic goods subjectively perceived, including charity. But the tradeoffs among those goods will depend on the relative prices confronting the individual and, therefore, on the property rights structure. Thus, the constitutional perspective is also a property rights perspective of individual action as it affects social and economic order. Changes in the property rights structure—the rewards an individual can capture for various actions and the costs he must bear—will affect his choices. The lower the relative price of any action, the greater will be the incentive to take it (other things being equal). This law of rational choice is as applicable to individuals within government as it is to those in the private sector.[11]

A constitution, viewed as a set of rules empowering government and constraining individual action, is an important determinant of the penalty-reward system and, hence, of individual action. A constitution affording broad protection to economic and noneconomic liberties, understood in the natural rights tradition, will ensure justice in terms of equal protection under the law. It also will yield an economic and social order in which individuals are responsible for their

[11]On the public choice perspective, see Buchanan (1983) and Gwartney and Wagner (1988: chaps. 1–2). On the property rights perspective, see Alchian (1965a, 1965b), McKean (1972), and Furubotn and Pejovich (1972).

actions and have an incentive to utilize information that will bring about mutually beneficial exchanges, enhancing both private and social wealth. In pursuing their self-interest, therefore, individuals will tend to bring about a spontaneous economic order in which resources are directed in line with consumer sovereignty. This "principle of spontaneous order," which Buchanan (1979: chap. 4) has called "the central principle of economics," is operative, however, if and only if there is a constitution of liberty—that is, one protecting property (broadly conceived) and the right to noninterference.[12]

An effective enforcement mechanism is essential if the Framers' constitutional principles are to be more than mere symbols of the higher-law background within which the Constitution was framed. It is in this regard that Madison saw the judiciary as the final arbiter and guardian of the Constitution. He considered a strong federal judiciary to be an essential element in protecting individual rights and for establishing a sound constitutional order based on the classical concept of commutative justice. In the First Congress, he argued for a judiciary that would act as "an impenetrable bulwark against every assumption of power in the Legislative or Executive" (Gales 1834, *Annals*, vol. 1: 439). Similarly, Madison (1865: 296–97) emphasized that "the Federal judiciary is the only defensive armor of the Federal government, or rather, for the Constitution and laws of the United States. Strip it of that armour, and the door is wide open for nullification, anarchy, and convulsion." Although the U.S. Supreme Court has largely fulfilled its protective function with respect to First Amendment rights, it has failed to provide equal protection for economic liberties, thereby leaving the door open for nullification of the economic constitution by the political branches.[13]

[12]According to Hayek (1967: 162), "Under the enforcement of universal rules of just conduct, protecting a recognizable private domain of individuals, a spontaneous order of human activities of much greater complexity will form itself than could ever be produced by deliberate arrangements, and in consequence the coercive activities of government should be limited to the enforcement of such rules." See also Hayek (1960: 160; 1982, vol. 1: 36–37) for a discussion of the principle of spontaneous order and its relation to a constitution safeguarding individual liberty, and Hayek (1945) on the importance of a decentralized system of markets and prices for utilizing the vast amount of knowledge available only to individuals on the spot.

[13]For a discussion of Madison's view of the judiciary, the Court's role in a federalist system, and the abandonment of substantive protection of economic liberties since the late 1930s, see Dorn (1988: 76–83).

In sum, a constitutional perspective of equality reveals that within a system of rules safeguarding property (in its larger Madisonian sense), freedom will flourish, and self-interest will operate to promote a spontaneous economic and social order. As Adam Smith ([1776] 1937: 651) pointed out more than two centuries ago, within a "system of natural liberty . . . every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men." It is in this spirit that Madison wrote:

> If industry and labor are left to take their own course, they will generally be directed to those objects which are the most productive, and this in a more certain and direct manner than the wisdom of the most enlightened Legislature could point out. . . . All are benefited by exchange, and the less this exchange is cramped by Government, the greater are the proportions of benefit to each [in Padover 1953: 269–70].

Insofar as the rules of just conduct are not enforced by a vigilant judiciary, the political branches will negate the Framers' constitutional principles. Majoritarianism and special interests will then undermine individual rights and give rise to a redistributive state.

Social Justice and Legal Plunder

The principle of spontaneous order and the importance of rules of just conduct in bringing about social and economic order are often disregarded. Instead of seeing the connection between constitutional order and socioeconomic order, policymakers tend to think in terms of placing better people in command of static institutions. Rather than changing the rules of the game in order to change incentives and behavior in line with constitutional principles and the free-market process, policymakers tend to ignore the constitutional perspective and focus on short-run solutions. Emphasis is usually on better government and the "public interest" rather than on upholding the Framers' Constitution. It is often heard that self-interest applies only in the economic regime, not in the political regime. That presumption, however, has been seriously challenged by

public choice theory and the reality of government failure. According to Buchanan (1983: 10–11),

> The constitutional perspective . . . emerges naturally from the politics-as-exchange paradigm or research program. To improve politics, it is necessary to improve or reform the rules, the framework within which the game of politics is played. There is no suggestion that improvement lies in the selection of morally superior agents, who will use their powers in some "public interest."

Calls for radical measures to achieve greater equality of income and wealth by Piketty and others, if realized, would vastly increase the power of government, violate private property rights, dampen market incentives, and increase rent seeking. In contrast, under a just rule of law and limited government, markets would be insulated from redistributive government programs, and rent seeking would be replaced by profit seeking and wealth creation.

Using the force of law to violate property rights is what Bastiat ([1850] 1964: 60] called "legal plunder." It is ruinous to civil society as freedom and responsibility are destroyed by the state. According to Bastiat, "it is quite impossible . . . to conceive of fraternity [charity] as *legally* enforced, without liberty being *legally* destroyed, and justice being *legally* trampled underfoot" (p. 64).

A judiciary that is active in striking down legislation that violates rights to private property and freedom of contract would change expectations and limit rent seeking. The economic and political regimes would then cooperate to produce economic and social harmony. However, it has been the Court's failure in this respect—and the success of legislative activists—that have eroded the economic constitution and allowed the emergence of the welfare state.

Restoring the Constitutional Perspective

In 1792, Madison stated what he thought to be the central principle on which good government should rest—namely, "the inviolability of property" broadly interpreted in the Lockean sense. In his opinion, "If the United States mean to obtain or deserve the full praise due to wise and just governments, they will equally respect the rights of property, and the property in rights" (in Hunt 1906: 103). Much progress was made in achieving a greater security of property

rights up through the early part of the 20th century. However, with the rise of the modern welfare/regulatory state, economic liberties have come under increasing attack (Dorn and Manne 1987, Levy and Mellor 2008, Mayer 2011, Pilon 2013).

The demise of the constitutional perspective has been fueled by a Supreme Court that has largely abandoned its duty of protecting economic rights, especially private property and freedom of contract. As Siegan (1985: 289) has written: "The most important civil rights for the framers of the original Constitution, the Bill of Rights, and the Fourteenth Amendment were those of life, liberty, and property. Contemporary Supreme Court policy largely ignores this understanding with respect to the last item of this trilogy."

The Case for Principled Judicial Activism

To restore the Framers' constitutional perspective, the judiciary needs to return to first principles and adopt what Macedo (1986) calls "principled judicial activism"—that is, activism aimed at enforcing the principles of equal freedom and justice inherent in the higher law of the Constitution. By acting as the final arbiter and guardian of the Framers' Constitution of liberty, the judiciary would reestablish itself as a bulwark against the political branches and help restore what Antonin Scalia (1985: 709) calls "a constitutional ethos of economic liberty."

Although Scalia has advocated such an ethos, he has not been a defender of Macedo's principled judicial activism. He believes a favorable change in the public's sentiment toward economic liberty must *precede* any change in the Court's policy toward reestablishing substantive protection of traditional economic rights. In his words, "the allegiance comes first and the preservation afterwards" (Scalia 1985: 709). That may be true as a matter of practice but not principle. Once the Constitution is in place, preservation of the Framers' *principles* comes first and public *sentiment* regarding the inviolability of property second. It is the judiciary's responsibility to give economic liberties the same protection as noneconomic rights.

Restoring the Constitution of Freedom

Buchanan (1977: 297–98) has argued that the time may be ripe for "genuine constitutional revolution" designed to restore the "constitution of freedom." Such a revolution, however, requires taking a

"constitutional attitude," by which he means "an appreciation and understanding of the difference between choosing basic rules and acting within those rules." Buchanan's public choice perspective has led him to focus on "constitutional choice"—that is, "to analyze alternative constitutional regimes or sets of rules and to discuss the predicted workings of alternative constitutional arrangements" (Buchanan 1983: 11).

Today, many critics of the existing social and economic order operate in an institutional vacuum, ignoring the potential for abuse under majority rule and harboring the illusion that a mere changing of the guard—without any effective change in constitutional rules and enforcement—will improve the operating characteristics of democratic government. This is not to deny that people make a difference. Rather, it is to warn that without changes at the constitutional level—in the effective set of rules constraining individual behavior—there is little reason to believe that any significant changes in either public or private behavior will occur. Property rights matter. As McKean (1972: 186) pointed out,

> In appraising special tools to increase efficiency, one should examine what happens to property rights and appropriability in order to form realistic expectations about the effects. Also, in trying to invent improved devices or institutional changes, or in launching new programs, we should keep the impacts on rights and opportunity sets in the forefront of our minds, and not just assume that good intentions pave the road to economic efficiency.

The Framers' adherence to the Lockean notion of justice, with its emphasis on the protective rather than the redistributive state, corresponds with the importance they attached to the priority of individual rights over democratic values. It also corresponds with the Framers' constitutional perspective whereby equality is viewed in terms of equal *rights* rather than equal *outcomes*. Social or distributive justice is nowhere mentioned in the Constitution, and its implementation by forced transfers cannot be sanctioned as a legitimate function of the state when viewed from the higher-law background of the Constitution. Indeed, as Hayek (1982, vol. 2: 96) has argued: "In a society of free men whose members are allowed to use their own knowledge for their own purposes the term 'social justice' is

wholly devoid of meaning or content." That is because "while an equality of rights under a limited government is possible and an essential condition of individual freedom, a claim for equality of material position can be met only by a government with totalitarian powers" (p. 83).

Trying to impose some predetermined outcome on a free-market order can only undermine freedom and, hence, the moral fabric of the Framers' Constitution. Thus, the Framers rejected the quest for distributive justice as a legitimate function of a free and just government, leaving that goal largely to voluntary charity and the private domain. Indeed, when asked about the meaning of the general welfare clause, Madison (1865: 171–72) wrote:

> With respect to the words "general welfare," I have always regarded them as qualified by the detail of powers connected with them. To take them in a literal and unlimited sense would be a metamorphosis of the Constitution into a character which there is a host of proofs was not contemplated by its creators. . . . [T]he words, in the alternative of meaning nothing or meaning everything, had the former meaning taken for granted.

Despite the clash between equal rights and equal outcomes, and the inconsistency of the welfare state with the Framers' voluntary principle and private property, modern liberals continue to claim the moral high ground for the redistributive state. In doing so, however, they reverse the order of importance the Framers placed on individual rights by giving priority to democratic values. As such, the priority of the higher law of the Constitution has given way to moral relativism if not skepticism and legal positivism. By inverting rights and values, proponents of the redistributive state have lost the moral high ground they claim to occupy. They ignore the fact that "there are many things that we value, and many things in which we have an interest, but these are not ours by right unless we hold title in them free and clear" (Pilon 1981: 9).

The restoration of a constitutional perspective, therefore, requires a restoration of the fundamental right to property and the principle of freedom/noninterference. Like Adam Smith, the Framers generally accepted the idea that "beneficence is always free, it cannot be extorted by force" (Smith [1759] 1976: 155). True beneficence is

outside the scope of legislation and cannot be compelled by law without destroying the voluntary choice that is the essence of moral action. As Brunner (1983: 354) notes,

> A society with a minimal and widely decentralized political structure offers the only opportunity for genuine moral decisions and concerns of justice. The imposition of such "decisions" and concerns with the aid of coercive police powers destroys the meaning of moral behavior. A "moral society" places the responsibility for moral decisions with individuals and their conscience and not with the police powers of the state's apparatus.[14]

In discussing the nature of moral choices and "genuine virtue," Pilon (1979b: 1194) observes:

> When individuals engage in Good Samaritan behavior they can easily say they are doing what they *ought* to do, as decent members of civilized society, quite apart from what they are strictly *obligated* to do (or have a right not to do). Here there is no difficulty because no issue of force arises—and indeed, only because they are *not* forced to perform these acts can genuine virtue arise.

Perfect and Imperfect Rights

In like manner, Adam Smith in his lecture "Of Jurisprudence" ([1762] 1982: 9) distinguished between "perfect rights" and "imperfect rights," with the former referring to "those which we have a title to demand and if refused to compel another to perform," and the latter referring to "those which correspond to those duties which ought to be performed to us by others but which we have no title to compel them to perform."

[14]Brunner (1983) derives the implications of alternative models of man and justice for the role of government. Like Bastiat, he distinguishes between the so-called Scottish model, in which man is self-interested and justice is in the form of equality under the law (and is commutative), and what he refers to as the "sociological model," which corresponds with the modern liberal's view of man and justice. The Scottish model yields a night-watchman/protective state while the sociological model yields a redistributive state. See also Sowell (1987).

According to Smith (p. 9),

> A beggar is the object of our charity and may be said to have a right to demand it; but when we use right in this way it is not in a proper but a metaphorical sense. The common way in which we understand the word right, is the same as what we have called a perfect right, and it is that which relates to commutative justice. Imperfect rights, again, refer to distributive justice. The former are rights which we are to consider, the latter not belonging properly to jurisprudence, but rather to a system of morals as they do not fall under the jurisdiction of the laws.

The distinction between perfect and imperfect rights is as pertinent today as it was in Smith's day. In particular, the imperfect nature of welfare rights as moral rights needs to be widely recognized if the moral pretense of activists operating under the banner of social justice—such as Piketty—is to be exposed and the rights-based approach to equality and justice restored (Dorn 2014a, 2014b, 2014c).

Freedom, Equality, and the Law

The failure to understand the connection between freedom and equality, and thus the tendency to substitute equality of outcome for equality of rights, serves to strengthen the hand of the state and produce constitutional anarchy as special interests come to dominate both the political and market processes. As Friedman and Friedman (1980: 139) note:

> A society that puts equality—in the sense of equality of outcome—ahead of freedom will end up with neither equality nor freedom. The use of force to achieve equality will destroy freedom, and the force, introduced for good purposes, will end up in the hand of people who use it to promote their own interests. On the other hand, a society that puts freedom first will, as a happy by-product, end up with both greater freedom and greater equality.

Regaining a constitutional perspective requires both an understanding of the higher-law background of the U.S. Constitution and an appreciation of the interconnectedness of stable government by

law, spontaneous market order, and economic progress. People should not forget that the Constitution was intended "to protect private markets from political pressures" (Epstein 1984: 28). The practice of judicial restraint in the review of economic legislation, however, has led to the politicization of economic activity and the consequent rise of rent seeking. In Epstein's view, this result was predictable because "the judicial surrender to legislative faction diverts resources from the production of wealth to the transfer of wealth" and "promotes political division that threatens the economic foundations of a stable, free and democratic society." For Epstein, "the connection between politics and markets, so understood by the Founding Fathers, has been all but forgotten today." A proper understanding of the connection between political action and economic choice, in other words, is a necessary ingredient for returning to the Framers' constitutional order.

Conclusion

A return to principle and reason, and therefore to a constitutional ethos of liberty, will not be easy. The existence and growth of the welfare state has immunized a large segment of the media and general public against thinking in terms of rules, equality of rights, commutative justice, and spontaneous market order. Individual cases of poverty and unemployment are typically generalized to crisis proportions in a matter of minutes on the nightly news. Long-run consequences of policies on social and economic stability are bypassed for immediate consequences, and so on. The public is led to believe that the Constitution is primarily a majoritarian document rather than a charter of rights and freedoms—and that it is a legitimate function of government to redistribute income and wealth via taxes and transfers, as well as by outright takings and regulation. In such an environment, it is not surprising that Piketty has attained rock star status, or that William Bradford Reynolds, while assistant attorney general for civil rights, remarked that he "never thought of private property rights as civil rights" (Crovitz 1986).

Reestablishing a constitutional perspective of equality will require a strong educational effort—one that returns to the roots of America's classical liberal heritage. If constitutional anarchy is to give way to ordered liberty, the judiciary will have to once again act as a bulwark against any usurpation of economic as well as noneconomic

liberties. Upholding the constitutional principles of the Framers and recognizing the primacy of individual rights over majoritarian values would help point the compass of liberty in the right direction. With a principled judicial activism, the public would better understand the importance of stable constitutional rules for long-run social and economic harmony, and an effective foundation would be established for restoring the constitutional perspective of equality.

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Current Lessons from the Past: How the Fed Repeats Its History

Allan H. Meltzer

> Here, then, the rulers of society have an opportunity of showing their wisdom—or folly. Monetary history reveals the fact that folly has frequently been paramount; for it describes many fateful mistakes.
>
> —Knut Wicksell

The Federal Reserve System came into existence 100 years ago after lengthy debate and discussion. It seems timely to look back on its founding, its history and development, and to consider its major successes and failures. This article looks at that history and discusses how the past is reflected in the present.

The Founding of the Fed

The new institution had little scope for discretionary policy actions. None of the parties discussing the proposed Federal Reserve Act of 1913 doubted that it would continue to follow a monetary rule—the international gold standard. Actions and initiatives remained greatly restricted by the Act. Monetary, credit, and

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interest rate actions consisted principally of setting discount rates on commercial paper and banker's acceptances. Rates influenced the amount of discounting, but the initiative for discounting remained with the banks. The Federal Reserve could purchase or sell bankers' acceptances on its own initiative, but individual Reserve Banks could decide whether to participate.

Agreement about economic issues included more than the gold standard. A series of financial disturbances in the 1890s and 1907 convinced most of Congress, the Wilson administration, and the informed public that the social cost of bank failures could be greatly reduced by creating a lender of last resort (LOLR) with power to lend on acceptable collateral in a financial crisis. The gain came from protecting the payments system, not, as now, protecting banks.

Agreement on another vital economic issue concerned the financing of government borrowing. The 1913 Act prohibited any direct loans to the Treasury. The authors understood, perhaps better than their modern counterparts, that financing government debt was likely to bring inflation.

Many economists act as if monetary policy is entirely an economic issue. Many articles analyze optimal economic policy. These articles neglect that the Federal Reserve is governed by political as well as economic concerns. That has been true since the founding, and it remains true, perhaps even truer now that discretionary actions have replaced the very restricted rules in the original design.

Article 1, Section 8 of the U.S. Constitution assigns the monetary power to Congress. The Federal Reserve is its agent. That makes political influence inescapable. Despite words about independence, it takes a very strong leader to remain independent. As former Fed chairman William McChesney Martin Jr. often remarked: "The Federal Reserve is independent within government, not independent of government" (Meltzer 2003: 713). That is not a very restrictive definition of independence.

The gold standard and discounting did not delay the 1913 legislation. The agreements that were difficult to reach were political issues.[1] Two issues stand out: (1) the issue of who would control the new agency—the Board in Washington or the 12 Reserve Banks

[1]To call them political issues does not mean that there were not major economic effects. The discussions did not dwell on the economic implications, though they were clearly important background knowledge.

spread across the country. And (2) where would the Reserve Banks be situated? The law assigned the second issue to a three-person board.

President Wilson, a former political science professor, proposed a compromise. The Reserve Banks would be semi-autonomous, with directors drawn from their region, with power to approve or dissent from purchases and authorized to set regional discount rates with Board approval. The Board in Washington had a supervisory role. The compromise satisfied the Western and Southern populists who thought that the Board would keep New York from setting interest rates at levels that would squeeze farmers and merchants. The large financial firms in New York preferred a structure like the Bank of England with no government participation. They did not get that, but they regarded the new arrangement for discounting as a very profitable opportunity to finance the annual crop movement to Europe in place of foreign banks, British especially, that could borrow from the Bank of England (Warburg 1930; Meltzer 2003: 69).

Popular discussion referred to the Board as "political representatives" and the Reserve Bank officials as "bankers." Populist concern that the bankers would run the system for their benefit continues throughout history. Most crises reduced the role of Reserve Bank directors, broadened director membership, ended their authority to decide on portfolio purchases and sales at their bank, and centralized discount rates and made them uniform. The last was as much the result of the creation of a national money market as a political decision to restrict Reserve Bank influence. The Board was subject to political pressure and influence, so a change in its relative power increased efforts at political influence. Political influence increased after the Second World War as a consequence of the Great Depression and passage of the Employment Act of 1946.

The Federal Reserve's Past Errors

The Wilson compromise got the legislation passed but did not end the struggle for control. Soon after the Federal Reserve began, the United States was at war. The Fed helped to finance wartime spending not by buying government debt as in later years, but by lending on favorable terms to banks that bought large amounts of debt. The prohibition against direct lending to the Treasury was still strong.

The prohibition was soon after circumvented. It is not correct to repeat that the Federal Reserve or Benjamin Strong discovered open market operations. The Bank of England first used open market operations about 100 years earlier. What the New York Fed learned was that open market purchases and sales could be used to change commercial bank reserve positions. The 1920–21 effort to control reserves by raising discount rates, as the Bank of England did, caused a political backlash and renewed fears of high rates dictated by New York. Raising rates, especially the selective high discount rates at several southern Reserve banks, created the need for an alternative means of control.[2] Punitive interest rates at some southern and western Reserve Banks raised political concerns. The Wilson compromise had not worked to keep interest rates low as the Act's sponsors had claimed. The conclusion was that raising rates for farmers and merchants was not a monetary control mechanism that worked in the United States. This was as much a political as an economic judgment, but it retained a controlling influence in 1928, when the board repeatedly vetoed discount rate increases above 6 percent. The political decision to avoid raising rates above 6 percent remained in effect until the Great Inflation and the anti-inflation policies of 1981–82.

In the 1920s, the Reserve Banks controlled decisions. Under the leadership of Benjamin Strong of New York, the Reserve Banks established the Open Market Committee to agree on purchases and sales of government securities and setting rates for acceptances. Open market operations circumvented the outright prohibition on financing the federal government. The Act permitted the Reserve Banks to engage in open market operations. The Reserve Banks could not directly lend to the Treasury, but they could purchase Treasury issues in the open market at rates that they influenced by their decisions. One of the main restrictions on inflationary policy was gone. The gold standard remained but not for much longer.

Strong was not an inflationist. In the 1920s, he agreed with Montague Norman of the Bank of England to allow gold flows to affect rates as long as they did not cause inflation. Other Reserve Bank governors (as they were called at the time) went along with Strong's policy because it provided income to pay reserve bank operating costs and the dividends promised on the member banks' shares.

[2]See Meltzer (2003) for details of the episode.

In the 1920s, some of the regional banks had insufficient earnings in some years.

The New York Reserve Bank managed the system's international transactions in the 1920s. Senator Carter Glass strongly opposed Strong's decision to lend to Great Britain to sustain return to the gold exchange standard. And he blamed the New York Bank for causing the Great Depression. In the 1933 and especially the 1935 legislation, Glass reduced the role of the Reserve Banks and strengthened the Board's role. Glass always opposed having a central bank. He would ask the regional governors: "Do we have a central bank?" The required answer was, no, we have an association of Reserve Banks. Yet, Glass, probably unwittingly, sponsored the Banking Acts of 1933 and 1935 that centralized control of monetary, credit, and interest rate policy in the renamed Board of Governors. Gone were the Reserve Banks' control of their portfolios and the power to refuse to participate in purchases and sales. Board members had often attended open market meetings in the 1920s, but they had no vote at the meeting. Nevertheless, they could veto an action using their supervisory responsibility. The new legislation gave them majority representation on the Open Market Committee. After 1935, New York lost the right to a permanent seat. In 1942, the Board restored New York's position on the Federal Open Market Committee (FOMC).

The next major changes came in the early to middle1950s when William McChesney Martin Jr. was chairman of the Board of Governors and the FOMC. In a series of steps, he gained support for procedural changes that transferred control of policy operations from New York to the Board. One very controversial action was to adopt a "bills only" policy that limited New York's power to intervene in long-term markets when demand for Treasury issues shifted. The Martin Fed maintained that the Federal Reserve should limit its operations entirely to the money or bill market. Martin and others saw "bills only" as a way to strengthen the market for long-term Treasuries after the wartime and postwar interest rate pegging period. The Democrats in Congress disliked bills only. After President Kennedy's election Martin and the Board made the political decision to cooperate with the new administration. One part of cooperation was an end to bills only.

The Council of Economic Advisers under Chairman Walter Heller wanted the Federal Reserve to cooperate in the administration's

effort to end the 1960–61 recession while reducing the capital outflow. To do this, they wanted the Federal Reserve to raise short-term rates and lower long-term rates. Martin was part of a small group that met with President Kennedy to coordinate economic policy. At these meetings, Heller and James Tobin encouraged the president to urge Martin to follow administrative interest rate policy.

Policy coordination sacrificed much of the Federal Reserve's independence. Martin did so willingly in some instances. One of his main reasons was his belief that the Federal Reserve was independent within government not independent of government. In practice, Martin said, Congress passed the budget and the president signed it, the Federal Reserve should not refuse to finance budget deficits even if the deficits were large.

That was a large departure from independence and especially from the founding principle of separating the Federal Reserve from responsibility for financing the federal government. Politicization of the Fed continued in the 1960s and 1970s.

In 1966, the Fed raised interest rates to slow inflation. Inflation responded quickly, but unemployment rose. The Fed reversed its actions. Markets learned a lesson about the Fed's priorities. The response of inflation and long-term interest rates was never again as rapid.

Fed Chairman Arthur Burns worked to support his friend Richard Nixon. After observing the much greater weight on unemployment and the failure to continue anti-inflation policies when unemployment rates rose, markets did not reduce long rates as much as in the past following reductions in short rates. Orphanides (2002) documents the errors in the 1970s. Most of the errors were errors of commission. The Federal Reserve was (1) slow to recognize Irving Fisher's earlier difference between real and nominal rates and (2) slow to accept that the Phillips Curve tradeoff was at most a short-term tradeoff. As Paul Volcker later reminded the Fed staff, Congress, and the public—contrary to the Phillips Curve, inflation and unemployment rose together in the 1970s and fell together in the 1980s.

In the Bernanke Fed, the Phillips Curve was again a guide to action. Prior to the credit crisis, the Board's staff relied for guidance on Woodford's (2003) model in which money is irrelevant, credit markets and asset prices are missing, and long-term rates are always at their rationally expected value. This model encouraged staff neglect

of the very markets in which problems arose. Earlier work by Friedman (1956), Tobin (1969), and Brunner and Meltzer (1993) considered some or all of the credit, monetary, and asset price variables. Absence of credit and asset markets from the Woodford model missed the source of the 2008 credit crisis. Taylor (1995) and Meltzer (1995) insist on the role of money and credit markets in the transmission process for monetary policy.

The neglect of concern for the transmission process is puzzling. No less puzzling is the staff's use of either large-scale econometric models or the bare-bones Woodford model. It is analytically elegant, but we must recognize that it is inadequate.

Monetary policy without money is a serious mistake. The reason for dismissing money, I believe, is that the staff believes that quarterly velocity movements are not predictable reliably as a function of short-term rates. Yet, when annual velocity from 1919 to 1995 is plotted against a long-term interest rate, which more adequately reflects expected inflation, the velocity relation is remarkably stable (Meltzer 2009a: 577). Moreover, the Bundesbank successfully used annual money growth to supplement and interpret policy effects. Issing and Wieland (2013) discuss the Bundesbank's use of money growth to check on the longer-term effects of short-term policy actions.

One additional flaw or missing element in the Federal Reserve's procedure is its treatment of its role as LOLR. We all know that this is a main reason for having a central bank. And we know, too, that failure to serve as LOLR was central to making the Great Depression a disastrous policy failure.

In a speech at the National Bureau of Economic Research, Bernanke (2013) recognized the Fed's responsibility to serve as LOLR. He referenced Bagehot (1873) and pointed to the massive response in 2008 that spared the United States and the world economy from a collapse of the payments system. That was necessary, courageous, and appropriate. It should remind each of us that unpredictable events occur and require responses that are not part of normal operating policy rules or judgments.

Bernanke's discussion of LOLR is deficient for two main reasons. First, in its 100-year history the Federal Reserve has never announced a LOLR policy rule. The need for announcing and following a rule is the main point of Bagehot's criticism of the Bank of England. Bagehot did not criticize the Bank for failing to act appropriately. He cited examples to show that, although the Bank delayed,

its actions eventually calmed the markets. His criticism is an early rational expectations claim—that the Bank failed to inform the markets of its LOLR policy rule. Announcing the rule that the Bank would lend on good collateral reduced uncertainty and encouraged prudent banks to hold appropriate collateral.

Second is the failure of regulators to understand that Bagehot makes them responsible for sustaining the payments system, not the troubled banks. The main reason for regulation is to close the gap between private and social cost as much as feasible. The main social cost is the collapse of the payments system. Economic activity cannot proceed. Sustaining the payments system does not require that regulators support failing banks; it requires five rules:

1. A clearly stated rule for the LOLR: Bagehot's rule—lend freely against collateral at a penalty rate—remains appropriate.
2. A rule to protect the payments system, not the troubled bank or banks.
3. A rule to prevent the problem from spreading to other banks and financial institutions by lending on good collateral.
4. A rule to require equity capital sufficient to absorb all anticipated losses: The Brown-Vitter bill requires the largest banks to hold a minimum of 15 percent equity capital against all assets.
5. A rule that banks must suspend dividend payments if equity capital falls to 10 percent of assets until they meet the 15 percent equity capital requirement.

There is considerable evidence that these rules work. Bagehot ([1873] 1962) gives a number of examples. And in the climactic years, 1929–32, no large New York bank failed because they held 15–20 percent equity capital.[3] Failures in 1929–32 were almost entirely small and medium-sized banks. Calomiris (2013) discusses the many problems in financial regulation policies. Borak (2013) reports on the difficulty of writing the many new rules proposed by the Dodd-Frank legislation. Many of the new rules transfer responsibility for risk management to the regulators. The five rules, instead, increase bankers' incentives to act prudently. Increasing banks' equity capital puts the incentives in the proper places.

[3]Some readers may wish to cite the failure of the Bank of the United States, but it was not a major bank. Regulators discussed saving the bank but did not (Meltzer 2003).

Currently, many central banks, including the Fed, have greatly increased their responsibility for financial stability. I urge them to avoid the intense pressure to take responsibility for regulating portfolios or portfolio risk that substitutes regulators' judgment for bankers' judgments. Such an approach has several drawbacks, chief among them is that it will at times require actions that are in conflict with proper monetary policy. Giving organizations multiple objectives that can conflict invites avoidance of responsibility. Also, there is little reason to believe that regulators can make better judgments than bankers if the bankers are required to hold much more equity capital. We know that in the years before 2007–08, the Federal Reserve and other regulators had many examiners in the largest banks observing portfolio decisions. I have been told by a leading examiner that they did not object to any transaction. Further, we know that regulators permitted large banks to open subsidiaries that acquired mortgage-backed securities but had little or no equity capital. Government agencies were willing to buy and hold poor-quality mortgages. It should not surprise us that markets supplied the mortgages. Some, like Countrywide, earned millions of dollars that way. In hindsight, the mistakes should be obvious. What few willingly recognize is that there was a strong, political dimension that appealed to leaders of both major parties. Presidents Clinton and Bush, and many members of Congress, welcomed the spread of home ownership down the income distribution. They neglected to wonder about what the buyers owned if they took out a no down payment loan. What they had is not equity in a house but an option to gain if prices rose and to lose if they fell. We know now how that tale ended in tears.

This experience does not give much confidence in regulator foresight or political forbearance. I believe we will do better by applying my five rules.

To summarize the historical evidence, I conclude that the Fed is no longer the much restricted agency intended to follow a rule—that institution vanished long ago. Political influence increased with the shift of power to the Board from the Reserve Banks.

How has discretionary policy under the Board's control worked? In my judgment, not well at all. It has two difficult, possibly impossible, hurdles to overcome. One is its short-term focus based on a quarterly forecast. Forecast errors are large—larger than the often large revisions to quarterly data. The other is a fundamental fact

about economics. Whether one learned economic theory using Modigliani's or Friedman's theory of consumer behavior, one learned about persistent and transitory events. Macroeconomic theory is more reliable when it concentrates on persistent effects. Transitory changes may be random, quickly reversed events. The Fed's response to monthly and quarterly data as it is announced increases uncertainty and encourages the army of financial market participants to pressure the Fed to respond.

There is some useful information in monthly and quarterly data. I have proposed that Muth's (1960) paper offers a useful procedure for extracting it. It uses the relative size of the variance of persistent and transitory components of the data to give weights to the two components. Perhaps there is a better alternative. Relatively large permanent variance implies that little weight should go on current data. More weight on current observations is appropriate if it is relatively more responsible for changes. Brunner, Cukierman and Meltzer (1980) show how Muth's procedure can be implemented to extract useful information.[4]

A simple example illustrates how monthly data can mislead. Reported monthly inflation is a mixture of the underlying rate of inflation and large relative price changes. The Federal Reserve now excludes energy and food price changes from its core inflation data. In the 1970s, it treated oil price rises as inflation. That was another error. But not all food or energy price changes are transitory. Some of the Reserve Banks use median price changes to exclude changes out in the tails of the distribution. These procedures are better than announcing large relative price changes as inflation. It is better to not respond by raising interest rates but instead letting markets adjust to relative price changes. The Fed finally adopted this change when oil prices rose early in this century.

The Fed's excessive attention to transitory events needs to end. Attention should be given to separating permanent and transitory changes. Alan Greenspan's recognition of persistent productivity growth in the 1990s is an example of proper response to a permanent change.

[4]Anderson, Chauvet, and Jones (2013) study permanent and transitory components of monetary aggregates using a more elaborate procedure.

The Fed's Persistent Errors

My reason for pointing out some of the Federal Reserve's past errors is that many are repeated now. The principal errors relevant to the present or recent past include:

1. The use of inappropriate models—from real bills, to simple Keynesian coordination, to the Woodford model—that neglect money and credit.
2. The failure to distinguish between real and nominal effects.
3. The excessive attention given to monthly and quarterly data, and the neglect of permanent or persistent changes.
4. The use of discretion instead of a rule both for monetary policy and lender-of-last-resort policy.

Since I focus on past errors that influence recent and current actions, I will start by offering some praise of some of the Fed's achievements. The Federal Reserve has never had a major scandal. A few minor problems occurred like occasional leaks of decisions, but it has a largely unblemished record. In part, this reflects another achievement—the very strong organizational structure and the loyalty of officials. At the operational level, the Fed developed from its very limited original duties to become the world's leading central bank.

From the 1920s on, it undertook research in ways that became a model for other central banks. It has not one, but several, high-quality research units.

One theme of this article is that current and recent Fed policy has had little effect on output and inflation. I, and others, predicted that the Fed would cause inflation by continuing a high rate of reserve growth after the initial crisis. My error was to expect that increased money growth would follow reserve growth. History supported that belief. There was only one exception. During the Great Depression, especially in 1932 but also after 1937, banks used only a small part of their increased reserves to expand money and bank credit. I did not expect a repeat of the 1930s, and I was wrong.

We do not have inflation because we do not have excessive money growth. As Milton Friedman (1969) noted, inflation is always and everywhere a result of money growth substantially faster than the growth of output. In October 2013, annual M2 growth was moderate at about 6 percent while bank reserves grew by 81 percent. At that

time, excess reserves held at the Fed were $2.3 trillion compared to $2 billion in 2007, while required reserves were $7.5 billion. Commercial and Industrial loans at all banks only increased by about 2 percent in 2013.

The main reason for the extraordinary increase in excess reserves is that the Fed engaged in quantitative easing (QE) to expand the Fed's balance sheet via asset purchases. More than 95 percent of the reserves supplied under QE2 and QE3 remained idle on banks' balance sheets. The Fed also incentivized banks to hold excess reserves by paying interest on those idle balances beginning in October 2008. Domestic and foreign banks receive $5.7 billion in interest payments for holding idle reserves. This policy permitted banks to rebuild capital and pay dividends and bonuses. The payments are made using money that would otherwise be paid to the Treasury. I doubt that Congress would vote for this transfer to banks, if it understood the Fed's program.

A main effect of the policy of accumulating massive amounts of idle reserves is that money and credit growth remains low. The UK and Japan now permit money and credit to expand. Output in both countries has increased.

Use of Inappropriate Models

The members of the Board and FOMC have never agreed on a model. The Board's staff has a sophisticated econometric model, but most or all of the Reserve Banks have their own models. When I refer to "the" model, I have the Board's staff model in mind. When reading my comments, the reader should remember that the principals require the staff to present forecasts at policy meetings based on models with which they disagree. An example is the Board staff's use of a Phillips Curve to forecast inflation. Paul Volcker and Alan Greenspan explicitly rejected those forecasts. Volcker publicly stated that over time inflation and unemployment rise and fall together, which is the exact opposite of forecasts relying on the Phillips Curve. Volcker added that the way to reduce unemployment is to lower expected inflation (Meltzer 2009b: 1058, 1082).

Bearing that caveat in mind, here are some examples of major policy errors based on faulty models. The real-bills doctrine was written into the Federal Reserve Act. The Board and some of the Reserve Banks believed that it was a mistake to expand reserves during the

years 1929–32. The governor of the Philadelphia Fed expressed the argument succinctly. He said that we would be putting out reserves when they were not wanted and would have to withdraw them when they were. That mistake does much to explain the mistaken policy driving the Great Depression.

Simple Keynesian models were used in the 1960s to encourage policy coordination. The economists in the Kennedy and Johnson administrations and on the Board's staff insisted that the Federal Reserve should coordinate with the administration by expanding money growth when budget deficits increased. The Federal Reserve did. However, President Johnson was reluctant to coordinate by reducing the budget deficit and slowing money growth. When he, after years of delay, agreed to raise tax rates temporarily in 1967, Arthur Okun and the Board's staff wanted lower interest rates and faster money growth (Meltzer 2009b). That error increased inflation, a major mistake. The Federal Reserve and the Nixon administration were unwilling to allow unemployment to rise for political reasons—and inflation continued.

Failure to Distinguish between Real and Nominal Effects

Milton Friedman's presidential address to the American Economic Association (Friedman 1968) carefully distinguished real and monetary effects and used that analysis to show why the Phillips Curve tradeoff had to be a temporary response of employment to inflation. The Fed continued to try to lower unemployment by inflating during most of the 1970s (Orphanides 2002).

The Fed frequently failed to distinguish between real and monetary influences. One example is the misinterpretation of low interest rates as "easy" in 1931–32. Another is the misinterpretation of interest rates during the Great Inflation. Still another is the attempt to reduce the unemployment rate by increasing inflation, an operation that continued after Friedman's 1968 article showed the error—and is still prevalent today.

I report this related error in volume 2 of my *History of the Federal Reserve.* During the Volcker disinflation, the FOMC interpreted increases in member bank borrowing as contractive because nominal interest rates initially rose. This interpretation ignores the expansive effect of the increase in reserves. This is a traditional Fed error based on the belief that banks are reluctant to borrow, so the increased borrowing would be temporary. This ignores the evidence showing that

cumulative borrowing typically continued to increase, thereby increasing money and credit (Meltzer 2009b: 1030).[5]

The current weak recovery is mainly a real problem that cannot be solved by printing reserves or making real interest rates more negative. The main real drag on growth is the uncertainty created by the Obama administration's fiscal and regulatory policies, including his insistence on increasing tax rates, costly regulations, and promoting labor unions (see Plosser 1989).

Some of the evidence that the problems are mainly real—not monetary—stares everyone in the face. Banks hold huge idle reserves. They can do anything the Fed can do to increase growth of credit and money. Corporations hold enormous idle balances. They do not choose to finance investment, so investment remains low and much of the investment is made for labor-saving robots and computer programmers. These idle balances at banks and corporations scream loudly that there is no unsatisfied demand for money.[6]

Porter and Rivkin (2012) asked 10,000 Harvard Business School alumni, officers at major corporations, about investment. They summarized the replies. The replies cited real factors, the complex U.S. tax code, an ineffective political system, a weak public education system, poor macroeconomic policies, complicated regulation, deteriorating infrastructures, and a lack of skilled labor. Many said they would move investment out of the United States.

Carlino and Inman (2013) found that many real problems result from the Obama administration's fiscal policy mistakes. They avoided permanent tax cuts and favored welfare spending that had small multiplier effects. An earlier op-ed by Cogan and Taylor (2010) made very similar criticisms. They wrote: the Obama stimulus "was a triumph of Keynesian wishful-thinking over practical experiences."[7]

Earlier I noted a recent example of the Fed's poor choice of model—the staff's reliance on Woodford's (2003) elegant model to

[5]As the statement was made, borrowing increased (Meltzer 2009a: n. 27).

[6]Some interpret the large idle balances as evidence of a liquidity trap. Brunner and Meltzer (1968) show that a liquidity trap cannot occur in a multi-asset model except, possibly, in a full equilibrium. Currently, Fed injection of reserves changes asset prices—contrary to a liquidity trap.

[7]Meltzer (2013) develops this assessment more fully.

judge the thrust of monetary policy and a possible recession. Since the Woodford model neglected asset prices and credit and money growth, it could not give correct information.

The Board staff also disregarded the Volcker and Greenspan warnings about relying on inflation forecasts generated by the Phillips Curve. That error continues.

In 1973, following months of rapid money growth during the period of price and wage controls, the economy was described as operating at 96 percent of capacity. The staff saw "clear and present danger of further overheating." Chairman Burns drew the right conclusion: "The basic reason [for rapid monetary growth] was that the System had been supplying reserves to commercial banks at a very fast rate. The rapid growth of the monetary aggregates was a most disturbing development." Despite this monetarist interpretation, members did not recognize that nominal interest rates included an expectation of continued inflation. Some members "expressed concern about the consequences of a federal funds rate above 10 percent" (Meltzer 2009a: 223).

A final example is the failure to distinguish between large positive relative price changes and rise in the general price level. Only the latter is properly called inflation. Chairman Burns urged some type of wage and price selective controls and later wage and price controls. The case for selective controls was also based on the mistaken belief that inflation was "cost-push" so that the rise in the general price level could be prevented by controlling a subset of relative prices.

The Federal Reserve and much of the profession interpreted the 1973 and 1979 increases in oil prices as inflation. By 2000, the Fed recognized that the oil price increase would increase the reported price level as a large relative price shock. Consequently, the Fed now excludes fuel and food price changes from its principal measure of inflation.[8]

Short-Term Focus

One of the most foolish decisions in the Fed's 100-year history is its current decision to make the reduction in reserve growth depend

[8]The Shadow Open Market Committee in 1974 pointed out that the Fed misinterpreted the oil price increase.

on current labor market data. First, the data is noisy and often subject to large revisions. Second, current QE policy increases idle reserves by $1 trillion dollars a year, so the problem of removing the reserves before they finance inflation increases. Third, and most important, the withdrawal of reserves to restore the Fed's balance sheet will require years of following a conditional rule. The Fed must develop a strategy.

The Fed's lack of strategy in managing the reduction of idle reserves is an example of its excessive attention and response to noisy monthly and quarterly data. This is a long-standing problem, probably reflecting political pressures and the excessive influence of the New York Federal Reserve Bank. That Bank has a permanent voice at the FOMC. Too often it is a captive of the large New York banks and financial firms.

The Federal Reserve's excessive weight on near-term events and reluctance to follow rules explains both its current mistakes and many past errors. Here are some examples from the past.

In 1976, the Fed announced targets for money growth, but it missed the M1 target often by large amounts. Stephen Axilrod, the chief of staff, explained the reason for the errors: "A large part of the Board's problem came from its short-term focus. . . . [I]f the objective was to have 6 percent M1 growth six months ahead, I could do it better by telling you what non-borrowed reserves to list than what FF [federal funds] rates to hit." Axilrod recognized that the main reason the Fed failed to come close to its monetary targets was that it put most of its efforts into managing the federal funds rate within a narrow band. He was not alone. The staff of the Philadelphia Reserve Bank found that the reason was "the constraints of modest week-to-week changes in the federal funds rate" (Meltzer 2009b: 982).

During the Volcker disinflation, some members favored more attention to unemployment. He responded to one challenge by insisting on the importance of maintaining a consistent policy and ignoring short-term deviations and criticisms. "Our credibility will be related more to making the right decision than to worrying too much about what the market says about it in the short-run" (Meltzer 2009b: 1098). And to those who proposed to tradeoff more inflation for lower unemployment, Volcker said: "More inflation has been accompanied not by less, but by more unemployment and lower-growth" (p. 1099).

Discretion at the Cost of Rules

The years when Volcker was chairman are one of the few periods in which the Federal Reserve was less influenced by short-term events. Volcker followed the successful disinflation by relying for guidance on a Taylor rule after 1985. His successor, Alan Greenspan, continued that policy until 2003. This produced the longest period in Fed history of price stability with relatively stable growth, and short, mild recessions. This period is known as the "Great Moderation." I believe that the reduction in fluctuations is mainly the result of a rule-based policy that focused more attention on the medium-term than on current data.

I believe that using the Taylor rule as a guide abetted moderation (i.e., reduced variability of output and inflation) by preventing large fluctuations in either inflation or output. The usual Fed operation focusses on one of the two variables. Expanding to reduce unemployment increases actual and expected inflation. Policy shifts to prevent inflation until unemployment rises and output falls. Variability is greater than a policy of stabilizing both.

Conclusion

The Federal Reserve's current mistakes are the third major blunder in its first 100 years. I have tried to show that the Fed repeats its history. Current errors are versions of past errors.

History has an important message for theory and policy. The two longest periods of stable growth, low inflation, and mild recessions are the years when the Federal Reserve was guided by a rule, the gold-exchange standard from 1923 to 1928 and the Taylor rule from 1985 to 2003.[9] There is no similar period of stability and low inflation when the Fed exercised discretion. The closest example is 1953–60, when budget deficits were small in nonrecession years and the budget was in surplus several times. But 1953–60 had three recessions, including a deep recession in 1957–58.

Kydland and Prescott (1977) show why rule-based policy achieves better results than discretion. Taylor (1993) proposed a rule that many central banks have used as a guide. Theory and

[9]Deep, prolonged recessions followed both rule-based periods. I believe policy errors explain what followed stability, but careful analysis should be done.

evidence strongly suggest that the Congress should enact a rule such as the Taylor rule.

No rule will work well in all circumstances. Unforeseen events may require suspension of the rule, just as Britain and others suspended the gold standard in the 19th century. Suspensions of the rule should be followed by explanations and accompanied by offers to resign. The authorities can accept the explanation or the resignation. That closes the wide gap between Fed operating authority and political responsibility for outcomes. The Fed's past major errors never resulted in dismissals.

A major advantage Congress gains from a rule is that legislators can greatly improve oversight. The rule provides a framework for judging outcomes. Congress has constitutional authority, but currently no effective means of implementing it. A rule-based policy provides a better standard by which to judge outcomes.

Markets would benefit from increased information about policy actions. Instead of the present guessing game, markets would forecast policy actions and would monitor any departures.

In addition to a monetary rule, legislation should require the Fed to announce a follow-up rule for acting as lender of last resort. That rule should recognize that protection of the payments system—not protector of troubled banks—is the public good that the LOLR should supply. In its first 100 years, the Fed has discussed its crisis policy internally, but it has never announced and followed a rule.

A rule guides banks to hold collateral and to increase equity reserves. Instead of replacing bankers' responsibility for safety and soundness with many rules and shifting regulatory responsibility to central bankers and governments, giant banks should be required to hold 15 percent equity capital.

Rules instead of discretion and regulation should guide both prudential policy and monetary policy. I believe that is the main lesson that the first century gives to make the next century much freer of policy errors than the last.

Let me end by repeating that in its first 100 years the Fed has completed many commendable actions. Like most others, I give the Bernanke Fed high praise for prompt and effective action in 2008. But it made other mistakes including frequent neglect of its responsibility as manager of the world's currency, and the failure to develop an international monetary arrangement that combines the public goods of more stable exchange rates and greater price stability.

Moreover, the Fed has sacrificed its independence repeatedly. My aim has been to highlight errors from the past that the Fed has repeated recently and is repeating now. As Knut Wicksell ([1906] 1935: 4) wrote before there was a Federal Reserve, "Folly has often been paramount."

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The Financial Crisis: Why the Conventional Wisdom Has It All Wrong

Richard Kovacevich

Like many of you, I am appalled at the political environment and gridlock that continues to exist in this town. I simply cannot understand nor do I accept why our elected officials continue to concentrate on party politics and the next election above doing what's right for America, especially as we endure the past five years of economic stagnation and high unemployment. Nothing is more debilitating and unfair than a head of household willing to work but who cannot find a job. Why hasn't job creation been the number-one focus of our government during this economic crisis?

Don't believe for a moment those economic theorists who tell us the reason for our slow growth, economic malaise, and continued high unemployment is due to the uniqueness of a financially led economic recession. Rather, it is due to the failure of the leaders in this town to adopt those monetary, regulatory, and fiscal policies that have successfully worked in the past while, alternatively, focusing on a political agenda that did not put economic growth and jobs at the top of the list. In my opinion, the early 1980s' economic recession—with its exceptionally high 10 percent

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inflation, 20 percent interest rates, and 12 percent unemployment—was far more difficult to correct and resolve. Yet our economy bounced back in 18 months with GDP growth of over 7.5 percent the next year. In the 1980 recovery, GDP growth averaged 4.9 percent, and for all recoveries since the Second World War, the average was 4.1 percent. The current recovery has been a paltry 2.2 percent.

With the appropriate monetary, regulatory, and fiscal policies our economy should be growing at 3 percent or even higher, which is what is needed to bring employment, our budget deficits, and the labor participation rate to acceptable levels.

One of the many reasons our economy is growing at historically low rates is the extraordinary and unprecedented increase in regulations facing job creators—the most by any administration ever. For example, small businesses have always been the major source of new jobs in our country as compared to large companies. Not this time, however. Why? According to small business polls over the past five years, the job malaise is due to excessive regulation, higher taxes, and increased health care and other costs—the exact opposite of job creation policies that have worked well in the past.

My focus today will be on financial regulation, but similar regulatory burdens are impacting all industries. For example, the Kauffman Foundation, a think tank, reveals in a survey that small businesses, the primary job creators forever, feel more overregulated than even overtaxed. The Competitive Enterprise Institute estimates that the total cost of complying with America's federal regulations in 2013 was $1.86 trillion, about $15,000 per household. I will also address why I think the conventional wisdom has it all wrong as to what and who caused the 2008 financial crisis and why the response to it was irresponsibly implemented and can be summarized as "senseless panic." I will posit that recent financial regulation would not have prevented the last financial crisis nor prevent the next one. I believe that because of the Dodd-Frank legislation, and the current monetary policies of the Federal Reserve, the bottom 25 percent of Americans on the economic ladder will have restricted access to mortgage and personal loans and will incur much higher fees for banking services, all of which is inhibiting economic growth and significantly widening the income inequality gap.

Origins of the Financial Crisis: TARP, a Massive Government Failure

So how did we get into this mess? The last time I was in Washington was in October 2008, for the infamous TARP (Troubled Asset Relief Program) meeting between the Treasury Department, regulators, and large bank CEOs. I believed at that time, said so at the meeting, and I still believe today that forcing all banks to take TARP funds, even if they didn't want or need the funds, was one of the worst economic decisions in the history of the United States. What should have happened is that only those financial institutions who were still solvent but had liquidity challenges, and who needed the funds temporarily, should have been given that choice. You can't fool the markets as Treasury officials and regulators believed you could. The market knew which financial institutions were in trouble as evidenced by stock prices and credit default swap rates that existed at that time. Forcing TARP funds on all banks did not restore confidence in the industry. It destroyed confidence as the market concluded that all banks must now be in trouble because all banks were receiving funding and presumed to have needed and wanted it.

You may have forgotten that prior to TARP, and even a month after the Lehman bankruptcy, markets had declined but were still behaving reasonably well, except for those financial institutions that were having liquidity issues. With the announcement of TARP, isolated liquidity issues turned into a tsunami impacting all banks and all industries. It precipitated a dramatic drop in the stock market, froze trading and the capital markets, magnified and extended the market collapse, damaged the reputations of many financial institutions who did no wrong, increased moral hazard, institutionalized "too big to fail," angered and outraged the general public, and provided Congress an excuse to burden the banking industry with a massive 25,000 pages of new regulations—the largest increase in bank regulations in history. Even four years after its passage, regulators have still completed only 52 percent of its 398 rules according to law firm David Polk and Wardwell. These Dodd-Frank regulations were authored not by considered judgment, but rather as anger and punishment for the TARP bailouts. Without TARP, the Dodd-Frank bill would unlikely have been passed or at least not in the form that now exists. It was TARP that started this whole mess.

Conventional wisdom, on the other hand, especially inside the Beltway, suggests TARP was a great success in restoring confidence in the financial industry. The facts suggest it was an *unmitigated disaster* and TARP should *never* be repeated. The spin never stops in Washington. No surprise, as all the authors of TARP were Washington insiders focused on protecting their reputations and deflecting blame for their failure to do their jobs of properly monitoring and reducing excessive risks being taken by some financial institutions.

TARP contributed to an unnecessary panic in the marketplace and required an unprecedented $29 trillion dollars of market intervention by the Fed and the Treasury, over twice the annual GDP of the United States, to restore the very markets that they, themselves, helped to collapse. I warned at that meeting that politicians, especially those from the rust belt, wouldn't stand for giving banks money but not to struggling automobile and other companies. I also argued that by giving capital to all banks, even the sound ones who didn't need it, the market would likely decide that even the healthy banks were in trouble and confidence levels in the industry would actually decline, not improve.

So what actually did happen? Why was TARP clearly a mistake? Within two months of giving all banks money, the Dow Jones Industrial Average fell by 40 percent and financial stocks fell by 80 percent. How can anyone claim that an 80 percent drop in the stocks of financial companies, reaching their all-time lows, is a show of confidence? In fact, it was an unmitigated disaster. Now giving some banks money, who were having liquidity issues, may make sense if those banks were not insolvent but are just facing liquidity pressure. Giving *all* banks funds should *never* occur—never ever again. Because of TARP, Congress and the administration demonized and vilified *all* financial companies, even those who did no wrong and who didn't want, need, or even use the money, destroying their reputations with customers and the general public.

Forever more, we will hear Wall Street was bailed out but Main Street wasn't. The 1 percent versus 99 percent "Occupy Wall Street" demonstrations against banks have been going on for years and still haven't stopped. Populist initiatives that increase taxes, fines, and other fees on banks are being justified because taxpayers bailed out Wall Street and now it's Wall Street's turn to bail out Main Street.

Who bailed out whom? Wells Fargo, for example, within one year of receiving TARP funds, paid the U.S. government back including $2.5 billion in interest costs and warrants for money we never wanted and for money we never even used. Is that a bailout? Wells Fargo had record earnings, the best in our 160-year history—the very next quarter after being forced to take TARP funds—and record yearly earnings for each of the last five years. Wells Fargo is now the highest-valued financial institution in the world, even though we are only the 21st largest in assets. Obviously, we didn't need the money.

TARP also cemented, perhaps forever, that too big to fail and moral hazard are acceptable U.S. policies—a profound mistake that should have been anticipated. And what about the small investor who lost hundreds of billions of dollars when they sold their bank stocks as they declined by 80 percent in price. Who should compensate the small investor for these unnecessary losses? The professional investor, on the other hand, profited on the way down by shorting bank stocks and then bought near the bottom and road them back up. Was that fair? Because of TARP and the anger it fomented with the general public, Congress responded with Dodd-Frank legislation, a grab bag of so-called reforms most of which had nothing to do with the actual causes of the financial crises.

Prudential Risk Taking and the Case against Too Big to Fail

So, instead of TARP, what should we have done? As we all know, banks provide loans and access to capital markets to allow businesses to grow and create jobs. We serve consumers and allow them to save, borrow, and make payments. Banks are absolutely essential to economic growth. We enjoy cursing banks from time to time, but in truth we cannot prosper, create jobs, and grow the economy without them.

There have always been bank failures and there will always be. The trick is to allow sufficient risk taking to promote economic growth but not so much that leads to widespread bank failures and financial panic. We also need to insist that no financial institution is too big to fail, period. Why don't we let banks just fail like all other companies? In my 40 years in this business I have seen hundreds if not thousands of banks that were rescued by using Federal Deposit Insurance Corporation (FDIC) and/or taxpayer funds to make uninsured creditors and depositors whole. In my opinion, there was not

any *systemic* economic reason to not let banks fail over this time. Why then has it occurred so consistently? Simple, rescuing failed banks is a method used by regulators to attempt to "cover up" their failures to properly identify the risk in the banks they regulate. It must stop!

In my opinion, for example, if Bear Stearns, which was about half the size of Lehman, would have been allowed to go bankrupt, instead of Lehman Brothers, Lehman would have been sold and the subsequent financial crises would have been greatly reduced. Both J.P. Morgan and the Federal Reserve made a profit as the rescuers of Bear Stearns so it would have worked. But assume it didn't work, then obviously Lehman Brothers would have been rescued and the financial crises would have been much shorter and dramatically less stressful than the way it was handled. We must always start first with letting financial institutions fail.

Regulatory Failures and the Need for Balance

Effective regulation is all about consistency and appropriate risk oversight. It's clear from the three major banking crises in the United States in the past 40 years (1974–76, 1980–82, and 2008–09) that the United States has not yet achieved this balancing act. None of these past crises occurred because of lack of regulatory authority but rather the failure of regulators to use their existing authority, effectively, to rein in excessive speculation by financial institutions. Politicians and regulators have responded to each crisis by piling on more extensive and burdensome regulation and assuring our citizens that we have now fixed the problems without addressing the actual causes of the crisis or the ineffective regulatory system that allowed it to happen.

So let me put these regulator failures in perspective. When Wells Fargo rescued Wachovia in the fall of 2008, it took us less than a week to determine that Wachovia would have credit and litigation losses exceeding their existing reserves by over $60 billion. The actual losses have been within 10 percent of that estimate. Yet the Federal Reserve, the Office of the Comptroller of the Currency, and the FDIC had been examining Wachovia's balance sheet for decades. Why did they not find these losses?

These same regulators, who failed to detect the high risks being taken by certain banks leading up to this crisis, continue to dictate to

banks how to improve their risk process. These same regulators, especially the Federal Reserve, say they have a risk model that they believe is so accurate that they will reject the stress test capital plans of those banks whose submissions show results different from the Fed model. The Federal Reserve claims to be transparent yet they will not share their model with banks.

How accurate is the Fed model? Here's my experience. In the first stress test submission in early 2009, banks were asked to submit their profit and capital forecast for a six-month period from May to November of 2009, a fairly easy thing to do given it is only six months in the future. The Fed's model showed that Wells Fargo's revenues would be over 30 percent lower than our forecast, resulting in lower profits and lower capital than our submission. Our actual results were 2 percent better than even our forecast. How can the Federal Reserve have confidence in a model that inaccurately forecast revenues only six months in the future by over 30 percent? I wouldn't share a model that inaccurate either!

Ineffective regulators are worse than no regulators at all because they give citizens a false sense of confidence that someone is watching out for and protecting them so that they don't have to do it themselves. As Will Rogers used to say, "If stupidity got us into this mess, why can't stupidity get us out?" Congress remembered what Will said and enacted, stupidly, the Dodd-Frank legislation. It's some 2,500 pages long and will produce more than 25,000 pages of new regulations from the same regulators who presided over the last three major financial crises. Dodd-Frank does not address the major causes of the recent crisis and offers few approaches to prevent the next one. It also specifically requires identifying systemically important financial institutions (i.e., SIFIs), thus reinforcing that those institutions are too big to fail. Dodd-Frank regulations are also prohibiting banks to offer certain products that the markets want and need. Products that did not in any way contribute to or cause the financial crises. Who is now offering these products? The so-called shadow banks. But hold it; it was the shadow banks that caused this crisis in the first place and who needed to be bailed out, not insured-deposit commercial banks. It was investment banks like Bear Stearns and Lehman and about a dozen others. We are just repeating our past mistakes. Why can't the administration, regulators, Congress, and the press see and understand this?

What Congress Should Have Done

So instead of Dodd-Frank, what should Congress have done? How do we end too big to fail once and for all?

First, given the long and consistent history of financial failures, we must recognize and acknowledge that regulators are seemingly not capable of using the authority they do have to prevent all failures. Consequently, we must build a regulatory system that assumes failures will definitely occur but limits the damage of such failures, makes them possible, bearable, and tolerable so it does not cause a systemic financial crisis that collapses the entire economy leading to recessions and taxpayer bailouts.

Second, and to mitigate systemic risk, from here forward, we must make clear that for any financial institution failure, large or small, and just like industrial company failures, all creditors, other than insured depositors, should take a "haircut" on their investment so that neither the FDIC fund nor the taxpayer is at risk as the institution is sold or liquidated.

Despite conventional wisdom, requiring large firms to increase their common equity capital to breathtaking levels—say above 9 percent of assets—is not the answer. That lowers returns on equity to the point that banks will not be able to raise sufficient capital and, instead, will shrink their balance sheets to meet their equity-to-asset ratios, impeding economic growth. Also, because the cost of capital becomes so expensive, the more marginable borrower will not get a loan. These are the very companies and individuals who do not have access to capital markets and need access to bank lending the most. This is exactly what is happening in Europe and the United States today. Of even greater concern, requiring excessive levels of capital might cause financial institutions to take even greater risks in order to earn a satisfactory return on the enlarged capital base. Moreover, because equity capital is permanent and cannot declare an "event of default" when it perceives the risks to be excessive, it is only marginally effective in imposing discipline on management. Finally, equity holders have upside potential from taking risks and are therefore more tolerant of risk than creditors.

A much more effective form of market discipline would be to ensure that the total long-term debt that a bank and a bank holding company hold on their balance sheets, when coupled with a bank's equity and reserves, is more than sufficient to cover any reasonably

conceivable losses the institution might incur. Let me emphasize, I said bank *and* bank holding company debt. Contrary to what regulators are saying at the moment, bank creditors must also be at risk as well as bank holding company creditors.

When an institution fails, the FDIC could choose to put the institution into traditional bankruptcy or use an orderly liquidation authority and create a bridge bank, or another similar functioning entity, that will operate under FDIC control with new management and directors. The bridge bank will continue to serve the needs of depositors and borrowers, leaving the equity and long-term debt behind in a receivership with no guarantee of recovery. The bridge bank will be sold or privatized as soon as possible.

Because total equity and long-term debt at both the bank and bank holding company levels is usually around 30 percent of assets, it is difficult to imagine that the FDIC, much less taxpayers, would ever incur losses on their failure. If more cushion were desired, a 5 or 10 percent hold-back on uninsured depositors or other creditors could also be imposed. Because debt holders have no upside and provide larger amounts of capital to banks than equity holders, they are in a far better position to moderate the size and the risks of banks than equity participants.

This plan would not only protect the FDIC and taxpayers against losses in the event of failure, it would impose discipline by the marketplace that would make failure much less likely. A bank would be required to issue senior and subordinated long-term debt on a regular basis. A risky bank would have to pay higher interest—sending a negative signal to management, the board, investors, and regulators—and ultimately might not even be able to issue debt, which would curtail its growth and force it to adopt a new, lower-risk business strategy. Should this approach be implemented, the role of the Federal Reserve and the FDIC should primarily be to provide the liquidity necessary to liquidate or sell the company but not to bail out uninsured depositors, creditors, and investors.

It's naïve and contrary to all historical experience to believe that Dodd-Frank and the new Basel III capital accords, which significantly increase the cost of capital and regulation on banks and their customers, will solve the problem of regulators failing to do their jobs or will eliminate too big to fail. To substantiate this point, let me ask you these questions: What regulatory authority did the Federal Reserve and other bank regulators not have to rein in the risks taken

by financial institutions that precipitated this crisis? I can't think of any. Can you? If that's true, then why did we need Dodd-Frank? What regulatory authority did the Securities and Exchange Commission (SEC) not have to rein in the excessive risks and grossly inadequate liquidity plans of investment banks? Or to properly regulate the rating agencies whose AAA ratings on certain subprime mortgages were incomprehensible?

Even if only the rating agencies had been doing their jobs, the subprime mortgage problem would have been contained and no national or global economic crises would have occurred. Why didn't the SEC overrule the financial accounting standards board, which insisted that banks "mark to market" their securities portfolios even when the markets ceased functioning, needlessly reducing precious bank capital during the crises by around $500 billion that was fully recovered when the markets normalized? The SEC also allowed the Financial Accounting Standards Board (FASB) to limit the size of the allowance for loan losses that is required for economic downturns. In short, the SEC completely failed in its regulatory oversight time and time again.

Why didn't Congress rein in Fannie Mae and Freddie Mac and their increasingly large portfolios of risky assets after two decades of warnings by industry experts, regulators, and administration officials that one day Fannie and Freddie would blow up and cost taxpayers hundreds of billions of dollars? The housing crisis got as big as it did to bring down our entire economy *only* because of the existence of quasi-private/public entities such as Fannie and Freddie. Now six years after the crisis, Fannie and Freddie still exist. Yet Congress passed Dodd-Frank in two years. Why the difference? Could it be due to politics as usual? Could it be to protect Congress and especially, Senator Dodd and Congressman Barney Frank, who were the biggest supporters of Fannie and Freddie for over two decades and who didn't heed those warnings?

Once again, we are repeating the mistakes of the past as the current bill recently passed by the Senate Banking Committee to replace Fannie and Freddie is only an improved version of a combined public/private entity. A huge mistake!

Why didn't the Office of Thrift Supervision—which was the primary regulator for the AIG London derivative entity, Washington Mutual, Countrywide, IndyMac, New Century Financial, First Franklin, Option One, Fremont Financial, and other major originators of risky subprime mortgages—do its job?

Finally, why didn't state regulators properly regulate the mortgage brokers who committed outright fraud by knowingly falsifying mortgage applications? Seventy percent of all subprime mortgages were originated by these brokers.

The Dodd-Frank Act does absolutely nothing to correct these devastating regulatory deficiencies. Until we do, we will continue to have bank failures. In fact, the Dodd-Frank Act ignores the fact that these *regulatory failures* actually were the real cause of what should have been a manageable problem but turned into a full-blown, worldwide, financial and economic crisis and the longest and worst recession since the Great Depression. Many in the financial markets knew what was going on. Hedge funds were betting against subprime portfolios. Responsible players, like Wells Fargo, were losing over 25 percent mortgage market share. Home prices were increasing to unprecedented levels. I personally told top bank regulators at least a dozen times that subprime mortgages were worse than toxic waste dumps. Where were our safety valves? Where were the regulators?

If you don't remember anything else I say today, please remember this: *only about 20 financial institutions perpetrated this crisis.* Only 20! About half were investment banks and the other half were savings and loans. Only one, Citicorp, was a commercial bank but was operating more like an investment bank. These 20 failed in every respect, from business practices to ethics. Greed and malfeasance were their modus operandi.

There was no excuse for their behavior and they should be punished thoroughly, completely, perhaps even criminally, yet 6,000 commercial banks are being punished with Dodd-Frank penalties in the same way as the 20 guilty parties. Why punish the vast majority of banks that behaved appropriately? Let me repeat that: Why are we punishing 6,000 commercial banks for the ineptness and malfeasance of 20 other financial institutions that were not even commercial banks? Even Barney Frank, no friend of the banking industry, has stated many times that mainstream commercial banks did not cause the 2008 financial crisis. He is right, but then why did he author Dodd-Frank?

Shockingly, certain members of Congress are actually trying to restore the Glass-Steagall Act that would resurrect these very same investment banks who just caused the crisis. What are they thinking? We finally got rid of all the large investment banks as the only two who are left, Morgan Stanley and Goldman Sachs, are now bank

holding companies under the supervision of banking regulators. Why would anyone want to recreate them so they can do it all again?

These uninformed Congress members believe that investment banking is more risky than commercial banking. Nothing could be further from the truth. Basic investment banking—such as best efforts to underwrite bonds and equities, providing M&A and financial advice, buying and selling securities for customers, and helping customers hedge their interest rate, foreign exchange, and commodity risks—is far less risky than making commercial and consumer loans. Lehman's major problem was actually commercial real estate lending not plain vanilla investment banking. If Glass-Steagall had not been in effect since the 1930s, investment banks would not have grown to be large, risky, trillion-dollar, wholesale funded financial institutions comprised of a very-low-risk traditional investment banking business combined with a giant hedge fund that was created from the profits from their exclusive authority to provide low-risk investment banking. In short, the existence of Glass-Steagall created the investment banks that caused this crisis, and we should never resurrect it or them again.

What Should Regulators Look For?

So what does cause a financial crisis? What should regulators be looking for in order to anticipate trouble ahead?

There are three warning signs when a financial institution, large or small, is approaching the danger zone. We don't need a Dodd-Frank Act; we do need regulators who have the political will and financial skill to take strong actions when they see these three warning signs develop.

The first and most common and important warning sign is concentration of risk. Most financial institutions fail because their risks are too concentrated by geography, industry, and/or product line. Actually, a large bank should be able to diversify its risks more broadly than a small bank. Yet conventional wisdom suggests that risk increases with size and that, therefore, large banks are more risky than small banks. Conventional wisdom is wrong, as far more small banks fail than big banks, because small banks are more concentrated.

Consider this. Assume a single bank operates across the entire United States, does its business in a similar fashion in all states, and is very diversified with 15 percent market share of banking and

related financial products in each state. If it did this, it would then be around two trillion dollars in size. Yet, I believe such a bank is actually at less risk of failing than say a two-billion-dollar bank that has a high concentration, say a 40 percent market share in only one or a few states or communities with limited products, even though the larger bank may be 100 times larger.

The six large Canadian banks essentially operate this way, have 80 percent market share, and have never failed or ever been bailed out. Admittedly, if a large bank does not diversify its risks, it can cause considerably more damage than a small bank.

Let me give some examples to make my point. During the 1980s, Texas banks were small by today's standards but among the most profitable and highly capitalized in the country just before nearly all of them failed. They failed because there was no interstate banking at that time, and they were geographically concentrated in Texas with a very high percentage of commercial real estate and energy loans.

The S&L crisis of the 1980s cost taxpayers $150 billion, equivalent to almost a trillion dollars today. None of the S&Ls were particularly large, but they failed because of concentrations in commercial and residential real estate.

There were a dozen major originators of risky subprime mortgages in the most recent financial crisis. Two were over $100 billion in assets. The rest were smaller than $40 billion in assets. All failed because their risks were concentrated.

The second warning sign is inadequate liquidity. Bear Stearns and Lehman Brothers reported relatively high levels of capital, but they failed because of insufficient liquidity—the proverbial run on the bank. Merrill Lynch, Goldman Sachs, Morgan Stanley, and other investment banks suffered similarly as the crisis unfolded. It is stunning that these institutions were allowed to operate with balance sheets approaching a trillion dollars funded primarily by short-term wholesale liabilities. When rumors—valid or not—surfaced that these firms had problems, they were unable to roll over their short-term funding and failed. Inadequate liquidity has been the primary cause of financial failures, forever. Why can't management and regulators get this right? It's really very obvious and simple to detect.

The third warning signal is significant exposure and concentration to capital markets on either the asset/funding side, or even worse, on both sides. Capital markets have seized up in the past and will seize up in the future—and it usually can't be anticipated. The Russian

crisis of the 1990s brought down long-term capital and intensified a recession in Asia and other markets. Russia was less than 1 percent of the world's economy, yet resulted in a worldwide financial crisis and meltdown. Cyprus with only 800,000 people rattled worldwide capital markets a short time ago.

Any company that syndicates and sells a large percentage of its loans and other assets is far more at risk of failure than a company that originates and holds assets. They have little or no "skin in the game" as they sell all the assets they originate and thus pay much less attention to prudent underwriting standards. Furthermore, capital markets can seize up at any time and severely disrupt the business of a company that relies on an originate-and-sell business model. Moreover, with little or no recurring income because originated and securitized assets are sold not held, they have to keep "feeding the beast"—originating and selling more and more regardless of the risk and markets. When this model also relies primarily on short-term wholesale funding sources, it is especially toxic—a clear sign to regulators to be vigilant.

Conclusion

So let me summarize why I think that enacting the largest increase in banking regulation in history was a huge mistake, that it would not have prevented past crises or future ones, and will likely deny credit availability and other banking services to the bottom 25 percent of consumers on the economic ladder who are in most need of it.

It was created and passed, not with sound judgment of what really caused the financial crisis, but as a political response to the understandable outrage of Americans by the ill-conceived creation of TARP, one of the worst decisions in U.S. economic history, which intensified and compounded the financial crisis rather than solving it and created the impression that Wall Street was bailed out and Main Street wasn't.

Without TARP, there would not have been a Dodd-Frank Act as we now know it nor the demonizing and vilifying of the entire banking industry. Only 20 institutions perpetrated this crisis and all of them should be punished, perhaps even criminally. Half of these institutions were investment banks. Half were savings and loans. None were mainstream commercial banks. So why are 6,000 banks being punished for something they didn't do?

Why isn't the focus on reforming those regulators who had the power to stop these 20 perpetrators and who completely failed to do their job? What about Congress admitting its role in allowing Fannie and Freddie to provide the financial support that caused subprime mortgages to grow from a 5 percent market share of the mortgage market to about 50 percent at the peak of the crises? This share gain and the crisis would never have occurred without Fannie and Freddie and other government agencies purchasing or insuring about 70 percent of all subprime mortgages.

I personally warned regulators and leaders in Congress in face-to-face meetings, in annual reports, and in speeches of the eventual collapse of Fannie and Freddie for over 20 years. Similarly, I warned bank regulators that subprime mortgages were worse than toxic waste two years before the crisis started. So did many others. Neither Congress nor regulators heeded such advice. Was Dodd-Frank and demonizing the entire banking industry a coordinated effort to deflect where the blame should be placed?

Today the 6,000 commercial banks and their boards and management are spending most all of their time and resources on compliance, regulatory changes, and litigation for something they didn't do. Regulators blame bank board members for improper oversight of management. Really?

There are upwards of 100 regulators at large banks. Those regulators have an average of over 15 years of experience in the financial services industry and work full time at these banks. Bank directors have roughly 12 members who spend about a day a month on bank business, and who are not experts in the financial services industry because if they were, they would not be considered independent. So who is more responsible for insufficient oversight of bank management: 100 full-time regulators or about 12 one-day-a-month bank directors? Who gets criticized the most for bank failures? Does this town get it?

We also need to immediately replace the litigation risk associated with the "ability to pay" language that is in the Dodd-Frank Act. Mainstream commercial banks have been making loans to lower-income consumers and those with credit blemishes on their records for decades. They were not among the 20 institutions who perpetrated this crisis. They did not originate loans to subprime borrowers who could never pay them back as the S&Ls did, nor did they buy and insure them as Fannie and Freddie did, nor did they package,

sell, and distribute them as investment bankers did, nor did they rate them "AAA" as rating agencies did.

Mainstream banks have the experience and expertise to make loans to appropriate borrowers, and take the credit risk, but not litigation risk. Because of this litigation risk, it is more difficult today to qualify for a mortgage than any other time in my 40 years in this business. Mortgages are one of the most valuable assets the general public owns. Housing is critical to economic recoveries and is usually one of the first industries to increase employment after a recession.

It doesn't have to be this way. Because of the litigation risk, most small community banks have closed their mortgage departments and aren't even making mortgages any more—a tragedy for small communities. Until the litigation language of Dodd-Frank is changed, the bottom 25 percent of Americans will not get loans, stifling economic growth and denying this group, who need banks the most, access to financial services.

By the way, if the current qualified mortgage (QM) exemption of 43 percent of income would have been in effect before the financial crises, 25 percent of all the homes that were foreclosed would have passed this test. Extending credit is much more complicated than congressional mandates and simplified guidelines can solve. Get rid of the "ability to pay" litigation risk and indict any institution or individuals who behave in a criminal or predatory fashion.

We also need to replace our current fiscal and monetary policies with those policies that worked well in the past for fast and strong economic recoveries.

As a result of all of the mistakes I have mentioned, our economy is growing at the slowest recovery pace in history, unemployment continues to be high, our labor participation rate is at an all-time low, our budget deficits are the highest in history, and Americans have lost confidence in our leaders, in themselves, and in our free enterprise system—a system that has created the greatest wealth of any nation in history. We have also lost the respect, admiration, and confidence of the rest of the world.

Dodd-Frank's Expansion of Fed Power: A Historical Perspective

Norbert Michel

It has become somewhat fashionable to refer to the vast expansion of the Federal Reserve's power under the 2010 Dodd-Frank Act. This Act certainly expanded the Fed's authority and its reach into markets, but the vastness of these changes should be kept in perspective. The Fed now has a full 100-year history to judge, and to a large extent its past exemplifies what we see with virtually all government bureaucracies: incessant mission creep. Glossing over this fact contributes to the general misunderstanding of what the Fed is and how it functions.

From the very beginning, this institution has grown in terms of its scope and general authority over both banking and the broader economy. Many of the changes have taken place through legislation, but others have come about by virtue of assertive Board members. The line between these two methods has become somewhat blurred now that the Board of Governors has a Congressional Liaison Office to actively lobby Congress for what the Board wants, but the distinction was much clearer at the Fed's founding. This article highlights two of the major changes in the Fed's early years to provide context for several of the major Dodd-Frank-mandated expansions in the Federal Reserve's power.

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The Decentralized Central Bank

The Federal Reserve Act of 1913 created a sleepy little institution by today's standard. The Fed's original purpose was to provide an "elastic currency" to stem seasonal fluctuations in reserve requirements and provide liquidity to member banks. These problems ebbed and flowed mainly with the agricultural seasons. Of course, the Fed was supposed to carry out its functions within the framework of the gold standard. Initially, the Federal Reserve System was designed primarily around the 12 District Reserve Banks, with a relatively weak federal oversight.

The Reserve System was created largely by nationalizing private clearing-houses and turning them into the Reserve Banks, which held gold reserves and operated fairly autonomously. The original Reserve Banks could be thought of as super-commercial banks that provided clearing functions to the system's member banks and served as their members' lender of last resort.

The original Federal Reserve Board was rather weak and served as a sort of liaison between the District Reserve Banks and Congress. The Board had agents situated in the Reserve Banks essentially to make sure the district managers were not breaking the law. It sounds paradoxical, but we really did have a decentralized central bank.

The lack of a strong central authority was by design. Some members of Congress, as well as members of the financial industry, were scared to death of a federally controlled central bank. For instance, Frank Vanderlip, president of National City Bank of New York, advised Rep. Carter Glass (D-Va.) and Sen. Robert Owen (D-Okla.) against creating a federal board in Washington. Before legislation was completed, Vanderlip predicted that a Washington-based Board would "very rapidly lose the power to direct wisely," because it would be "subject to all the vicissitudes of political pressure and party trading" (Livingston 1986: 219).

After the law was passed, some in the congressional majority staunchly denied they had created a central bank, likening the institution instead to the (supposedly benign) Interstate Commerce Commission (Timberlake 1993: chap. 15). Some members genuinely believed they had created a system of autonomous, regional Reserve Banks with a benevolent federal regulator.

Others in Congress, though, understood exactly what they had created. Sen. Gilbert Hitchcock (D-Neb.), for example, argued that

"the central bank does not consist of a vault. The central bank does not consist of a mass of money. . . . The central bank consists of central control, and that is provided in this bill. The control is centralized [in the Federal Reserve Board], and when you get your control centralized you have a central bank (Timberlake 1993: 231–32).

Hitchcock recognized that the essence of a central bank existed in the Federal Reserve Act, but others did more to point out the long-term dangers and philosophical contradictions of the 1913 Act. Rep. Charles Lindbergh Sr. (R-Minn.), for instance, noted: "This Act establishes the most gigantic trust on earth, such as the Sherman Antitrust Act would dissolve if Congress did not by this Act expressly create what by that Act it prohibited" (Timberlake 1993: 233). Taking a broader view, Rep. Frank Mondell (R-Wyo.) presciently warned:

> The Federal Reserve Board under this bill is an organization of vastly wider power, authority, and control over currency [and] banks . . . than the reserve associations contemplated by the National Monetary Commission. . . . [I]t is of a character which in practical operation would tend to increase and centralize. . . . In your frantic efforts to escape the bogey man of a central bank . . . you have come perilously near establishing the most powerful banking institution in the world [Timberlake 1993: 223].

Mondell was certainly on the right side of history, and it didn't take long for the Fed to start evolving into the powerful central authority he feared.

Expansions without Legislative Changes

The Fed has evolved in many ways since it was founded in 1913. Some of these changes were initiated by legislation that amended the Federal Reserve Act; others occurred without any formal amendments. For instance, the Board did not originally have discretionary powers to conduct open market operations by purchasing U.S. government debt. The framers of the 1913 Act wanted to avoid creating an institution perceived as one designed to "lend to the crown," so they limited the ability of the Fed to buy government debt.

Section 14 of the original Act provided the limited authority to buy U.S. government securities to the District Reserve Banks, not the Board. In other words, the District Reserve Banks could, at their

discretion, buy U.S. bonds but only within certain limits. In particular, they could purchase U.S. securities only when their reserves were not needed for their intended purpose—namely, providing liquidity to member banks. These purchases were to be carried out at the discretion of the Reserve Banks because the system was designed so that member banks would initiate credit needs. The District Reserve Banks were supposed to be on the front lines of the credit markets, so there was no need for them to carry out open market purchases at the direction of a central authority.

Very soon after the System began, though, the Board inserted itself into the middle of these open market purchases. In its 1914 Annual Report, the Board superfluously authorized the District Reserve Banks to purchase government securities "within the limits of prudence as they might see fit" (Meltzer 2003: 142). The 1914 report went on to say that "the scope of open market operations must rest largely with the purchasing [Reserve] bank, subject to suggestions based upon analyses by the credit department of the Federal Reserve Board" (Timberlake 1993: 257). Open market operations, the report concluded, were designed "to give the Federal Reserve Board the necessary economic control of the domestic money market and to preserve a proper equilibrium in international operations."

Regardless of one's current perspective on the Fed's authority, it strains all credibility to argue that the original intent of the 1913 Act was to convey "control of the domestic money market" to the Board. The Board and the Reserve Banks—as well as the Treasury—went back and forth on the nature and necessity of open market operations until the Banking Act of 1933 created the Federal Open Market Committee. In the intervening period, the Treasury unsuccessfully tried to force the Reserve Banks to liquidate their holdings of U.S. securities, and various Fed officials proffered their own justifications for open market operations.

By 1927, the Board's Annual Reports had provided at least four distinct reasons for the necessity of open market operations (Timberlake 1993: 262). In no particular order, the Board stated that these operations were required to

- Provide income for District Reserve Banks so they could pay expenses and dividends to member banks;
- Lower interest rates and discourage gold imports;

- Build up an inventory for sales that could head off gold inflation; and
- Provide spending stimulus in Europe (through purchases) so that U.S. agricultural products would enjoy healthy demand abroad.

Thus, in a very real sense the Board gave itself the discretionary power to conduct open market operations. By the end of the 1920s, even though the Federal Open Market Committee had not yet been created, it was clear the Federal Reserve System had morphed into much more than an emergency reserve currency facility. Although this early expansion of Fed power took place without new legislation, new laws also helped the Fed's authority grow during its first quarter century.

Expansions through Legislative Changes

Many expansive legislative changes occurred during the Great Depression. One good illustration is the Banking Act of 1935, which created the Federal Reserve structure we have today. This Act stemmed from a behind-the-scenes collaborative effort between the Treasury and the Board. Both wanted a way to better coordinate expansionary fiscal and monetary policies. Some of the key changes made in the 1935 Act were

- Replacing the old Federal Reserve Board with the new Board of Governors;
- Giving the new Board the authority to change reserve requirements for member banks; and
- Giving the new Board the balance of power on the Federal Open Market Committee.

In brief, the 1935 Act centralized the power of the Fed in Washington and ensured that the Open Market Committee would conduct monetary policy at the Board's discretion. Although in the minority, U.S. Senators Gerald Nye (R-N.D.) and William Borah (R-Idaho) fought against this expansion of discretionary power and tried to have some sort of price-index rule written into the 1935 law (Timberlake 1993: 285). The minority obviously lost its battle, but there was real opposition to giving the Board that kind of discretionary power.

None other than Sen. Carter Glass (D-Va.), an original House sponsor of the 1913 Federal Reserve Act, stood against expanding

the Fed's centralized power in the manner of the 1935 Act. Glass complained:

> It is now presumed to make the open market committee the supreme power in the determination of the credits of the country. No such thing was intended [by the original FR Act], and no such thing should ever be done [because the Board] does not have a dollar of pecuniary interest in the Reserve funds of the deposits of the FR banks or of member banks [Timberlake 1993: 283].

Strangely enough, Glass's opposition to the 1935 Act put him at odds with Rep. Henry Steagall (D-Ala.), the other half of the famed Glass-Steagall Act. Steagall openly wanted to wrest control of the system away from the Reserve Banks and bring it to Washington. He championed the Act as one that would bring "the system with its vast resources into full harmony with the advanced policies of the present [Roosevelt] administration" (Timberlake 1993: 283). The Banking Act of 1935 finished the job of relegating the Reserve Banks' relevance to the background of the Federal Reserve System, and the Fed's structure has remained virtually unchanged since 1935.

Thus, the Fed was radically transformed—both with and without legislative amendments—during the first 25 years of its existence. That early transformation provides a useful perspective for viewing more recent changes to the Fed.

The 2008 Financial Crisis and the Fed's Emergency Lending

One key aspect of monetary policy has always been a central bank's role as the lender of last resort. The role is somewhat misnamed, though, because now central banks tend to carry out this role by injecting reserves into the system as opposed to lending money to anyone. The Federal Reserve injects reserves into the system through buying U.S. Treasuries on the open market, and thus avoids lending to specific banks through its discount window (Goodfriend and King 1988). During the 2008 financial crisis, however, the Fed went well beyond these norms by invoking its Section 13 (3) emergency lending authority (White 2009: 120–24).

A well-publicized instance involved the investment banking firm Bear Stearns, one of the Fed's largest primary dealers. On March

14, 2008, the day after Bear's management told the Fed they would file for bankruptcy unless they could secure an emergency loan, the Fed announced it would lend Bear $13 billion (GAO 2011b: 84). This loan was promptly repaid but just two days later the Fed announced it would provide a $30 billion loan to facilitate J.P. Morgan Chase's acquisition of Bear Sterns. After several days of confusion and negotiation, the Fed ultimately created a special purpose vehicle (SPV) named Maiden Lane, LLC, to carry out the transaction.[1]

Shortly after the deal was completed, former Fed chairman Paul Volcker remarked that this loan was "at the very edge" of the Fed's legal authority (Brinsley and Massucci 2008). Regardless, the Bear Sterns deal was only one small part of the Fed's emergency lending in the wake of the 2008 crisis. The Fed initiated at least 22 programs that provided loans to specific firms and groups of companies (White 2014, GAO 2011a).

Rather than avoiding the perception of favoritism, these loans were specifically designed to allocate credit to individual institutions. Initiatives such as the Term Auction Facility were directed to depository institutions, but others, such as the Primary Dealer Credit Facility, were directed to securities dealers. Ultimately, these loans spurred Congress to limit, at least superficially, the Fed's emergency lending authority.

Recent Changes under the 2010 Dodd-Frank Act

An electronic search of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act for the term "Federal Reserve" returns more than 200 matches. Some of these matches reflect relatively minor changes to the Fed's authority, but others dramatically expanded the Fed's reach into the economy. On the relatively minor side, the Fed is now involved in such things as creating rules for compliance with real estate appraisal standards, developing alternatives to credit ratings, creating procedures for securities holding company

[1]All of these transactions took place *after* the Fed initiated its Term Securities Lending Facility (TSLF), the goal of which was to provide short-term loans to its primary dealers. The TSLF marked the first time during the crisis that the Fed provided funds to nondepository institutions, and many market participants believed the TSLF had been designed specifically to protect Bear Stearns (GAO 2011b: 84).

registrations, fashioning new reporting requirements for S&L holding companies, and regulating escrow account requirements.

More important, the Fed chairman now sits on the Financial Stability Oversight Council created by Dodd-Frank. This appointment makes the Fed's Board of Governors partly responsible for identifying firms that pose a threat to U.S. financial stability. In addition to singling out these firms, the Fed is ultimately responsible for developing specific rules and regulations for these preidentified companies. This new regulatory framework applies to predesignated nonbank financial firms (both foreign and domestic), as well as some firms that received TARP funds and all bank holding companies with assets of more than $50 billion. Collectively, these firms are frequently referred to as "systemically important financial institutions" (SIFIs) although Dodd-Frank confers no such legal distinction.

Two of the duties for the Fed in this new role include implementing living wills for the SIFIs and implementing stress tests for several financial firms. In particular, the Fed is now responsible for implementing stress tests for all bank holding companies with at least $50 billion in assets, all individual banks with at least $10 billion in assets, and the predesignated nonbank financial institutions. The Federal Reserve remains, as always, the prudential regulator for all bank holding companies as well as all financial holding companies, but Dodd-Frank extended the Fed's reach into financial holding companies' subsidiaries.

Specifically, Section 604 gives the Fed the authority to "write rules for, impose reporting obligations on, examine the activities and financial health of, and bring enforcement actions against subsidiaries, including entities regulated by the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC) and state-regulated entities." Even more pervasively, Section 120 of Dodd-Frank expanded the Fed's authority over practically every sector of the market. Because the Fed now sits on the Financial Stability Oversight Council, it is involved in requiring new regulations for any financial company it determines poses a threat to "financial markets of the United States, or low-income, minority, or underserved communities."[2]

[2]Although the Council's decision to designate large interconnected financial firms for heightened supervision by the Fed requires a two-thirds vote by the members of the Council, these Section 120 regulations do not require a two-thirds vote.

The Fed is now involved in regulating more companies than before the crisis, yet some critics still insist that Dodd-Frank limited the Fed's power (Miller 2011). These critics typically point to Section 1101 of Dodd-Frank, the provision which amended the Fed's emergency lending powers. In particular, Section 1101 provides that the Fed can no longer legally lend to any individual, partnership, or corporation. Instead, the Fed can provide emergency lending only through programs that have broad-based eligibility, and it can provide these loans only with the approval of the Treasury secretary.[3]

To argue that this amendment actually restrains the Fed is to completely ignore history. Aside from the distant examples of collaboration between the Treasury and the Fed, a large portion of the 2008 government bailouts were financed by the Fed in conjunction with the Treasury. Further, approximately half of these emergency lending facilities were broad-based programs such as the Term Asset-Backed Securities Loan Facility (Office of Financial Stability 2012, White 2014: 3). The notion that Dodd-Frank restricted the Fed's authority is based on an overly narrow view that ignores the fact that the Fed is now in the formal position of being the nation's systemic risk regulator. The Fed now has a mandate to regulate "financial stability"—a concept that lacks an objective definition. This vague charge gives the Fed more reach into both banking and nonbanking institutions than ever before.

Conclusion

Now in its 100th year, the Federal Reserve has a rich history of bureaucratic mission creep. Today's Fed is very different from the institution created in 1913, and it has morphed into something that many of the original sponsors of the Federal Reserve Act never intended it to become. Originally, the Federal Reserve System was a decentralized group of Reserve Banks with a weak oversight presence in Washington. The Fed served as a clearing bank, a lender of last resort, and a regulator for its member banks.

[3]The Fed's final rules have not been issued, but the proposed rules state that the emergency lending program will be considered to have broad-based eligibility only if it "is designed to provide liquidity to an identifiable market or sector of the financial system" (*Federal Register* 2014: 619).

Through time, each of these functions grew in scope, and the Fed's governing structure became highly centralized. Along the way, the Fed took over as the exclusive issuer of currency and the sole director of the nation's monetary policy. In more recent years, the Fed has officially taken on the role of the U.S. regulator of systemic risk for both banks and nonbank financial companies. Many of these changes have taken place through the legislative process, but the 2008 financial crisis provides a good example of how changes have often arisen extra-legislatively as well.

Much of the Fed's emergency lending, for instance, was done in novel ways that pushed the bounds of the organization's legal authority. Then, in 2010, the Dodd-Frank Act purported to restrict the central bank's emergency lending by preventing it from lending to any one financial company. The law now states that the Fed can offer emergency lending only to a group of companies, but this so-called restriction wouldn't have prevented half the programs the Fed employed during the crisis. What's more, the Dodd-Frank Act provided the Federal Reserve with an ill-defined mandate to regulate financial stability, a directive that is the polar opposite of restrictive.

The Fed has always had trouble fulfilling its main responsibilities, and Congress has continuously responded to those difficulties by expanding the Fed's reach into the economy. Dodd-Frank is no exception to this long-term historical trend.

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What Stiglitz and Stockman Have in Common

Randall G. Holcombe

The role of government in the economy has been a major public policy issue for more than two centuries. Critics of capitalism, at least since Karl Marx, have argued that the system is skewed to benefit the political and economic elite at the expense of the masses: the proletariat over the bourgeoisie, as Marx put it, or the 1 percent over the 99 percent, as the Occupy Movement that began in 2011 put it. Two recent books have looked at these issues, one from the vantage point of the political left and the other from the political right. Joseph Stiglitz, a Nobel laureate economist and frequent commentator on the political left, discusses the way the system is skewed to support the 1 percent over the 99 percent in his book *The Price of Inequality* (2012), while conservative writer and former Michigan congressman and budget director in the Reagan administration David Stockman addresses these same issues from the political right in *The Great Deformation* (2013). Considering their political leanings, it is worth emphasizing how much their books have in common when describing the causes of the major economic and political problems they perceive in the United States.

Both Stiglitz and Stockman argue that corruption of the U.S. political system is damaging both the economic system and democracy. This article documents the commonality of ideas in their two books

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while recognizing the significant differences in their policy recommendations.

Views on Crony Capitalism, Rent Seeking, the Fed, and Democracy

In Chapter 1 Stiglitz outlines the problem he sees, which, as the title suggests, is inequality, and he offers some data to back up his claims.[1] Chapter 2, titled "Rent Seeking and the Making of an Unequal Society," places much of the blame for inequality on government policy. Stiglitz (2012: 39–40) argues: "We have a political system that gives inordinate power to those at the top, and they have used that power not only to limit the extent of redistribution but also to shape the rules of the game in their favor." Stockman (2013: 169) agrees, saying that public policies to try to regulate the market "fail to recognize that the state bears an inherent flaw that dwarfs the imperfections purported to afflict the free market; namely, that policies undertaken in the name of the public good inexorably become captured by special interests and crony capitalists who appropriate resources from society's commons for their own private ends."

Discussing the lawyers and accountants hired by the elite, Stiglitz (p. 53) says, "They help write the complex tax laws in which loopholes are put, so their clients can avoid taxes, and they then design the complex deals to take advantage of these loopholes."[2] Regarding the market power that the elite use to enhance its income, Stiglitz (p. 54) writes, "The simplest way to a sustainable monopoly is getting the government to give you one." Stockman (p. 181) says, "Like in all instances of crony capitalism, economic outcomes are as much a gift of the state as they are the fruits of capitalist virtue." Stiglitz (p. 40) agrees, saying capitalists write the rules in their favor "to extract from the public what can only be called large 'gifts.'"

[1]Piketty's (2014) best-selling book emphasizes inequality also, but the big difference between Stiglitz's analysis and Piketty's is that while Stiglitz argues that government policy is the major cause, Piketty argues that growing inequality is an inherent characteristic of capitalism. A review of additional literature below suggests that Stiglitz's view is more widely held, at least among U.S. economists.

[2]A more pessimistic view of this type of activity is presented by Schweizer (2013: 4), who states, "Hiring a lobbyist aligned with a powerful politician is more important than hiring a lobbyist with a certain expertise or experience. Hiring a former staff member or family member is better still. It's the favor that matters."

Stiglitz (p. 59) argues that the rules are being written by the 1 percent for their benefit. "It's one thing to win a 'fair' game. It's quite another to be able to write the rules of the game—and to write them in ways that enhance one's prospects of winning. And it's even worse if you can choose your own referees." Discussing government regulation in various sectors of the economy, Stiglitz contends, "The problem is that leaders in these sectors use their political influence to get people appointed to the regulatory agencies who are sympathetic to their perspectives."[3]

Stiglitz (p. 62) says, "It doesn't have to be this way, but powerful interests ensure that it is." Stockman (p. 560) agrees, saying, "We have a rigged system—a regime of crony capitalism—where the tax code heavily favors debt and capital gains, and the central bank purposefully enables rampant speculation by propping up the price of financial assets and battering down the cost of leveraged finance." Stockman's (p. 606) dismal view is that "In truth, the historic boundary between the free market and the state has been eradicated, and therefore anything that can be peddled by crony capitalists . . . is fair game."

Stiglitz (pp. 104–5) argues that "When one interest group holds too much power, it succeeds in getting policies that benefit itself, rather than policies that would benefit society as a whole. When the wealthiest use their political power to benefit excessively the corporations they control, much-needed revenues are diverted into the pockets of a few instead of benefiting society at large." Why does this happen? Stiglitz tells us that interest groups hold too much power and use it to get policies that benefit the wealthiest.

Echoing Stiglitz's message, Stockman (p. 672) says our government "is no longer a system of democratic choice and governance: it is a tyranny of incumbency and money politics." He argues (p. 692) that "the gangs of crony capitalism will fight tooth and nail to preserve their slice of an imperiled pie, thereby disenfranchising even further ordinary taxpayers and citizens who have no voice in the Washington policy auctions."

In Chapter 9, titled "A Macroeconomic Policy and a Central Bank By and For the 1 Percent," Stiglitz finds fault with the Federal Reserve for monetary policies that subsidized banks and boosted the

[3]Economists will recognize that Stiglitz is referring to Stigler's (1971) capture theory of regulation.

stock market, aiding the elite at the expense of the masses. He criticizes the bank bailouts, saying (pp. 307, 309), "More broadly, the bailout strategy put the interests of the banks (and especially the large banks) and bankers ahead of the rest of our economy. . . . The big banks can thus prosper not because they are more efficient or provide better service but because they are in effect subsidized by the taxpayers." Stockman (p. 22) discussing the bailouts during the financial crisis, offers a similar message: "The Washington bailouts rescued the perpetrators, not the victims."

Stockman (pp. 658–59) agrees with Stiglitz on Fed policy:

> The Bernanke Fed has showered speculators with windfalls again and again in the various risk asset classes, yet the problem is not merely the unfairness of these massive unearned rents and the resulting further skew of societal wealth to the top 1 percent. In truth, the Fed's radical financial repression policies cause vast economic deformations, even as they generate gratuitous upward redistributions of the wealth. . . . Never before had so much cash been hauled home by speculators—literally hundreds of billions—for so little value added.

Chapter 5 is titled "A Democracy in Peril." Stiglitz (pp. 148–49) argues:

> Politics is the battleground for fights over how we divide the nation's economic pie. It is a battleground that the 1 percent have been winning. . . . In earlier chapters we saw how markets are shaped by politics: politics determines the rules of the economic game, and the playing field is slanted in favor of the 1 percent. At least part of the reason is that the rules of the political game, too, are shaped by the 1 percent.

Stockman (p. 52) agrees: "Trying to improve capitalism, modern economic policy has thus fatally overloaded the state with missions and mandates far beyond its capacity to fulfill. The result is crony capitalism—a freakish deformation that fatally corrupts free markets and democracy."

Stiglitz (p. 225) thinks Warren Buffett was correct when he stated: "There has been class warfare going on for the last 20 years and my class has won." In Stiglitz's opinion (p. 102), rising inequality, to a large extent, "is the result of government policies."

Stockman is not optimistic that the increasing cronyism he sees can be reversed. One might think that the Republican Party would be the political party that could reverse the trends he sees, but Stockman (p. 551) emphasizes that "there is no conservative party left in America—at least not one that is willing or able to defend sound money, free markets, and fiscal rectitude. So the drift into the crony capitalist end game will now accelerate, suffocating what remains of free market prosperity and honest political democracy." Agreeing with Stiglitz's message in Chapter 5, "A Democracy in Peril," Stockman (p. 614) concludes;

> A government which is responsible for every bob and weave of the entire national economy will quickly succumb to pure crony capitalism, a regime which cannot avoid eventual fiscal insolvency and the destruction of any semblance of a free market economy. . . . Most importantly, it means a fatal corruption of political democracy.

In sum, Stiglitz and Stockman see a system of cronyism, where government policies are designed by the economic and political elite to benefit themselves at the expense of the masses. Both use the language of the Occupy Movement to describe how the 1 percent rigs the system to increase their power and wealth. And both show how crony capitalism, rent seeking, and Fed bailouts have damaged the market economy and democratic government.

Other Critics of Cronyism and Special Interest Politics

Stiglitz and Stockman offer good examples of the similarity in the way the left and right perceive the causes of problems that face the economic and political systems, but a substantial literature shows that they are not unique in describing a political and economic system characterized by cronyism and skewed to promote the interests of the political and economic elite. Holcombe and Castillo (2013) look at cronyism outside the United States dating back to the early 20th century, and Holcombe (2013) discusses a strong foundation for this line of reasoning in the economics literature.

Gabriel Kolko, a left-leaning historian, sees government as an organization that provides regulatory advantages to the economic elite. He discusses this in the content of Progressive Era policies that

are often viewed as favoring the general public over moneyed interests (Kolko 1977).

Peter Schweizer (2013) discusses in detail the negative effects of cronyism, but differs from Stiglitz and Stockman by arguing that the special interest political activity that often appears as bribery—interest groups bribing legislatures for favorable outcomes—is more accurately described as extortion. In this respect, he follows the lead of McChesney (1987, 1997): Legislators threaten businesses and other interests with harmful legislation, or threaten to hold up legislation they desire, until those interests make payments to the politicians. Still, Schweizer describes a system of cronyism that works for the benefit of the elite but imposes costs on the masses.

John Allison (2013), like Stockman, is a strong supporter of free markets and sees the Fed as a major contributor to the 2008 financial crisis, along with various government policies like deposit insurance and the taxpayer subsidy inherent in Fannie Mae and Freddie Mac as government sponsored enterprises. While he focuses more narrowly on the financial crisis, Alison sees the problems with intervention in a manner similar to Stockman.

While Schweizer and Allison write from the vantage point of the political right—or, more accurately, from a libertarian perspective—there is a substantial literature on the political left making similar points about cronyism. Larry Bartels (2008) calls the political privilege the elite enjoy at the expense of the masses the “New Gilded Age,” noting how the political process is skewed to benefit the 1 percent. Hacker and Pierson (2010) and Gilens (2012) argue along with Stiglitz that the growing privilege of the 1 percent is not due to market forces but to the political power of those at the top. Finally, Gilens and Page (forthcoming) offer a persuasive empirical analysis which concludes that government policy conforms to the preferences of the elites, and goes in the direction average citizens prefer only when their preferences correspond with those of the elites.

Different Policy Recommendations

As far as specific solutions to the problems they perceive, both Stiglitz and Stockman come up with a list of desirable reforms. Their lists are different because Stiglitz sees inequality as the major problem while Stockman sees the major problem as the undermining of a free-market economy. Overall, Stiglitz calls for more

government oversight and involvement in the economy while Stockman calls for less.

Stiglitz lists more than 20 policy reforms he recommends to address the problems he and Stockman agree plague the economic and political system. His recommendations are not specific policies but rather policy goals. For example, under the heading of "curbing the financial sector," he offers six reforms designed to curb excessive risk taking, make banks more transparent, increase the competitiveness of banks and credit card companies, make it more difficult for banks to engage in predatory lending, curb bonuses that encourage excessive risk taking, and close down offshore banking centers. Yet, Stiglitz does not offer any specific policies that would achieve those ends.

Stiglitz wants stronger competition laws, better corporate governance, an end to government giveaways and corporate welfare, a more progressive tax system, a more effective estate tax, better access to education, universal health care, and stronger social protection programs. Again, he does not recommend specific policies, but rather provides a list of what he views as desirable policy outcomes. Those outcomes are left-leaning: They would produce higher taxes, more government spending, and more government oversight of the economy.

The inconsistency between Stiglitz's diagnosis of the problem and his recommended reforms is that he believes the problems are caused by government policy, yet he recommends more government as the solution. If government is the problem, the obvious solution would be less government, not more.

Stockman offers a list of 13 "crucial steps" he says are needed, including reforming the Fed, abolishing deposit insurance, developing a "super Glass Steagall" to separate commercial banking from investment banking, abolishing incumbency, requiring a balanced federal budget, separating the state from the free market, abolishing social insurance, ending bailouts and subsidies, eliminating 10 federal agencies and departments, establishing a cash-based means-tested safety net, abolishing the minimum wage, eliminating health insurance, imposing a 30 percent wealth tax to pay down the national debt, and repealing the Sixteenth Amendment.

In contrast to Stiglitz, Stockman recommends actual policies rather than the results he hopes to see from policies, and his recommendations in most cases call for smaller government rather than

bigger government. Both authors want to end corporate welfare, but Stiglitz wants to enhance the welfare state's support of individuals while Stockman wants to abolish that system and replace it with means-tested cash transfers. Stiglitz wants to increase the progressivity of the income tax; Stockman wants to eliminate the income tax. Both are pessimistic that the system that is controlled by the 1 percent can be turned around.

The Road Ahead: The War of Ideas

Stockman sees no hope. He says (p. 672), "Alas, none of these solutions are even remotely possible within our now fully corrupted constitutional framework. The latter is no longer a system of democratic choice and governance; it is a tyranny of incumbency and money politics." Stiglitz is slightly more optimistic. He notes the importance of ideas, saying (p. 183), "The fact that the 1 percent has so successfully shaped public perception testifies to the malleability of beliefs. When others engage in it, we call it 'brainwashing' and 'propaganda.'" But the 1 percent controls the media and controls people's perceptions. Regarding the present state of affairs, Stiglitz says (p. 186), "I show how the 1 percent has used these advances to alter perceptions and achieve its aims—to make our inequality seem less than it is and more acceptable than it should be." He continues (p. 233), "We've seen how the powerful manipulate public perception by appeals to fairness and efficiency, while the real outcomes benefit only them." The way out, then, is to win the war of ideas.

Dani Rodrik (2014) says the same thing, echoing Keynes's (1936: 383) famous statement that "the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else." Academics reading this article will be sympathetic to the notion that ideas trump interests, but therein lies the big tension between Stiglitz and Stockman. They identify the same problems, attribute those problems to the same causes, and agree on the same pernicious results. But they offer very different solutions. Stiglitz argues for bigger government and more government oversight of the economy to address the problems caused by faulty government policy, whereas Stockman argues, in the main, for the opposite.

Public policy recommendations, however, should take account of the incentives of policymakers and the information available to them to make informed public policies (Holcombe 2012). Both Stiglitz and Stockman do this when diagnosing the problems, and they should extend this methodology to designing policies to address those problems.

Conclusion

This article has demonstrated the similarity of the ideas of the political left and right on the causes of contemporary political-economic problems and their consequences, using Stiglitz as the spokesman on the left and Stockman on the right. A brief reference to other scholars on the left and right shows that their ideas are representative across the political spectrum.[4] There is substantial agreement that faulty U.S. government policy that systematically favors the elite over the masses is damaging the market system and democracy.

Stiglitz and Stockman both believe their policy recommendations represent the interests of average Americans, and neither believes that the policies they recommend favor the 1 percent over the 99 percent. Yet, the fact that their recommendations are so different points to the political challenges working against reform.

It would be easy to argue that Stiglitz and Stockman both overstate the degree to which ordinary Americans are harmed by government policies that favor the 1 percent. Gilens and Page (forthcoming) offer a more optimistic view. After undertaking an empirical study that shows the influence of the preferences of elites and impotence of the preferences of ordinary citizens, they find that "this does not mean that ordinary citizens always lose out; they fairly often get the policies they favor, but only because those policies happen also to be preferred by the economically elite citizens who wield the actual influence."[5]

[4]A recent exception is Piketty (2014). While Stiglitz, Stockman, and a number of other authors noted earlier focus on faulty government policy as the problem, Piketty argues that the inequality he and Stiglitz view as the primary problem is inherent in the nature of capitalism. Like Stockman, Piketty argues for a wealth tax, although Piketty's wealth tax would be an annual progressive tax whereas Stockman's recommended tax would be a one-time tax at a much higher rate.

[5]Note the similar conclusion drawn by Beard (1913), who offered a similar message of elite opinion trumping the masses in the writing of the U.S. Constitution.

The degree to which the elite control the political process is certainly open to question. The highest income earners face a marginal income tax rate of 40 percent or more when considering federal and state taxes while the bottom half of the population pays almost no income taxes. The U.S. corporate income tax rate is the highest in the world, while more than half of government spending goes to transfer payments. But set aside the question of whether Stiglitz and Stockman and others have exaggerated the influence of the elite. Their agreement that government is the cause of the problems they cite makes a powerful argument for limiting the scope and power of government. The fact that there is agreement on the left and the right on these problems and their causes is worth noting. That points to the policy question of what should be done to address those problems.

A government run by an omniscient benevolent dictator could implement the policy proposals that Stiglitz or Stockman recommend (but not both, because many of their recommendations are in conflict). In fact, government policies are created and implemented through a political process in which people who have more political power are naturally inclined to use it for their benefit. If these authors are correct in diagnosing the problem as being created by the abuse of government power, the only real solution is to constrain the the power of government. To think that increasing the scope and power of government will make government more benevolent is wishful thinking.

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Celestial Anarchy: A Threat to Outer Space Commerce?

Alexander W. Salter and Peter T. Leeson

The wealth-creating potential of outer space commerce is tremendous. Companies such as SpaceX are successfully providing private sector responses to public sector demands for transportation to the International Space Station. Planetary Resources and Deep Space Industries promise to create wealth by mining asteroids for rare metals and water. And Virgin Galactic and Space Adventures are pioneering the market for space tourism.

The world's first commercial spaceport, Spaceport America, in New Mexico, which cost nearly $209 million to build, is already in use by SpaceX and Virgin Galactic. In addition, high-powered investors, such as Elon Musk (creator of PayPal, now CEO of SpaceX), Larry Page (co-founder of Google, now also involved with Planetary Resources), and Sir Richard Branson (chairman of the Virgin Group, the venture capital conglomerate behind Virgin Galactic), are pouring hundreds of millions of dollars of their own capital into outer space ventures.[1]

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[1]See Solomon (2012) for a historical overview of companies currently pioneering space-related commercial activities.

Yet an ominous feature of the celestial environment seems to threaten the ability of outer space commerce to achieve its potential: celestial anarchy. Although, terrestrially, governments enjoy the sovereignty over their territories needed for the state to define and enforce property rights in those territories, celestially, things are quite different. In outer space, much as in international space, no government has sovereignty. This fact is enshrined in the 1967 Outer Space Treaty, signed by the spacefaring nations. Article II of the treaty prohibits signatory nations from extending territorial jurisdiction to celestial bodies.[2]

In practice, at least, the same Article prevents even private citizens from using their sovereigns to define or enforce privately held property rights in celestial bodies.[3] As White (2002: 84) points out, "in common law countries such as the United States, legal theory dictates that the government must have sovereignty over territory before it can confer title on its citizens. Consequently, traditional real property rights [in outer space] are inconsistent with this theory."

The problem celestial anarchy seems to create here is straightforward. Private parties who have property disputes when operating in outer space need to settle their disputes in courts of law. But such courts are within the legal domains of national sovereigns. Enforcing private parties' property rights in outer space therefore requires a de facto concession of national sovereignty, running afoul of Article II.[4] As Pop (2000: 281) puts it, because "the Outer Space Treaty prohibits the national appropriation of outer space and celestial bodies, a State endorsement" of private parties' property rights

[2]The full text of this treaty and list of signatories and parties are available at http://disarmament.un.org/treaties/t/outer_space. Because of the lack of signatories among spacefaring nations, we don't consider here the 1979 Moon Treaty (http://disarmament.un.org/treaties/t/moon).

[3]Whether or not the Outer Space Treaty precludes private citizens from holding property rights in celestial bodies in principle is contested. Some scholars argue that some form of private property rights is reconcilable with the requirements of the Outer Space Treaty (see, for instance, Groove 1969 and White 1997, 2000, 2003). Others argue that the Treaty precludes all private property rights (see, for instance, Pop 2000 and Dunstan 2002).

[4]This is why White (2002: 84), a defender of private property rights in outer space, argues in favor of a "quasi-territorial" jurisdiction for the establishment of any kind of private property rights regime. In this sense the analysis that follows has implications for civil law nations as well.

in such bodies "would be interpreted as a means of national appropriation, hence it would be unlawful."

Economists have long highlighted the necessity of private property rights for thriving commercial activity (e.g., Smith 1776, Mises 1949, Alchian and Demsetz 1973, North 1990). Without some means of enforcing claims to mine and thine, individuals have little incentive to risk investing in and growing commercial enterprises. This is as true for celestial enterprises as it is for terrestrial ones. As White (2000: 2) notes, "Implementing [a] real property regime would provide greater legal certainty to investors and entities participating in the development and settlement of outer space." Celestial anarchy thus appears to pose a serious obstacle to flourishing outer space commerce.

But what if private parties sidestepped the problem posed by sovereigns' inability to support celestial property rights by enforcing such rights *privately*—that is., without reliance on any government? Pop (2000: 281) summarizes the conventional view of this possibility: "Appropriation of land can exist outside the sphere of sovereignty, but its survival is dependent upon endorsement from a sovereign entity."[5] In other words, it is widely believed that a purely private celestial property rights regime is not possible.

This article argues that conventional wisdom is wrong. Celestial anarchy is genuine, but the ostensible problem it poses for the development of outer space commerce is not. Private property rights can and do survive without the endorsement or involvement of any sovereign entity. This suggests that private parties can, if given the chance, enforce property rights in outer space. Economically, at least, celestial anarchy poses no obstacle to the flourishing and full development of celestial enterprise.

The conventional wisdom's failure to grasp this fact stems from two sources: unfamiliarity with economic theory and unfamiliarity with economic reality. Economic theory demonstrates how private individuals can enforce property rights without reliance on government. And economic reality demonstrates how they in fact do so. There's nothing special about this theory or its manifestations in practice that would limit it to terrestrial property rights.

Our argument does not deny potential political problems associated with private individuals of particular nationalities claiming

[5]See also Coffey (2009).

property rights in outer space when those claims run afoul of sovereigns' interpretation of the Outer Space Treaty. It denies the alleged economic problem of them doing so, upon which the prevailing view that celestial anarchy threatens to undermine outer space commerce is based. In this sense, our article complements existing contributions to the literature on governance in outer space that discuss mechanisms for achieving resource usage (see Weeden and Chow 2012, Cooper 2003, Milligan 2011, and Simberg 2012). In our concluding section, we briefly consider the relevance of our analysis of the economic (non-) problem of celestial anarchy for the political problem such anarchy may pose.

Enforcing Property Rights without a Sovereign in Theory

According to conventional wisdom, a sovereign state—a monopoly authority that all parties must submit to as the final arbiter of property disputes—is necessary to enforce and thus sustain a regime of property rights. To understand this claim it's helpful to consider an analytic scenario that has done much work for economists who study the nature of governance: the Prisoners' Dilemma. Figure 1 depicts this scenario.

Alice and Bob are considering how to behave toward one another in an environment without a sovereign. The rows and columns in Figure 1 depict the strategies that Alice and Bob, respectively, can pursue in their interaction with one another. Inside each row-column box are Alice's and Bob's payoffs—that is, what each party earns by interacting with the other—depending on the strategy they pursue and the strategy the other party pursues. Alice's payoff appears first in each box and Bob's appears second.

Alice and Bob each have two strategies they may follow in their interaction with the other. They choose their strategies simultaneously. Each party can "cooperate" by respecting the property rights the other party claims to have, say by trading with the other party honestly. Or they can "defect" by violating the property rights the other party claims to have by, say, by stealing what the other party claims as his or her own or trading with him or her fraudulently.

When both parties cooperate with each other, both capture gains from trade equal to $A > 0$. When one party defects but the other party cooperates, the defecting party benefits at the cooperating party's expense. In this case the defecting party earns $C > A$, and the coop-

FIGURE 1
The Prisoners' Dilemma

	Cooperate	Defect
Cooperate	A, A	B, C
Defect	C, B	0, 0

erating party earns B < 0. When both parties defect, both parties earn 0: mutual theft is damaging to both parties, but not as damaging to either party as being "suckered"—i.e., respecting the other party's property rights when the other party violates their property rights.

Without a property right-enforcing sovereign to keep them in line, how will Alice and Bob behave? Examining each party's payoff under each of the possible scenarios in Figure 1 reveals that both Alice and Bob will defect. This is because, no matter what the other party does, both Alice and Bob maximize their own payoff by violating the property rights of the other.

If Alice thinks Bob will cooperate, Alice wants to defect because she earns her highest payoff possible, C, in this scenario. If Alice thinks Bob will defect, Alice again wants to defect because she earns 0 in this scenario, which is higher than what she earns if she cooperates and Bob defects, B. Bob, whose situation is symmetric, reasons the same way. So he always defects too.

Both parties therefore earn 0, which is less than what both could earn if they could instead agree to respect each other's property rights, A. Each party can promise the other that they will cooperate. But without a sovereign to enforce that promise, each is led to break their word, tempted by the specter of earning C if the other party keeps his or her word, or of at least earning 0 instead of B if they expect the other party to break his or her word.

This dilemma described by Figure 1 is a stylized version of that which conventional wisdom suggests must be the outcome under

celestial anarchy in arguing that enforceable property rights are unsustainable here. Consider what happens, however, if we modify the analytical situation that Alice and Bob confront in a small way that more closely resembles reality. Suppose that Alice and Bob interact, and thus have the opportunity to respect or violate one another's property rights, not just once, but an indefinite number of times—the case of a repetitive game. Suppose that both parties defect on the other party for all subsequent interactions if he or she defects on him or her even once and that both parties tell the other as much. Now how will Alice and Bob behave without a sovereign to keep them in line?

Unless Alice or Bob is excessively impatient, both will cooperate. Where $\gamma \in (0,1)$ is the discount rate that Alice and Bob apply to payoffs from interacting in the future (since earnings in the future are worth less than earnings today), for both parties, cooperation now yields:[6]

$$(1)\ \sum_{t=0}^{\infty} \gamma^t \mathrm{A}.$$

And for both parties, defecting now yields C. Recalling the rule for solving an infinite geometric series and using simple algebra to solve for γ reveals that cooperating is now more profitable than defecting for both Alice and Bob when:

$$(2)\ \frac{\mathrm{A} - \mathrm{C}}{\mathrm{C}} > \gamma.$$

As long as Alice and Bob are patient enough to satisfy this inequality (i.e., they don't discount future payoffs too steeply), both will respect the other's property rights despite the absence of a sovereign.[7] Simply permitting Alice and Bob to interact repeatedly and conditioning each party's strategy choice on the strategy chosen by

[6]Alternatively, one can think of γ as the probability that Alice and Bob's interaction in a particular period will be their last—that is, the probability with which the game they're playing ends each period (or as a parameter that reflects Alice and Bob's discount rate and the probability with which the game they're playing ends each period).

[7]Because outer space commerce requires large up-front investments before net benefits can be secured—and even then only after repeated periods of cooperative interaction with fellow space entrepreneurs—the "space business" selects for individuals who are patient.

the other party in the past reverses the result we found earlier. Instead of always violating one another's property rights, Alice and Bob always respect one another's rights.

The reason for this result is what economists call the "discipline of continuous dealings." The intuition that underlies it is simple. When Alice and Bob interact indefinitely rather than just once, the possibility of being "punished" by the other party in the future for defecting in the past emerges. Both parties know that if they violate the other party's property rights today, the other party will defect when interacting with them tomorrow—and in every period after that—preventing the defecting party from earning positive payoffs ever again. Since the gain from defecting is a one-time gain but the gains lost from defecting even once are forever, if parties don't discount the future excessively, they earn more by always cooperating than by ever defecting. Property rights are *self-enforcing*.

In Figure 1 there are only two parties. But the logic is the same if there are more than two. Indeed, when there are more than two parties, reputations become possible, strengthening self-enforcing property rights still further. Suppose, for example, that in addition to Alice and Bob, there's another party, Charlie. Now if, say, Alice violates Bob's property rights, not only may Bob defect when interacting with Alice in the future, cutting her off from the gains of future cooperation with him, but Bob may tell Charlie that Alice is a property right violator, leading Charlie to defect on Alice in all his future interactions with her as well. This makes the "punishment" that Alice suffers for defecting even stronger, which in turn strengthens her incentive to respect Bob's and Charlie's property rights.

The discipline of continuous dealings illustrates theoretically why a sovereign isn't necessary to sustain enforceable property rights. In what follows we draw on economic reality to illustrate how private parties leverage self-enforcing property rights without a sovereign in practice. Although there are many examples we could draw on for this purpose (see, for instance, Friedman 1979; Ellickson 1994; Anderson and Hill 2004; Leeson 2007a, 2007b, 2009, 2013), we focus on one in particular because of its similarity in several important respects to the situation of celestial anarchy this article is interested in—namely, international anarchy.

Enforcing Property Rights without a Sovereign in Practice

International anarchy refers to the fact that, although globally many sovereigns exist to define and enforce property rights among persons engaged in commerce in each of their domestic domains, no formal supranational sovereign exists to define and enforce property rights among persons engaged in international commerce—commerce between citizens hailing from different territories governed by different national sovereigns. Nor has such a sovereign ever existed. In this sense the property rights situation that parties to international commerce confront is similar to the property rights situation that prospective parties to outer space commerce confront.

Yet international anarchy hasn't prevented international commerce from flourishing. In the absence of a supranational sovereign that could create a sustainable property rights regime for international traders, international traders have developed a private regime of self-enforcing property rights for this this purpose instead. The result has been booming international commerce that generates nearly a quarter of the world's wealth annually. Central to this regime of self-enforcing property rights is the discipline of continuous dealings described above.[8]

The Medieval Law Merchant

In the ninth and tenth centuries a professional class of merchants emerged across Europe. These merchants confronted the central obstacle of international anarchy pointed to above: the absence of a supranational sovereign that could protect international traders' property rights, enabling the growth of international commerce. Given this situation, if a trader from Italy entered a commercial contract with a trader from Spain, how could their contract, and thus the property rights embodied in that agreement, be enforced?

A trader who believed his counterparty had violated their agreement might attempt to seek enforcement against his counterparty in his nation's courts. But such courts typically refused to adjudicate international cases on the grounds that they involved citizens from

[8]However, this isn't the only mechanism of self-enforcing property rights that international traders rely on. For a discussion of a second mechanism—one rooted in signaling—see Leeson (2006a, 2008a).

other nations, over whom they had no jurisdiction. Even if one agreed to adjudicate such a case, since it lacked authority over the counterparty, who was from another country, it had no means of enforcing its decision. An Italian court, for example, couldn't seize the assets of a merchant located in Spain. Further, on the basis of which sovereign's law should such a court adjudicate the traders' disagreement? The laws created and enforced by the government of Italy to govern Italian citizens didn't (and don't) apply to Spanish citizens governed by Spanish law.

In response to such obstacles to international commerce, medieval merchants resolved international commercial disputes privately on the basis of merchant-developed law in private, merchant-developed courts. This system of self-enforcing property rights is called the medieval *lex mercatoria* (law merchant). As Benson (1989: 645) notes in his discussion of the medieval law merchant, this system demonstrates that international "commerce and commercial law have developed conterminously, without the aid . . . of the coercive power of nation-states."

Although initially based on what knowledge of Roman civil law had been salvaged after the fall of the Roman Empire, the medieval law merchant evolved as customs and practices common to many geographic locales became standard practice for merchants engaged in international commerce (Benson 1989: 648). Common rules enabled merchants to capture more of the gains from international trade, further cementing them as a cornerstone of acceptable practices among international traders.[9] By the 12th century, international "commercial law had developed to a level where alien merchants had substantial protection in disputes with local merchants" (Benson 1989: 648).

The private merchant courts that adjudicated property conflicts under this body of private law developed their own rules of evidence and employed experts to decide specialized matters involving international commercial contracts. Compared to the national courts prevalent in the nascent sovereigns of the period, merchant courts were informal and reached decisions quickly—a feature valued highly by international merchants (Benson 1989: 649–51).[10]

[9]This "snowballing" effect whereby the success of least-cost norms and behaviors further entrenches their common usage is a hallmark of spontaneous social institutions, such as the common law, language, and even the use of money.

[10]See also Milgrom et al. (1990).

To enforce merchant court decisions, members of the international commercial community leveraged the discipline of continuous dealings described earlier. Although these courts had no formal enforcement power, most traders complied with their decisions. Refusing to do so resulted in the members of the international trading community blacklisting the uncooperative traders, cutting them off from the benefits of future trading opportunities with members of that community. The discipline of continuous dealings between international traders rendered commercial contracts between them, and thus traders' property rights, self-enforcing.

The Modern Law Merchant

In the absence of a supranational sovereign to enforce and sustain property rights between contemporary international traders, modern international trade is similarly governed privately—by a modern law merchant. Given the difficulties, and for many years the impossibility, of using national sovereigns to enforce international commercial disputes, contemporary international traders rely on private international arbitration associations instead. Indeed, at least 90 percent of modern international commercial contracts contain clauses stipulating the resolution of contractual disputes via private arbitration (Leeson 2008b: 68).

The sums of money at stake in these private courts are enormous. For example, in 2001 roughly 1,500 parties from 115 countries used the arbitration services of the International Chamber of Commerce (ICC), the largest of such organizations, in property conflicts that ranged in value from $50 to $1 billion. Over 60 percent of these disputes were for amounts between $1 million and $1 billion (ICC 2002). Likewise, in 2001 another private international arbitration association, the International Center for Dispute Resolution (ICDR), adjudicated contracts worth $10 billion involving parties from 63 different countries (ICDR 2002).

When forging their contracts, parties to private international arbitration choose the law they want to apply to their agreement in the event of dispute. They may choose commercial law as embodied in the laws of various sovereigns. Or they may choose to have customary law, as it has evolved and developed under the modern law merchant, to govern their contracts instead.

Like those of their medieval merchant-court counterparts, the decisions of private international arbitration associations are over-

whelmingly respected by the international traders who rely on them. The ICC, for instance, estimates that 90 percent of its decisions are complied with voluntarily (Leeson 2006b: 50). As in the past, the discipline of continuous dealings plays a crucial role in securing such compliance and rendering property rights self-enforcing. A trader who refuses to comply with the decision that one of these private courts has handed down to him faces losing his reputation among the community of international traders, and with it, the prospect for future commerce.

In 1958 the first multinational treaty aimed at facilitating the enforcement of private international arbitral decisions in the national courts of sovereigns emerged: the United Nations New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Since then, many, though not all, countries have signed the New York Convention (NYC). Leeson (2008b: 63) describes how the NYC works:

> Private parties to international commercial contracts agree to have their disputes settled by arbitration associations. Since these associations are private, they cannot formally compel losers to comply with their decisions. However, under the terms of the NYC, winners can have their arbitral decisions enforced by losers' governments if these governments are members of the convention. . . . A simple example illustrates how the NYC provides state enforcement for international traders. Suppose a Bulgarian importer contracts with an Argentinian exporter for a shipment of grade A quality leather. When the shipment arrives, the Bulgarian finds that the leather is only of B quality, though his trade partner insists it is A. Before 1958 these traders would have privately settled their dispute through an international arbitration association. If the arbitrator decided the Argentinian did not fulfill his end of the contract and ordered him to pay, the Bulgarian had no means of compelling payment should the Argentinian refuse. However, the introduction of the NYC in 1958 changed this. Traders still use private arbitration to settle disagreements. But now, under the NYC, if the Argentinian refuses to pay, the Bulgarian can call on the Argentinian government, which has signed the NYC, to enforce his arbitral award.

Because of the NYC, at least in principle, post-1958 international traders have been able to rely on the support of sovereigns to enforce

their property rights. But it would be mistaken to conclude that the NYC has succeeded in removing international traders from international anarchy and thus that international commerce requires, or indeed is ultimately based on, sovereign enforcement. Prior to 1958 the NYC didn't exist. Yet international commerce, which was already substantial, flourished. Equally important, in the absence of s supranational sovereign, the NYC—which is a contract between sovereigns—itself has no sovereign that could enforce its terms. What enforces the NYC's terms is the discipline of continuous dealings.

The NYC is nothing but a statement of promises from its sovereign signatories to agree to respect private international arbitral awards rendered by other sovereigns. No third-party enforcement of these promises exists, or in the absence of a global government is possible. To the extent that sovereign signatories of the NYC fulfill their promises under the treaty, they do so under the threat of being ostracized by the Convention's other signatories who may refuse to enter into future treaties with a sovereign that goes back on its word.

Thus, even in the case of the NYC, the discipline of continuous dealings—ultimately a mechanism of self-enforcement—drives compliance. As Leeson (2008b: 83) puts it, "Like all multinational treaties, for the NYC as well, there is no formal supranational agency of authority to compel states that have joined it to abide by its terms. This leaves the enforcement of the NYC to informal mechanisms, such as reputation, and the interstate equivalent of international arbitration through such organizations as the UN."

Conclusion

The economic theory of self-enforcing property rights and the economic reality that illustrates this theory's application under international anarchy suggests that conventional wisdom, according to which a sustainable property rights regime under celestial anarchy isn't possible, is mistaken. If there are special features of the celestial environment that preclude our analysis' relevance for this environment, we can't think of them—and the absence of an enumeration of such features by others suggests they can't either.

This statement does not, of course, deny that special, particular features of the outer space environment that would bear on how privately created governance might emerge in this context exist.

For example, self-enforcing property rights in international traders' anarchic context differ from their manifestation in the anarchic, 19th century American frontier (which we did not consider, but see Anderson and Hill 2004). These differences reflect specific features of the property rights problem situation that individuals confronted in each case. Likewise, the particular property right problems that outerspace entrepreneurs may confront will also surely be different, suggesting that the precise way in which self-enforcing property rights would manifest in this anarchic environment differ too.

Perhaps commercial space pioneers would use already-existing arbitration associations, such as the ICC, in order to enforce celestial property rights. Or perhaps a body of private outer space law—informed at its core by familiar precedents relating to nuisance, damages, liability, and so on—might progress to the point that space-specific arbitration agencies, employing their own experts in space law, would serve as the primary dispute resolution mechanism and process by which precedent is set. Alternatively, the first space pioneers might have a voluntary convention in which their representatives form a kind of outer space "social contract," thereby setting the rules for original appropriation of unowned resources, property rights enforcement, and the proper bounds of behavior between parties when one party's behavior imposes uncompensated burdens on others.

The specific self-enforcing arrangements that might actually develop under celestial anarchy can't be established with any certainty ex ante. What can be established is that some system of self-enforcing property rights would develop if given the chance and that such a system would reflect the particular issues that space entrepreneurs confront in their efforts to secure the substantial gains that cooperative celestial commercialization offers.

As economists, our comparative advantage is analyzing the economic problem that celestial anarchy seems to, but, as our analysis suggests, does not in fact, pose for sustaining enforceable property rights in outer space. Nevertheless, in concluding we think it worthwhile to touch briefly on the implications that our analysis may have for the potential *political* problem posed by celestial anarchy. That problem is this: There may be political consequences to private individuals' securing property rights in outer space if these individuals' claims run contrary to political actors' interpretation of Article II of the Outer Space Treaty.

We have in mind here something along the lines of political elites in country X, in response to the establishment of property rights in celestial bodies in a manner consistent with what we have described in this article by an individual citizen of country Y, objecting that such an establishment violates the "genuine intent" of the Outer Space Treaty. Such objections could escalate into tensions between the sovereign nations of which X and Y are citizens. And those tensions may have further political consequences.[11] Our finding that the economic problem of celestial anarchy is actually not a problem could help diffuse such a situation. To the extent that political elites are interested in seeing the establishment of private property rights in space so that commercial space activity can flourish, but worry that this must involve violating the sovereignty restrictions in the Outer Space Treaty, our analysis shows their concern is misplaced.[12]

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[11]We don't wish to ascribe empirical content to political elites' motivations. Perhaps political elites in country X believe the arrangement entered into by the individual citizen of country Y violates the spirit of the treaty, and thus is an injustice requiring rectification. Alternatively, these political elites may make threatening gestures in the hope that they will be compensated with some of the wealth generated by commercial space activities entered into by the citizen of country Y and his or her co-parties. Both of these scenarios, and countless others, are plausible.

[12]In doing so, our analysis also frees up intellectual and physical resources that might otherwise be spent devising unnecessary rationales for the de facto extension of sovereignty to celestial bodies.

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Rare Coin Grading: A Case of Market-Based Regulation

John M. Cobin

This article draws on and expands my earlier empirical study of the rare coin grading industry (Cobin 1997). Major additional contributions are to (1) show the significant and important changes in the market during the last two decades (different firms, improved services, and greater competition); (2) add important and essential information that was missing or unknown due to innovations that have occurred in a now much more mature market; (3) vastly improve the tables with more data and comparative statistics that support the case for market regulation; and (4) provide details of the historical development of the industry. This updated study confirms that the industry provides high-quality, market-based regulation at low cost for the multibillion-dollar rare coin marketplace. Ease of entry has have permitted dozens of firms to compete, forcing the current 13 survivors to improve quality. Prices for the best firms' services remain low even though higher than in 1994 because of quality improvements. As a result, a strong case can be made for replacing government "public interest" regulation with more efficient market-based regulation, which emerges spontaneously to satisfy consumer demand.

Government versus Market Regulation

Many studies have appeared in the last few decades that suggest that government-enforced codes and regulations often fail to improve

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safety and quality. Without a market test, there can be no assurance that the benefits of regulation exceed its costs. Government regulators face different incentives than private ones, which actually impel them to be inclined to overlook infractions. Public choice problems relating to inefficient institutions, rent seeking, regulatory capture, and perverse incentives—as well as the knowledge problem—preclude government regulation from being effective in producing higher levels of safety and quality (Holcombe 1995).

Politicians and bureaucrats who implement public goods programs are always constrained by such public choice impediments. When government fails—that is, provides less net welfare (considering the cost of taxes and public inconvenience) than what can be obtained through market forces—there is no longer any justification to continue its regulatory activities. However, when private interests can be served indirectly through a regulatory apparatus to reduce competition, damage competitors, and force consumers to buy their products, an incentive is created to find some public interest purpose that can provide the needed justification (Cobin 2014: 190–92). If, at the same time, politicians and especially bureaucrats can benefit from such disguised private interest regulation—through larger status-enhancing budgets, greater job security, more power, and indirect perks—they will have an even stronger incentive to regulate (Niskanen 1971, 1994; Simmons 2011). In the last several decades, the economics literature has called into question the notion that bureaucrats will work to serve the public interest. As Nobel laureate James M. Buchanan (1991: 37) stated, "The mythology of the faceless bureaucrat following orders from above, executing but not making policy choices, and motivated only to forward the 'public interest,' was not able to survive the logical onslaught" from public choice theory.

In an attempt to find a remedy for government failure, at least in the arena of regulation and planning, a literature has evolved that promotes the idea of market-based regulation (e.g., Alger and Toman 1990; Blundell and Robinson 2000; Cobin 1997, 2013a, 2013b, 2013c; O'Driscoll and Hoskins 2006; Poole 1982; Benson 1989). This article provides a case study of grading and evaluating in the rare coin industry that tests the hypothesis of this literature: When competition and concern for reputation are present, markets will spontaneously emerge to efficiently regulate the quality of goods and provide consumers with essential information (De Alessi and Staaf 1994, Klein 1997, Komhauser 1983, Shapiro 1983).

Under normal circumstances, there is no reason to believe that market provision will fail. Certain services might be under-supplied if people who do not pay for them can benefit from them. However, the existence of positive externalities does not necessarily preclude market provision. This article builds on the evidence from my study of the rare coin industry and helps determine whether quality assurance is a public good that should be provided by government or merely a private good that can be provided by the market.

Savas (1982) has argued that government is wasteful and substantial privatization is in order. Likewise, Schmidtz (1991) has made the case that private enforcement mechanisms like "the assurance contract" or other voluntary solutions might be used to replace government's role in public goods production, because the free-rider problem cannot justify coercion. In his view, "government is itself an imposer of negative externalities" (Schmidtz 1991: 89). Foldvary (1993) points out that (1) the nonprovision of a public good becomes a public bad, (2) determining the optimal provision of a public good is a highly problematic process, and (3) governments are unlikely to relinquish power voluntarily.

There is theoretical support for the privatization of public services. Government enterprises have higher costs of production (Lindsay 1976); private airlines are more efficient and productive than their public counterparts (Davies 1971); and inefficient state-owned copper mines do far worse than privately owned mines (Villagrán and Vermeo 2013). Surely, the last 50 years is replete with examples of public enterprises that are less efficient than private ones. If decision-makers have neither an ownership interest in their organization nor direct accountability to the owners, then both the organization and decisions will be subject to perverse incentives and distorted resource allocation.

Market failures are cited as the main justification for government intervention. However, the articles in Cowen's (1988) compendium, *The Theory of Market Failure*, strongly suggest that the theory of market failure has theoretical and empirical shortcomings. Externality and free-rider theory is particularly questionable (see e.g., the essays by Brubaker, Buchanan and Dahlman, Demsetz, Goldin, and Tiebout in Cowen 1988). Indeed, many important case studies that provide empirical critiques of market failure theory show that alleged cases of public goods can be provided by markets. These include Coase (1974) and Mixon (1992) on lighthouses, Cheung

(1988) on the interaction between bees and apple blossoms in honey production, Poole (1982, 1988) and Cobin (1997, 2013a, 2013b, 2013c) on fire safety, and High and Ellig (1988) on the provision of education in the United States and Great Britain. Therefore, many of the goods and services often considered to have a public nature may be provided by markets. As de Jasay (1989) notes, it is also possible that the incidence of public goods in modem economies has been exaggerated, leaving room for efficiency improvements by policies that commend market alternatives. He argues that voluntary participation in collective action often is consistent with self-interest.

Holcombe (1995) and Sowell (1996) extend Austrian economic insights by Mises and Hayek about knowledge to show that government provision of collective or public goods will not be efficient. If planners were omniscient, then they might be able to plan effectively. However, they are not omniscient (even as a committee) and are thus wholly incapable of planning either effectively or efficiently—no matter how altruistic they might be. Moreover, it may not simply be assumed that regulations actually accomplish what they are intended to do because of public choice problems, including agencies having a natural inclination to favor the industries they regulate. The problems of inadequate knowledge, perverse incentives, and inefficient institutions must be taken seriously when evaluating public provision of private goods.

The studies already noted have shown that consumers can be protected without government regulation. O'Driscoll and Hoskins (2006) provide additional cases of private regulatory alternatives that work well: free banking (without a central bank or its regulation), currency emission, arbitration and customary law, brand name generation, approval seals like Good Housekeeping, and quality certifiers like Dun & Bradstreet and Underwriters Laboratories. More of such institutions would exist, except that the government crowds them out. As Holcombe (1995: 103–4) writes, "With this illusion of a government umbrella protecting everyone from harm, there is relatively little public demand for private regulation."

It is evident that consumers are not entirely satisfied with governmental information generating services. The existence of institutions like the Underwriters Laboratories, founded in 1894 by insurers to provide risk data, and the Hearst Empire's Good Housekeeping seal of approval, a magazine marketing approach used from 1910 to the present day, are market mechanisms that

augment the standard-setting and regulatory infrastructure. However, the former has a tacit connection with government through its entwinement with the state's regulatory apparatus and by potentially providing assistance for manufacturers that seek government privileges, while the latter is more of a marketing technique than a serious quality-certifying firm—making both of them poor examples of market-based regulation. Alternatively, the sports card (Dobrow 2014) and gemstone (Cobin 1997: 105–6) grading and certification services are good examples of market-based regulation. However, they are not as impressive or mature as the rare coin industry, which provides the best case to date of pure market-based regulation.

Consumers want to know more than just basic characteristics about an expensive product or service. They want to know something about comparative and prevailing quality (and thus value), given the large capital outlay involved. In spite of the fact that much may be gleaned from considering Good Housekeeping and Underwriters Laboratories from the standpoint of certification, neither of them are *grading* firms. In addition, it is not clear that they are suitable examples of certification services that would develop without government regulation of safety or quality. It is possible that, because of its privileged position, Underwriters Laboratories is not being continually honed by the competition that would exist without government regulation of building quality. Moreover, because of the nature of government regulation, it is not clear that they efficiently transmit the lowest cost to consumers. Without rigorous competition, which is also rivalry for reputation, there can be no certainty that standards will be set optimally, that is, without serving private interests of a single firm or industry that is resting on political privilege.

Quality Grading Services in the Rare Coin Industry: A Clear Case of Market Regulation

Because a market framework with wholly market-based institutions is vastly different from a government-regulated one, it is appropriate to consider only the most market-based institutions that have emerged to alleviate imperfect information, in this case those in the rare coin industry. Given the absence of government regulation and the demand for grading and certification services for rare coins, markets have spontaneously generated institutions to meet consumer

needs. The rare coin industry is a lucid example of a market-regulatory institution. It serves a vibrant and large market (Milburn 2013), where a single coin can sell for several million dollars, and has generated many billions of dollars in annual sales (excluding unreported transactions), with trading in hundreds of mintages.

Rare coins have become a strong investment alternative, partly because of their precious metal content ("realness"). According to Allard (1990: 279), returns on rare coin investments exceeded 15 percent annually on average from 1970–90, and rare coin sales skyrocketed to nearly $1 billion annually by the late 1980s. Today sales exceed $10 billion, according to CoinTrackers website. Although rare coin prices do not always rise, they always warrant quality certification because the price differentials between grades are so large. Indeed, at the "proof" level, even a slightly different grade can double a coin's price, or more than double it in the case of the highest grades. The bottom line is that the rare coin market is fluid, dynamic, often pricey, and a single step in grade can make a big difference in price. Quality grading is of paramount importance to both the seller and especially the buyer.

Rare coin grading and certification requires great skill and knowledge, and specialists can expect to earn salaries in excess of $200,000 per year (Cobin 1997: 96). Moreover, just as information leading to building grading and certification services can be viewed as a public good, rare coin grading and authenticating could be considered as providing a public benefit. Potentially, the information might be considered a public good because consumption is nonrival and excluding those who do not pay for the services would be difficult. Rare coin shops face this reality because anyone walking by can see the grade of the coin; online auction services face it as well.

The potential free-rider problem in rare coin grading and certifying arises since someone is receiving an external benefit without paying for it. That is, many shoppers benefit from better information being displayed by graded and certified rare coins, but the only one who actually pays for it is the buyer, not the shoppers.

In fact, markets for private grading and certification (information) services help circumvent the free-rider problem because graded and certified coins command a premium, allowing rare coin dealers to capture the benefits through giving information to *every* potential buyer. Moreover, since each rare coin is unique, it is possible to grade one without grading them all, making the grading and certification of

a particular rare coin an excludable service. Hence, rare coin owners and sellers have an incentive to give away grade and certification information, much like advertising.

The Rare Coin Certification Industry

Governments are not the only institutions that provide certification and grading services. The market has also met demand for such services in many industries, including the rare coin industry. It is clear enough, on account of the existence of private inspectors and certification firms which are employed by lenders, insurance companies, and consumers, that private industry could provide market regulatory alternatives that alleviate negative externalities and improve knowledge (although they are ancillary to the government regulatory process). The ensuing subsections demonstrate that even without having a government grading service in place, the market for rare coins has generated an alternative to government quality certification that alleviates both imperfect information and externality problems. It shows that when consumers demand such services, the market is able to provide them.

Coin Grading Schemes, Certification Firms, and Reputation

The U. S. government has minted coins since 1793, using various metals and sundry denominations (Cook, Cribb, and Carradice 1990). Collecting American coins has evolved from a hobbyist's fascination to a lucrative investment activity. Indeed, rare coins have been one of the top-performing investments in the last several decades, with some Wall Street firms even developing limited partnership interests in rare coin portfolios and a rare coin index to track the market (Allard 1990, Milburn 2013).

Since 1986, the industry has generally accepted a system in which uncirculated coins are graded by one of many independent organizations that assign numerical standards based on appearance. The U.S. system established by the American Numismatic Association, as described in Table 1, is the most widely used.

The rare coin industry provides a lucid example of how the free market handles the demand for grading services. Prior to the 20th century, all coins were simply graded as either "new" or "used" (Ruddy 1995: 5). Today, rare coins are valued according to both their rarity and their grade. "Proof" (PR or PF) refers to the method of

TABLE 1
American Numismatic Association (ANA) Coin Grading Scheme

Coin Condition/Grade	Ordinal Grade	Grades Used in the Market
Poor (P)	P-1	1
About Good (AG)	F-2	2
Very Fair (VF)	AG-3 and AG-3.5	AG, AG3, AG3.5
Good (G)	G-4 to G-7	G or G4 and G6 or G+
Very Good (VG)	VG-8 to VG-11	VG or VG8 and VG10 or VG+
Fine (F)	F-12 to F-19	F or F12 and F15 or F+
Very Fine (VF)	VF-20 to VF-29	VF, VF20 and VF25
Choice Very Fine (CVF)	VF-30 to VF-39	VF+, VF-30, VF35 or CVF
Extremely or Extra Fine (EF)	EF-40 to EF-44	EF40 or EF
Choice Extremely Fine (CEF)	EF-45 to EF-49	EF45 or CEF
About Uncirculated (AU)	AU-50 to AU-54	AU or AU50
Choice About Uncirculated (CAU)	AU-55	AU55 or CAU
Borderline/Brilliant Uncirculated (BU)	AU-56 to AU-59	BU, AU-58 or CAU
Mint State (MS)	MS-60 to MS-64	MS60, MS61, MS62, MS63, MS64
Choice Uncirculated	MS-65	MS65
Gem Uncirculated	MS-66 to MS-69	MS66, MS67, MS68, MS69
Perfect Uncirculated	MS-70	MS70

Sources: Ruddy (1972), Yeoman (1994).

manufacture and the condition is usually perfect uncirculated. Uncirculated levels above "borderline or brilliant uncirculated" (BU) are also referred to as "mint states" (MS). A corresponding numerical ranking system now predominates, with the lower grades of coins being assigned numbers from 1 to 49, and "about uncirculated" (AU), BU, and MS grades of coins receiving numbers from 50 to 70 (Yeoman 1994: 5).[1] The technique for grading coins was standardized by the end of the 20th century (Halperin 1990), which has provided a means for markets to identify the rarest and most valuable coins. According to the Professional Coin Grading Services (PCGS) website, there are 15 very rare, graded U.S. coins worth between $4.5 million and $15 million each.

Grades of 60 to 70 are reserved for a "perfectly preserved coin" (Allard 1990: 279). In general, other than perhaps a handful of exceptionally rare coins, only coins with grades of BU or MS-60 to MS-67 are actively traded as investments. Sometimes a + symbol will be added to the grade to indicate that it is close to another level. Higher grades from MS-68 to MS-70 are extremely rare or do not exist for most collectible, nonbullion coins.

Coins with AU grades are often purchased as substitutes for gold or silver, not having a significant premium over the value of their metal content. Nonetheless, they do have some collectable value and provide insurance against confiscation by government because they are a coin rather than just hunks of gold or silver (holding gold was declared illegal by President Franklin D. Roosevelt in 1933 for all but jewelers, dentists, collectors, and miners).

A coin's grade is affected by authenticity, luster, strike, color, toning, friction, coin or die flaws, and obverse/reverse grade consolidation (Martin 2008). Rare coins are slabbed—that is, encapsulated by grading firms into acrylic holders to protect the coins—and their grade is certified in the encasement. Typically, the encasement also indicates the name of the grading firm and the type of coin encapsulated. The grade is invalidated if the encasement is tampered with. Daily market quotations are available for slabbed coins. Thus, dealers of rare coins are enabled to trade more productively with the increased knowledge, as well as reliability and verifiability, generated by this market process (Allard 1990: 279).

[1]There is also the Sheldon numerical system of grading, from which poor, very fair, BU and Gem classes are derived (Ruddy 1995: 112).

Dealers and consumers benefit from the existence of numerous newsletters, reports, catalogs, and pricing guides, which provide contributive analyses and recommendations (Allard 1990: 284–85). These publications include the *Coin Street Journal, Coinage, COINfidential Report, Coins, ANS Newsletter, The Numismatist, Numismatic News, Coin World*, *COINage* Magazine, and *World Coin News*. Services provided by rare coin grading and certification firms include grading, authentication, photo certification, encapsulation, and low-cost, comprehensive insurance (Cook, Cribb, and Carradice 1990: 7). Table 2 gives the names and locations of the major firms in North America, Europe, and Asia that provide some or all of these considerable and specialized services. The percentage columns in Table 3 reflect the average percentage of "sheet price" paid for a coin by dealers when the coin purchased is unseen—that is, when it is ordered by telephone or the Internet. The percentage measures the relative confidence that dealers have in the slabbing firm's ability to grade a coin correctly; it is an excellent proxy for reputation. A higher percentage translates into a better reputation relative to market competitors. Thus, the typical buyer can easily assess the value of the information produced by a particular firm. A higher percentage suggests that a firm is reliable and, subsequently, translates into greater market share.

Benefits of Low-Cost, Competitive, Innovative Grading Services and Products

Inexperienced buyers can now purchase coins that have been graded and authenticated by third-party services to assure the quality of each item, and there is more written information available for beginners than ever before. The pricing of rare coins is also very competitive in today's open market where profit margins are often lower than in the past. In addition to the benefits, the industry has done a credible job of upgrading the quality of services provided by coin dealers through organizations and associations that promote strong professional conduct and ethics (Yeoman 1994: 6). The industry is large and competition is fierce in North America, Europe, and Asia. While the preeminent firms' market positions have changed little in the last 19 years, most firms have lost some prestige, indicating the value the market places on coin grading service quality.

TABLE 2
Coin-Grading Firms by Country, Ranked According to Prestige

Prestige Level	Name of Firm	Acronym Trade Name
United States		
Tier 1 (Best)	Professional Coin Grading Services (1986)	PCGS
	Numismatic Guaranty Corporation (1987)	NGC
Tier 2	Independent Coin Graders (1998)	ICG
	American Numismatic Association Coin Services (1972)	ANACS
Tier 3	Photo Certified Institute (1986, acquired by Dominion Grading Services in 2008)	PCI/DGS
	Sovereign Entities Grading Service (1998)	SEGS
Tier 4 (Worst)	Numismatic Certification Institute—Heritage Coins (1984)	NCI
	INS Authentication Bureau Coin Grading (1970s, out of business)	INS
Residual Firms, Specialty Firms, Newcomer Firms, Minor Players[a]	ASA-Accugrade (1984, out of business, capsule patent acquired by PCGS)	ACG
	American Coin Grading Service (2002, out of business)	ACGS
	Global Certified Service (2001, out of business)	GCS
	Numismatic Conservation Service (2001)	NCS
	American Coin Club Grading Service (1987)	ACCGS
	Star Grading Service (2003)	SGS
	NumisTrust Corporation (2013, restarted)	NTC
Canada	International Coin Certification Service (1986)	ICCS
	Canadian Coin Certification Service (2006)	CCCS

continued

TABLE 2 (*cont.*)

Coin-Grading Firms by Country, Ranked According to Prestige

Prestige Level	Name of Firm	Acronym Trade Name
United Kingdom	Coin Grading Service Ltd. (2005)	CGS
Germany[b]	Numismatic Guaranty Corporation (1987)	NGC
	Numismatic Conservation Service (2001)	NCS
France	Pacific Coin Grading Services (1986)	PCGS
Switzerland	Numismatic Guaranty Corporation (1987)	NGC
	Numismatic Conservation Service (2001)	NCS
Hong Kong	Pacific Coin Grading Services (1986)	PCGS

[a]There were at least 25 other minor grading companies that went into business and then failed, leaving their slabs behind in the marketplace.

[b]For German coins, another important grader is Ron Guth (affiliated with PCGS) in San Diego, since 1988.

Sources: "Red Book" (*A Guidebook of United States Coins*), www.allcertifiedcoins.com/coins_slabcompanies.html, company websites, and Cobin (1997: 101–2).

TABLE 3
Top U.S. Coin Grading Firms' Reputation Ratings

	Greysheet Rating[a]		
Firm	November 12, 1994	November 29, 2013	Percentage Change
PCGS	98	83.1	−15.2
NGC	89	82.9	−6.9
ICG	n/a	65.7	
ANACS	74	65.2	−11.9
PCI/DGS	84	52.1	−38.0
SEGS	n/a	47.6	
NCI	42	42.5	+1.2
INS	43	34.0	−20.9

[a]Average percentage of "sheet price" paid for an unseen coin, with a range of ±15 percent for the four better firms, and as much as ±32 percent for the others. The "greysheet" is jargon for a price list of slabbed and "raw" coins found in the *Coin Dealer Newsletter*. There is also a "bluesheet" for unseen slabbed coins only, without return privilege.
Source: *Coin Dealer Newsletter*.

Of course, the greysheet percentages vary widely, and that dynamism gives consumers prices and up-to-the-minute information on how informed decisionmakers view the grading services. The percentages might also reflect concern in the market over the unchecked existence of counterfeit slabs, against which firms have had to raise technological capability that preclude falsification. Newcomer NTC claims that it has been creating a niche market by offering a counterfeit-proof service, but the firm provided me with no special evidence to support the claim. Nonetheless, the issue is one of increasing relevance to collectors.

Furthermore, the fact that there are eight American competitors, three or four of which are doing well, suggests that there are no substantial barriers to entry and thus little evidence of monopolization from the pre-1990s firms: ANACS, PCGS, and NGC. PCGS has graded over 27 million coins since its inception in 1986, with a market value of nearly $30 billion. NGC has graded over

28 million coins since 1987. Together, PCGS and NGC still have more than one-half of the overall market share (Vousvounis 2013), but all the new competitors with lower prices have eroded the massive market share disparities of the 1990s. In 1994, firms estimated industry market share as follows: PCGS had about 60 percent, NGC had 35 percent, and all the other firms had 5 percent (Cobin 1997: 104). Now the market has many more participants, and NGC, ICG, and ANACS have all improved their greysheet positions, with newcomers like SGS and NTC making significant inroads.

The rare coin industry is a vibrant example of fervent competition and resulting industrial organization. The following are illustrative and suggest that high fixed costs, lack of scale economies and of established reputation do not prevent firms from entering the market: PCI's entry in 1994, its subsequent merger with Hallmark in 1991, changes of ownership in 2001, 2002, 2006, 2007, and the DGS takeover of PCI in 2008; SEGS and ICG's entry in 1998; NCS's entry in 2001; ACGS's entry in 2002; CGS's entry in 2005; and NTC's re-entry in 2013. Moreover, the more than two dozen failed entries indicate that the market is quite mature and that newcomers must overcome significant reputation disadvantages in order to break into the rare coin grading market and survive; trust and reliability are paramount (Vousvounis 2013).[2]

There are also do-it-yourself or pre-made slabs in circulation, which are really just "shells" that look like the acrylic slabs used by professional firms. These shells are commonly seen in the market and carry names like Coin World, American Coin Club Grading Service, Certified Coin Grading Service, International Numismatic

[2]These failed grading firms include: National Numismatic Certification, TruGrade Service, American Grading Service, American Numismatic Institute, Capitol Coin Grading Service, Digital Coin Grading Service, Fiducial Select Capitol, Hallmark (1987), Independent Grading Service, Millennium Coin Certification Services, North American Numismatic Certification, New Standard Coin Grading Service, NuGrade Service, Numismatic Grading Service, NUMIS-PRO, Premier Certified Coins, Premier Coin Grading and Authentication, Professional Numismatic Grading Service, Professional Grading Service, Silver Dollar Grading Service, Twenty-first Century Grading Service, Universal Grading Service, and United Numismatic Company. These companies, by and large, were formed from 2000 to 2006.

Bureau, Original Coin Certifiers, and Liberty Coin Grading Service.[3]

Numerous attempts have been made to enter the certification wing of this multibillion-dollar industry, obviously, because the high volume of coins to be graded makes for a lucrative business and consumer demand for services is brisk. Nevertheless, there have been only minor allegations of antitrust violations and collusion in the industry.[4] Private lawsuits are another story. Given the high value of many coins, there have been a number of significant lawsuits regarding rare coins, and there are now law firms with practices that specialize in rare coin cases, especially slab counterfeiting or fraud. Thus, coin-grading firms are keen to stay on top of potential problems (Loftus 2012).

Rates and services vary considerably between firms. Table 4 and Table 5 list prices of the main grading services at the end of 2013. Table 6 provides special slab features offered by some U.S. firms.[5]

Additionally, most firms offer rush services, substantially increasing the grading cost per coin, which may demonstrate how firms serve consumers that "search for firms with acceptable waits" (De Vany and Saving 1983: 996). At the end of 2013, there were eight main competitors in the rare coin certification industry in the United States and perhaps six elsewhere (including multinationals like PCGS, NGC, and NCS).

[3]Others include United States Grading Service, Certified Rare Coins, Certified Service, Investment Grade Coins, Colonial Coin Graders, Coin Fixation, First Strike Grading, Global Coins Grading Service, Heritage Coin Grading, International Numismatic Certification Service, MS Society D&E Coins, Numismatic Evaluation Service, National Numismatic Grading Service, Professional Coin Graders, Professional North American Numismatic Service, Pacific Northwest Graded Coin, Quality Coin Grading & Certification Service, Specialty Coin Grading, Expert Grading Company, Elite Numismatic Grading Service, Investment Grading Service, Hallmark Coin Grading Service, Modern Coin Specialists, Northwest Coin Grader, Professional Numismatic Grading Service, and World Coin Grading, Gallery Grading Company.

[4]See, for example, *ASA Accugrade v. American Numismatic Association, et al.*, 370 F.Supp.2d 213 (2005), U.S. District Court, District of Columbia (www.swcgs.com/ASA_v_ANA.html).

[5]Company websites on December 6, 2013, were: PCGS (www.pcgs.com), NGC (www.ngccoin.com), ICG (www.icgcoin.com), ANACS (www.anacs.com), PCI (www.pcicoins.com), ACCGS (www.accgs.org), SEGS (segscoins.com), SGS (www.stargrading.org), NCS (www.ncscoin.com), NTC (www.ntccoin.com), CGS (www.coingradingservices.co.uk), and CCCS (www.canadianccoincertification.com). Note that ICCS did not have a website when this research was being conducted.

TABLE 4
U.S. Rare Coin Grading Service Pricing

	Pricing (U.S. Dollars)						
	Standard (One Pre-1965 Gold Coin) 12–15 Business Day Normal Turnaround Time						
Firm/Criteria	Value Under $3,000	%Δ Since 1994[a]	$20,000 Max. Value 4–5 Days	%Δ Since 1994[b]	Nongold Coins or Other Economy Price	$100,000 Max. Value with 2–3-day Rush	Rarities w/o Value Limit (% Value Charged) and/or One-day Service
PCGS	45	+200%	65	+333%	25	125	250 (+1%)
NGC	30	+100%	60	+300%	17	125	600
ICG[c]	19	n/a	25	n/a	12	50	90
ANACS[d]	19	+58%	29	+142%	15	49	100
PCI[e]	n/a	n/a	10	+33%	10	16	35
SEGS[f]	15		15		15	15	15
ACCGS[g]	9		19		9	24	29
NCS[h]	30	n/a	60	n/a	17	100	50 (+3%–5%)
SGS[i]	10		10		10	10	10
NTC[j]	15		16		12	30	50

[a]Value limit was $2,000 in 1994; prices based on data in Cobin (1997: Table 9). One-day rush service cost $140 in 1994 for PCGS.
[b]Value limit was $5,000 in 1994; prices based on data in Cobin (1997: Table 9). One-day rush service cost $125 in 1994 for NGC.
[c]For ICG, foreign (non-U.S.) coins cost $19. One-day service for all coins is $90. The two-day service rate of $50 is only for coins valued under $10,000. The five-day service rate of $25 is only for coins valued under $7,500. The 10-day service rate of $19 is only for coins valued under $5,000. The economy service rate of $12 is only for coins valued under $500. Coins over these

values will be charged the full $90 and have one-day service. On December 6, 2013, the website advertised a special price program: if 10 coins were submitted, the price of each coin in the economy program would be reduced to $10 and to $15 each in the 10-day turnaround program.

[d]For ANACS, foreign (non-U.S.) coins are the same price but have no precise delivery time specified. One-day service for all coins is $100; it was $59 in 1994 (see Cobin 1997: Table 9). The two-day service rate of $49 is only for coins valued under $10,000. The five-day service rate of $29 is only for coins valued under $5,000. The 15-day service rate of $19 is only for coins valued under $2,000. The economy service rate of $15 ($19 foreign) is only for coins valued under $500, has a five-coin minimum, and cannot be gold coins (except foreign). Coins over these values will be charged the full $100 and have one-day service. Modern coins (post-1950) have a five-coin minimum and cost $10 ($12 foreign, maximum value of $500).

[e]For PCI, add $15 to the stated price for foreign (non-U.S.) coins. The $35 price has nothing to do with rarity in this case but rather one-day service. Coins valued from $1,000 to $5,000 pay an additional $15, and coins worth more than $5,000 pay $20 additional. On December 6, 2013, the website advertised a special price program: "Under New Management. 10 Coins! 5 Days. 7 Bucks ea.!"

[f]For SEGS, the single price applies to any coin regardless of value, date, rarity, etc. SEGS charges $5 to pre-screen and grade the coin. If encapsulation is desired later, an additional fee of $8 is required. There is no explanation as to why the $13 total cost for this method is less than ordering the entire program for $15.

[g]ACCGS only designates price tiers based on speed of service; no consideration is made for a coin's value or rarity. "Dated appraisal" included in the slab costs an additional $2, as does "estimated surviving census" information. "Photo certificates" cost $10.

[h]NCS is a coin conservation service related to NGC. Service prices for slabbing are the same as NGC's. The "evaluation" service costs 1 percent of the coin's value ($10 minimum). The "conservation" stage costs "4 percent of declared value up to $150,000 per coin, 2 percent of declared value over $150,000 per coin, $15 minimum fee," according to the company website. There is a $100 "walkthrough" fee and a $50 "expedite" fee.

[i]The SGS website says that firm only slabs coins with a grade of 60 to 70. Others are certified and/or returned: 10 percent for 10–99 coins; 15 percent for 100+. The single price applies to any coin regardless of value, date, and rarity. The company claims that it grades 7 percent of all coins listed on eBay online auctions.

[j]NTC (NumisTrust Corporation) offers a 7-day service (instead of 4–5 days) with a three-coin minimum. They offer a 20-day service for $10 per coin ($16 for gold coins. Modern coins since 1955 are only $6 each, although another line on the website states $5 each, and the "non-gold economy" rate is $8 per coin (24–30 day service). Coins prior to 1955 cost $7 to grade. The $50 figure in the rarities column has nothing to do with rarity value but rather with one-day service.

Sources: Company websites viewed on December 6–7, 2013; Cobin (1997: 101–5).

TABLE 5
Canadian and British Rare Coin Grading Service Pricing

	Standard Service Turnaround Time Varies					Other/Special	
Firm/Criteria	Value Range 1	Value Range 2	Value Range 3	Value Range 4	Value Range 5	Nongold Coins or Other Economy Price	Rarities w/o Value Limit (% Value Charged) Fast Service
CCCS[a]	CDN 20	CDN 20	CDN 20	CDN 20	CDN 20	n/a	n/a
CGS[b]	GBP 14	GBP 24	GBP 39	GBP 65	GBP 95	GBP 14	$^{1}/_{2}$% of value

[a]One Canadian Dollar was worth 0.94 U.S. Dollars on December 7, 2013.

[b]One British Pound was worth 1.64 U.S. Dollars on December 7, 2013. Some prices in the table are rounded. Coin Grading Services of Kent, UK, appears to be affiliated with the TaxFreeGold store. “Standard service” (£13.75) takes 30 to 90 days and the coin values must be under £200. “Normal service” (£23.75) takes 30 to 90 days and the coin values must be under £2,000. “Deluxe service” (£39) takes 15 days and the coin values must be under £5,000. “Premier service” (£65) takes 10 days and the coin values must be under £10,000. “Star service” (£95) takes 5 days and the coin values must be under £20,000.

Source: Company websites.

TABLE 6
Rare Coin Grading Service Slab Special Features

Firm/ Criteria	Slab Special Features			
	Holder Has Top Edge Viewing Label	Oversized Holder Option for Added Fee	Chemically Inert Flexible Plastic Case	Coin Edge (Inside Slab) Is Viewable
PCGS	No	Yes	No	No
NGC	No	Yes	No	Yes
ICG	No	No	No	No
ANACS	No	No	No	No
PCI	No	No	No	No
SEGS[a]	Yes	No	Yes	No
ACCGS	No	No	No	No
NCS	No	Yes	No	Yes
SGS	No	No	No	No
NTC	No	No	No	No
CCCS	No	No	No	No
CGS	No	No	No	No

[a]This firm also provides a "sovereign series" service for $35 in which the signature of a grading expert is encapsulated with the coin.
Source: Company websites.

The consumer price index stood at 149.7 in November 1994, rising to 233.6 in October 2013 (an increase of 56.1 percent). The percentage change in prices in Table 4 is based on nominal prices, but the changes in real terms are still significant, evidently reflecting returns to reputation and higher quality. Fierce price competition forces even the best firms to keep their fees low. The rare coin industry is a remarkable testimony to just how well competition reduces consumer prices for important services. The volume is also high enough that many firms can enter the market (charging a lower price) and still make money, sometimes with slight product differentiation. One can see exactly how much reputation is worth in the price differentials between PCGS or NGC and everyone else (Wolinsky 1983).

Table 7 indicates that truly rare coins make up a relatively small portion of all graded coins, especially coins minted outside of the United States. NGC subsidizes its core rare coin business by mainly slabbing bullion and other nonrare (but still collectible) coins, which

TABLE 7
Summary of Selected Coins and Tokens Graded by NGC (December 22, 2013)

Coin Type / Number Graded	MS (+ sm. % < 60)	Proof	Total	Percentage of all Coins Graded
U.S. Silver Dollars (5 types), 1840–1978	3,509,817	41,356	3,551,173	12.64%
All U.S. Gold Coins (nonbullion coins), 1795–1933	2,682,408	9,597	2,692,005	9.58%
U.S. So-called Dollars (mainly tokens, variety of metals), 1826–1956	18,966	312	19,278	0.07%
Total U.S. Nongold Common Coins: Pennies (1859-), Nickels (1866-), Dimes (1837-), Quarters (1838-), Half Dollars (1839-)	1,814,858	2,215,257	4,030,115	14.34%
Italian Coins (post-1861 unification)	5,211		5,211	0.02%
French Coins (post-1870)	10,928		10,928	0.04%
Russian Imperial Coins (1801–1918)	70,824		70,824	0.25%
English Imperial Coins (1600–1707)	3,319		3,319	0.012%
Mexican Colonial Coins (1601–1823)[a]	6,526		6,526	0.023%
New Zealand Coins/Bullion Coins (post-1856)	3,352		3,352	0.012%
Chilean Coins, Mainly Gold and Some Silver				
Colonial Era	999		999	0.004%
Republic (1817-)	2,292		2,292	0.008%
Total	3,291		3,291	0.012%
U.S. Bullion Coins				
Silver (1 ounce)	5,768,889	977,728	6,746,617	24.01%
Silver (5 ounce)	62,215	23,776	85,991	0.31%

Gold	1,050,628	372,352	1,422,980	5.06%
Platinum	141,579	62,487	204,066	0.73%
Total	7,023,311	1,436,343	8,459,654	30.11%
Chinese Panda Coins				
All Bullion	353,587		353,587	1.26%
Hong Kong $1,000				
Gold Bullion	871		871	0.003%
Canadian Maple Leaf, 1979- (all sizes)				
Gold and Silver Bullion	14,204		14,204	0.051%
Canadian Maple Leaf (18.7%), other 1 oz., 1973-				
Silver Bullion	22,028		22,028	0.078%
South African Kruggerand				
Gold Bullion	5,273		5,273	0.02%
Australian $200 Koala				
Gold Bullion	1,049		1,049	0.004%
U.S. Medals and American Arts Medals	8,324		8,324	0.03%
All Other Coins, Tokens, and Medals				31.5%
Total				100.0%

[a] Many Mexican coins in this category are graded less than MS-60.

Source: NGC coin census (www.ngccoin.com/poplookup/us-coin-census.aspx).

TABLE 8
Coin Grading Service Markets for NTC
(Percentage of Coins Graded by Category)

Rare Coins	Collectible Coins MS-60+	"Bullion" or Proof Coins	Other Coins	Medals & Tokens
5%	70%	5%	10%	10%

Source: emails received from Joe LaBarbera with NumisTrust Coin Grading Service on December 24 and 26, 2013, including data from operations since the firm restarted on May 1, 2013. He adds: "The New NTC is dedicated to providing consistent coin grading according to the current market standards with excellent turnaround time, at fair pricing levels with outstanding customers service. Dealers and collectors will be able to distinguish the 'New NTC holder' because of the new hologram that is exhibited on the backside of our holder. NTC has also added secret security features to the holder to provide additional security and anti-counterfeiting. Our concern is that counterfeit slabs will undoubtedly plague the certified coin business in the future. NTC has taken steps now to prevent this."

are by definition much more abundant. My email conversations with some other firms and information posted on the Internet suggest that the industry has changed over the years. There is far more diversity in coin grading now than ever before, which is confirmed by the data from NTC in Table 8; NTC mainly deals with collectible coins but also has a significant business in grading medals and tokens.

It seems plausible that very valuable coins only go to the best firms for grading since an incorrect grade would be so costly. In addition, the higher grading cost of the top firms is often miniscule relative to the price of the coin, making the use of lower-quality firms less sensible, other things being equal. About 70 percent of the coins graded by NTC contain silver, gold, or platinum, rather than copper or a base metal (Table 8). This fact likely reflects the new firm's comparative advantage in grading rare or collectible coins with strong slab anti-counterfeiting measures.

Innovative Services Offered by Coin Grading Firms to Meet Changing Demand

Coin grading firms also offer special services. For example, some provide medallion, medal, and token grading; imaging services;

ancient coin authentication; shipwreck certification; conservation (residue removal and surface protection) services; slabbing into oversize holders; and metallurgic analysis. Newcomer SEGS is challenging the market share of PCGS and NGC by offering its upgraded slab for a lower price and quicker turnaround time, although the recent Professional Numismatists Guild industry survey indicates that dealers consider SEGS standards to be poor. Hence, SEGS will not be catching up to the bigger players anytime soon. Apparently, people are willing to pay more for widespread acceptance (higher reputation) and perhaps the security associated with the longevity of leading firms. Market-based regulation of quality seems to work well.

Another interesting fact about the grading industry has to do with the apparent consumer ignorance regarding the quality of different grading services. Although many consumers are well apprised of coin grading services, others may not be so careful in their selection still. Accordingly, any encapsulation and grading may well be better than none at all—especially for lower-valued coins, and in that case, the very-low-cost firms fill an important niche (especially firms like ANACS, ICG, and perhaps NTC, SGS, and SEGS). This consumer demand feature also allows easier entry for newcomers to the industry.

This case study has primarily focused on the grading of *rare* coins, that is, coins with low mintage, few surviving specimens, or a very high grade based on quality (condition). Nonetheless, as noted earlier, companies in the certification industry actually serve other important and profitable markets, too, from which the lion's share of their income is apparently derived. Probably more than one-half of all coins slabbed could not rightly be considered "rare." The grading companies contacted were loath to give out sales information.

However, a few firms did provide data on the kind of coins they grade. As noted in Table 7 and Table 8, changing consumer demand has permitted NGC and NTC to profit by grading modern coins and "bullion coins" (i.e., those having only precious metal value). They also grade collectible coins and some medals that do not necessarily carry significant value over the value of the precious metals they contain—if they contain any precious metal at all. Nowadays, many more modern coins are slabbed and in many cases hardly carry enough value to pay for the slabbing. In effect, the smaller volume of the most specialized and rigorous grading services for rare coins are being subsidized by more mundane, higher-volume ones. Also of interest is the

dominance of U.S. coins. According to tables on the NGC website, about 75 percent of the millions of coins graded by NGC have been U.S. coins. This 75 percent figure is echoed by NTC, too, which focuses far less on bullion coins and far more on medals and tokens than NGC does.

Moreover, coin dealers have subjective preferences that cause them to prefer one service to another on a micro level. For example, they may prefer NGC for "tighter" grading of gold coins and PCGS for "tighter" grading of silver dollars (Cobin 1997: 101–2). Firms specialize in such nuances to meet consumer demand. Those firms that do not adapt may fall into disrepute. Poorer grading reputations generally reflect conflicts of interest perceived by the market. Notably, a grading firm might have an affiliated business as a coin dealer, and this nexus can naturally cause suspicion. Perceptions of inferior grading techniques, such as assigning a different grade to the front and back of a coin, also tends to lower a firm's reputation. Bad firms eventually go out of business; the black sheep provider INS in 1994 (Cobin 1997: 103) could not stay in the market for long once it had attained its bad reputation.

Additionally, coins graded "early" (usually identified by the different shape of the slabs used when coin-grading services were just emerging) are considered to have been graded "tougher" and carry a premium. The market adjusts for this fact. Older graded coins may well be "upgraded" after re-grading (Cobin 1997: 101–2). The price of slabbing services is generally low (an expected result of competition), especially when one considers the cost relative to higher-valued coins. Thus, onlookers can readily see how the industry dynamically assimilates information about firm quality, past products, and consumer or dealer tastes over time.

The market has spontaneously generated a firm that evaluates the output of top graders NGC and PCGS, too. Certified Acceptance Corporation, founded in 1987 by John Albanese (co-founder of PCGS and founder of NGC), affixes a "green tamper-evident holographic sticker" when a coin is correctly graded and a "gold" one if it is undergraded. Coins that "just make the grade" or overgraded coins receive no sticker. Another important market innovation in the coin grading industry is offering "reconsideration" or "crossover" services (Table 9). With this service, a firm promises not to break open the slab of the competing firm unless it can assure the submitter that the grade will be at least as high or higher. The cost of

TABLE 9
Reconsideration (Crossover) Fees Charged by Participating Coin Grading Services

Firm	"Reconsideration" or "Crossover" Fee
PCGS	Basic fee for chosen service + 1% of value if coin upgrades.
NGC	"There is no additional fee for Crossover; only the grading tier charges apply." Only PCGS graded coins can be submitted, except that sister-company NCS coins can be done for $5.
ACCGS	$10
SEGS	$22

Source: Company websites.

upgrading one's grading service need not be expensive (except perhaps for high-valued coins sent to PCGS), and the potential gains from an improved grain are significant. Top firms are thus enabled to damage competitors and put distance between themselves and other firms.

Shipping and Insurance Costs

Shipping costs are reasonable, and depend on speed of delivery, size of order, insurance, and distance to destination. The greater the number of coins submitted, the lower the average shipping cost. Regular service turnaround times range from 10 to 15 days. Additional fees are charged for insurance coverage during shipping.

The United States Post Office will not insure *coins* being shipped but it will accept and insure "numismatics and collectibles" (including coins in that category) with value proven by a third-party service. For example, a numismatic coin worth $200,000 can be shipped insured by registered mail in the United States for $180 and, for coins worth up to $100,000, shipped insured internationally anywhere for $55 ($46 to Canada and $52 to Europe).

The ANACS website lists a price of $79 to ship and insure a coin valued at $100,000 (customers must call for a shipping and insurance quotation on higher-valued coins), and NTC charges $80 for a coin of the same value. Customers with accounts at private courier services like Federal Express and UPS can also obtain reasonably priced

insurance for the coins shipped, around $200 for a coin valued at $75,000.

There is company called ShipAndInsure[6] mentioned on NGC's website, which is affiliated with the North American Collectibles Association, that specializes in facilitating coin shipments using major carriers in the United States and worldwide. Association members are able to get discounts and, importantly, larger limits on the value of coins that can be shipped. Some shippers for certain classes of service will not insure a coin for more than $75,000 or even as little as $10,000. In some cases in the United States, a homeowner's insurance policy might cover all or part of the value of a shipped coin.

Some of the major grading companies also provide insurance, such as ICG, which has base prices as low as $20 per coin, in the United States, to $75 internationally. SGS will insure five coins worth up to $4,999 each for an $18 fee. PCI has an insurance cost table on its website; the insurance cost for a $25,000 coin is $35. The cost of coin insurance has evidently dropped in the last two decades. In 1994, PCI charged a fee of $115 for a $25,000 valued coin (Cobin 1997: 104)—329 percent higher than current pricing—which was (at the time) relatively expensive compared to other firms.

Effective Grading Services Alleviate Market Imperfections

Rare coins are uniquely differentiated goods. Differences and discrepancies between coins are not easily noticed. Typically, greater supply and fungibility in a widely minted coin series means that a coin in that group is less likely to command a high price beyond its commodity value as a metal. Even in low mintage issues, there are considerable differences in coin condition that warrant grading to differentiate them. Until the late 1980s, coin grading was not a standard process. Individual dealers would grade the coins. Those individuals who did not have the same specialized knowledge as the coin dealer were at a disadvantage when buying or selling rare coins.

For example, a dealer could say that a coin offered to him is an MS-65 when in fact it is an MS-66, which commands a higher price. (The visual difference between an MS-65 and an MS-66 is not discernible to most people.) After buying the coin, packaging it and

[6] The company website is https://shipandinsure.com.

offering it for sale as an MS-66 would be facile for the dealer. Because of the fineness of the coin, fungibility, and extensive supply, such quasi-fraud would be virtually undetectable. (The same coin could be seen by its former owner during a future visit and not be detected.) A similar problem arises when the roles are reversed in the transaction. The dynamic rare coin certification industry has evolved to alleviate such inequity.

As we have seen, privately owned and competing grading firms have spontaneously generated in the market, offering sufficient salaries to attract noted industry experts to grade coins exclusively. The resulting grading and slabbing provides market participants with an objective and reliable means of evaluating rare coins. These intermediaries allow buyers and sellers to avoid the costs of irksome assay testing, weighing, and examining for genuineness, rarity, or fineness. Accordingly, transactions (knowledge acquisition) costs associated with information gathering and verification are minimized. Not surprisingly, the cost of grading is also internalized into the price of traded coin (i.e., an encased or slabbed graded coin often sells for a slightly higher price than if it is still "raw"). Markets have ample incentives to provide information and that public benefit is often regarded as a public good. Notably, the influence of free-riding has not precluded the provision of this service.

Therefore, the market can be trusted to produce a reliable high-quality informational public good, and the quality of market provision is automatically enforced since grading and certification services have an incentive to protect their reputations. As demonstrated in Table 3, firms with the best reputation for reliability (i.e., greysheet percentage) also have the highest market share, and command the highest prices for services. Grading and certification services inadvertently mitigate the free-rider problem. Of course, these firms did not evolve with the express purpose of resolving a public goods problem, but rather to provide third-party assurances that are demanded by many private shoppers and investors. Like the self-interest motive of Adam Smith's baker that ended up "feeding" Paris, the economic goals of rare coin graders has inadvertently led to social benefits.

Rare coin grading and certification firms have met consumer demand, and thus created "public good" benefits for everyone who wants them. Yet rare coin owners and sellers are content to continue to purchase these services nonetheless, despite the fact that the information is nonrival in consumption. All who can partake of the good

do so without lessening the amount to other people. Each coin is unique, but if rare coin owners or dealers display them for the purpose of sale then they cannot bar certain patrons. Consequently, information about the coins "publicly" provided by the market might be considered nonexcludable.[7]

Conclusion: A Market Alternative to Government Regulation

The preceding example of grading and certification services in the rare coin industry has considerable ramifications for the grading of real property, military hardware, public transportation highway vehicles and aircraft, air and water quality, farmland and watershed evaluation, food, electrical generation dams and devices, automobiles, pharmaceuticals, educational institutions, and many other goods and services. In North America, South America, and Europe, grading and certifying is often provided by the state or one of its municipal subdivisions, although private inspectors in some cases (e.g., for buildings) are occasionally hired by individuals, insurance companies, and utility companies. Planning boards and their inspectors provide grading services, *despite the fact that the market could provide effective grading services,* as it does in other industries.

The ostensible purpose for government intervention into transactions for both real and personal property is multifarious, but it has been primarily to alleviate imperfect information and to reduce negative externalities. An assumption is made that the government will not garner monopoly profits because it exists for the "public interest" and not to maximize profits. Moreover, the government is often presumed to provide a dispassionate, objective, and reliable evaluation of quality—conjecture that has been called into question by many economists.

Certainly, the cost of these government benefits is considerable; there is no free lunch. In other words, a uniform minimum standard of quality is expensive. But are transactions costs really lowered by government regulation of the quality of goods, or have the costs just

[7] However, other providers of information that might be considered public goods, such as library councils, building owners, and Internet services, can likewise bar "undesirable" persons from consumption. Hence, if informational services are considered public goods, there must ultimately be exceptions to nonexcludability. Consequently, these services can hardly be considered public goods.

been shifted or internalized into the price of the improvements? Contrary to findings that price regulation improves quality (Anderson and Enomoto 1986: 87), other evidence suggests that government regulation minimally impacts (Jordan 1972) or even debases quality, not to mention increasing the associated transactions costs that would have otherwise been avoided (Cobin 1997, Anderson 1994, Lave 1992) and the shortcomings of government-provided informational services (Magat and Viscusi 1992). The present study of grading in the rare coin industry demonstrates, too, that markets have provided high quality without government regulation (High 1991), avoiding the pitfalls of regulation that have worried researchers (Hertog 2010: 46), such as bureaucratic inefficiency, public choice, and knowledge problems.

Important questions need to be answered. Would transactions (knowledge) costs be lower if the market were to provide an alternative, competitive grading system? Are consumers merely being forced to buy a very expensive insurance policy from the government? If the evidence from the rare coin industry provides a clue, then we may conclude that markets would provide more effective and efficient means of generating information when it certifies quality. The government's informational "insurance policy" is demonstrated to be too expensive and does not provide the quality of coverage that would be cheaply provided by the market.

Furthermore, it is not clear that people demand such a uniform degree of certainty when buying goods, services, or real property. Why should everyone be compelled to pay for part of the same public good (i.e., quality information), which is an additional cost of regulation? For instance, it is conceivable that if the cost of such certainty exceeded even a small percentage of the good or property's value, then some consumers would prefer to save the added expense by assuming the associated risks themselves (i.e., self-insuring).

Markets are capable of developing effective and reliable means for grading other goods and property that are analogous to grading services in the rare coin industry. The rare coin industry has spontaneously developed an effective, inexpensive grading system. It was an unintended consequence of human action, which led to greater coordination and increased knowledge. Moreover, those individuals who participate in trading rare or otherwise valuable coins are not disgruntled over the existence of grading firms. Will regulators argue with this success? If so, are they, as Mises (1996: 850) asked, merely

protecting favor brokering and rent seeking, and aiming at the perpetuation of their own supremacy? Surely, it makes no sense to blindly accept the preferences of a majority of unenlightened voters or a handful of ostensibly enlightened bureaucrats.

What would a world certified by private grading firms look like? One could imagine a potential situation where grading firms compete with one another. As long as each grading firm maintains high standards—because of competition—it will be able to receive premium revenues and preserve its reputation relative to other firms and consumer costs will fall. Lower-quality services will be obliged to assuage consumers by charging lower prices, and will likely go out of business if they do not improve the quality of their service over time. In the information market, a reputation for accuracy and reliability is of paramount importance. One foul-up and a firm may be finished.

Furthermore, market-based grading and certification services can be a higher-order "knowledge" good. While the knowledge problem (Hayek 1945, Holcombe 1995, Sowell 1996) can never fully be overcome, its severity may be alleviated by more and better information. Yet obtaining such information is costly. As Alchian (1977: 133) notes, "Those costs of becoming informed about what a good or service or rented good will do, raise transfer costs and also reward longer or greater searching activity by potential buyers or employers." Therefore, information, like most things, is scarce and needs to be economized. In addition to economizing scarce information, grading firms must also adapt to changing conditions. "It is certainly true," wrote Mises (1996: 852), "that the necessity of adjusting oneself again and again to changing conditions is onerous. But change is the essence of life." Markets are flexible and dynamic enough to handle that change.

Accordingly, because consumers are uneasy about their ignorance and want to improve their market information, it follows that firms will spontaneously develop (in the Hayekian sense) and specialize in providing knowledge (e.g., grading or certification services) at the lowest cost. Far from being nugatory market institutions, the existence of such firms indicates the further advancement of economic prosperity.

In the final analysis, reputation enhancement and knowledge production are indispensable elements of the market process. Hence, the key issue concerns whether government bureaucracies or the market is the superior generator of such knowledge. What is clear

from the study of grading services in the rare coin industry is that the market process has successfully made provision for setting standards and regulating quality without any reliance on government. Market-based regulation is not only possible, it is likely, and it emerges without public policy to satisfy consumer demand efficiently.

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Monetary Policy Structures

Milton Friedman

With respect to monetary policy, I only want to say a few words, not about the details of monetary policy, but about how we can get a more satisfactory monetary policy. All of us can agree that it has not been very satisfactory, not simply for the past year or two, but for as far back as you can go. I shall limit my comments mostly to the period since the Federal Reserve System was established in 1914 because most commentary is about that.

But any notion that the period before 1914 was a golden age in the double sense of a properly operated gold standard and in the sense that all went well is a misconception. It was a period that saw its ups and downs. But the period after World War II is a new era in one respect: in 1939 the price level in the United States was lower than it was in 1800. The notion that somehow or other inflation is endemic to the American economy—it's always been in our history—is a bunch of nonsense. The price level doubled during the Civil War; it doubled during the First World War. But each time after the war it returned to the initial level. There was a roughly stable price level. The period since 1960, the past 25 years, is the only period in United States history during which there has been a nearly continuous secular increase in the price level. Again there were ups and downs, but they were around a sharply rising trend.

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Milton Friedman, the 1976 recipient of the Nobel Memorial Prize in Economics, was the Paul Snowden Russell Distinguished Service Professor at the University of Chicago and Senior Research Fellow at the Hoover Institution. This article originally appeared in *Candid Conversations on Monetary Policy*, published by the House Republican Research Committee in 1984.

The monetary policy was unsatisfactory from the very beginning of the Federal Reserve System. The Federal Reserve System presided over a doubling of prices in World War I, a severe recession in 1920–21, then, after a few years of relative stability in the 1920s came the Great Depression of 1929–33. Subsequently, there was a doubling of prices during World War II. So when I talk about poor monetary policy, I am not referring simply to recent policy.

Public Interest Approach

For many years, I and other economists have been trying to improve monetary policy. I now realize in my later years that our approach has been misconceived. It was our view that the way to improve monetary policy was (a) to learn more about how money operated, (b) to construct appropriate rules for the conduct of monetary policy, and (c) to persuade the people who run monetary policy that they were the right rules. We took it for granted that if we could succeed in doing that, they would put them into effect. That is to say our approach was what has come to be known as the public interest approach to the role of government. The idea was that government bureaucrats, government officials were people who were trying to promote the public good. That's not the way we consider businessmen. We don't think that businessmen go into business to promote the public good. They go into business to make money. If we have the right structure of the economy, if we have the free market system that Adam Smith spoke about, then, as he said in his book, people who tend to promote only their own interests are led by an invisible hand to promote a public interest that was no part of their intent to promote.

I have come to the conclusion, belatedly, that we have to look at government in the same way. The people in government—that goes for all of you, me, congressmen, everyone—are here to promote our own interests. Our interests may be broad; we may want to reform the human race. They may be a narrow selfish interest but in either case we are here to promote our interests. And I have come to the conclusion that the political system that has been set up is one in which Adam Smith's invisible hand works in reverse. People who intend to pursue only the public interest end up pursuing private interests which it was no part of their intention to pursue. And so I have come to the conclusion that the way to do something about

monetary policy is not to persuade beneficent monetary controllers to do the right thing but to ask a different question: What is the structure of monetary policy that will have the effect of making the political invisible hand work the same way as the economic one? How can we set up a structure of monetary policy under which government officials who intend only to promote their private interests are led by an invisible hand to promote the public interest?

Political Invisible Hand

Let me demonstrate my point with a very simple and obvious example. Let me emphasize this, I'm not criticizing anybody. I'm only trying to describe. We don't criticize businessmen for pursuing their own interests. I don't criticize politicians and others for pursuing their interests; we're humans. We all do the same thing. Suppose that 20 years ago the Federal Reserve had adopted the advice that I was then giving them completely. That advice was that they should adopt procedures that would produce a steady rate of growth in the quantity of money at 3 percent a year. Suppose they had done that. There is not the slightest doubt in my mind that the country would have been far better off. We would have avoided the inflation of the past 20 years entirely. We would still have had a few ups and downs, but they would have been modest. But I ask you a question: Suppose the Federal Reserve had adopted that modest task and suppose you conducted a poll asking: Who are the most important persons in the country? Is there the slightest chance that the chairman of the Federal Reserve Board would be listed as the second most important person in the country? The Federal Reserve would have no great prestige. It would be a modest accounting agency that was carrying out a simple mechanical job. And it would have occurred to more people than me up to now that you might as well replace it with a computer.

So it was not in the self-interest of members of the Federal Reserve System to adopt that policy. The reason they didn't adopt the policy wasn't that I wasn't persuasive enough; perhaps I wasn't. It wasn't that I was wrong; perhaps I was. I don't think so. The fundamental reason was this was not in their self-interest to adopt that policy. Again, don't misunderstand me. You all remember that famous statement that got so much attention during World War II: "What's good for General Motors is good for the country." The one thing

every one of us is capable of doing is persuading ourselves of that. So I'm not criticizing anybody for any ulterior motive. But as long as proposed policies were against their self-interest, they would be able to persuade themselves very easily that those policies were not good for the country.

That leads me to the conclusion that *the only way to get a sensible monetary policy is to change the fundamental structure of our monetary institutions*. We shall not get better policies by appointing better people to the Federal Reserve Board, by changing the chairman. That might make a difference, a marginal difference. Some members of the board are better; some are worse. I've studied for decades the detailed history of the Federal Reserve System, and the last thing I will look at to see what the policy of the Federal Reserve is [is] the name of the chairman. That doesn't matter. It's a major institution that operates under its own terms.

I'm going to suggest what I think is the most promising ultimate reform and say we're a long way from it. We're not going to get there, but we ought to have in mind where we would like to go if we could. My ultimate ideal at the moment—I have changed this over time as I've become more and more persuaded what the real problem is—is to eliminate every element of discretion. At the moment, my ultimate proposal is that we freeze what is called high-powered money, that is to say, current Federal Reserve notes and deposits at the Federal Reserve. To put is more simply, we could replace those notes and those deposits by Treasury notes, just pieces of paper, and then never print another one except to replace those that wear out. Just freeze it, and you don't need a Federal Reserve System. You can cut the work of the Bureau of Engraving and Printing down so they can devote most of their effort to printing your reports instead of money. That really would replace the present discretionary monetary policy apparatus by a pure automatic system. Under those circumstances, what would happen would be that the markets would determine and would adjust the total quantity of money in the sense of the money we use including deposits plus currency. Because then commercial banks and other financial institutions would need to keep some of that high-powered money in reserve in order to be able to meet demands for it and so on. I won't go into details; you're all capable of doing that. In my opinion, the effect would be roughly stable prices. Judging from experience, I would expect the quantity of money as people currently interpret it to go up something like 3 percent a year,

which would just roughly keep pace with total output and give a roughly stable price level.

We're not going to get that reform tomorrow, and, indeed, we're not going to get any major change until there's a crisis. You don't get major changes just because somebody believes they're good. You get major changes because there's a crisis. The role of people like myself, who suggest what ought to be done when there is a crisis, is not really to persuade anybody to do anything. It's only to keep options open so that when a crisis emerges, there's something available that can be picked up. The best example of that, of course, was the adoption of floating exchange rates. For decades, I and others had been urging floating exchange rates. We had no effect on anybody until a crisis emerged, and something had to be done. When something had to be done, there was a well thought through approach that could be adopted. The same thing is true in respect to monetary policy. Now some intermediate possible reforms, and then I'll open up for questions and answers.

Intermediate Reforms

One great improvement would be to put the Federal Reserve in the Treasury Department because right now you have a division of responsibilities. If you read the reports of the Federal Reserve System, as I have had to do for my sins, you will find that every Federal Reserve chairman in the history of the Fed has blamed fiscal policy for difficulties that have emerged. For example, right now, why do you have high interest rates? According to the Fed, that has nothing to do with what the Federal Reserve has been doing. It's you people down here who have created the deficits. It's the Treasury's fault. And every Secretary of the Treasury has blamed the Federal Reserve for what's happened. So you have a division of responsibility. It would be far better for those two agencies to be in one place.

I have always been in favor of greater congressional supervision of monetary policy. I don't think Congress will do the right thing, but there's an enormous difference between Congress and the Federal Reserve. The members of the Federal Reserve Board are appointed for 14 years; congressmen are elected for only two. If Congress had been in control of monetary policy, you would not have had the Great Depression. Members on the floors of Congress were demanding that the Federal Reserve do something different than it did in 1930,

1931, 1932. One of the most dramatic episodes was in 1932 when the Fed did undertake a large scale open market operation. It started it the day before the head of the New York Federal Reserve Bank, George Harrison, was supposed to testify in Congress. According to the minutes of the open market meeting on that day, they decided that they were going to have to engage in open market purchases in response to congressional pressure. Ordinarily, they would have started the next day. Harrison asked if they could make an exception and let him leave the meeting to phone New York to start the purchases that afternoon because he was going to testify to Congress the next day, and he wanted to say they had already started. That open market operation ended less than two weeks after Congress adjourned. I don't say congressional control would be ideal. It might lead to many more small mistakes, but it would avoid major mistakes like the Great Depression and the great inflation. Congressional supervision is not going to do very much. In 1975, when Congress passed a joint resolution requiring the Fed for the first time to state its monetary targets for a year in advance, the Fed completely emasculated the resolution first by what we call "base drift" and second, by creating multiple money definitions so they could shift from one to the other.

So I'm not overly optimistic about what congressional control can do. However, it would be better than what we have now. As you can see, I am not in favor of the independence of the Federal Reserve. This is a democracy. And I believe that money is too important to leave to [a] central bank, that it is intolerable that a group of non-elected people should have the power to create a major inflation or a major recession. Entirely aside from the economic effects I believe it is not an acceptable political system. To repeat, as a minor change I'd have the Fed made part of the Treasury. As an alternative, it would be better to have the Fed more directly under congressional control. The best change of all would be to abolish the Fed completely, and simply have zero creation of high-powered money and no discretionary powers anywhere. I hope I said enough to stimulate some questions.

Questions [from Members of Congress] and Answers

Question: What if Congress decides it wants to seek growth in high-powered money?

Friedman: My preference is to have a constitutional amendment to enforce a zero growth in high-powered money. That is, as I said,

an ultimate solution and a major reform. If monetary policy is under Congress, and Congress wants to increase high-powered money, there will be an increase in high-powered money. I'm not saying that's a good thing. I'm saying that the effects of the inflation will force changes in that policy more rapidly than when the Fed makes a major mistake. I'm talking about the lesser of two evils.

Question: I believe in the past you predicted that there will be an increase in inflation. I don't remember the exact time frame, but [I think] it was second quarter 1984. How is that prediction faring?

Friedman: Not badly really. I have been saying for a long time, oh, since late third quarter 1983, that inflation has passed its low point. I believe the low point of inflation in this cycle was in the first or second quarter of 1983. The consumer price index rose at the annual rate of 3.3 percent during the first six months of 1983, 4.3 percent in the second six months, and about 4.9 to 5 percent in the first five months of 1984. So far as the future is concerned, I am a little more optimistic now than I was a few months earlier. That's because I have been doing a more careful evaluation of the effects of the various changes in regulations, and particularly the introduction of Super-NOW's. Whereas earlier, I was saying that by the end of this year, I thought that the inflation rate—not year-over-year but during the fourth quarter—would be somewhere between 7 and 10 percent. I'm now inclined to cut it down to something like 6 to 8 percent. Before I said that there was a better than 50-50 chance that inflation would be above 10 percent in 1985. Now I would say there's a decidedly less than 50-50 chance it would be above 10 percent.

Question: Would that also tend to explain why interest rates have gone up? And then secondly, why haven't gold prices tended to be more volatile?

Friedman: Gold is a terrible index of general prices. If you look at the pattern of gold over the past 10 years, the price of gold has fluctuated very widely. There is not a close relation between the short-term movement of the price of gold and the short-term movement of price indexes. It simply is a lousy indicator for where inflation is going. It depends on many other things including the interest rate. Higher interest rates discourage people from holding gold. So I don't believe gold is a good indicator.

Historically, a change in monetary growth tends to have its first impact on total [spending] one or two quarters later. The change in total spending in turn will take the form mostly of a change in the real

volume of sales, partly out of inventories, partly out of new production. It will have very little impact in the first instance on prices or on inflation. As time rolls on, the impact on real output and real sales declines; the impact on inflation grows. Typically, the effect of a change in monetary growth takes two years to work itself through to inflation. That's not a new phenomenon. William Stanley Jevons, the famous English economist, in a paper he wrote in the 1880s or '70s—I've forgotten the exact date but more than a century ago—said that the change in the currency shows up in prices two years later. I've studied the data for the United States for over a century, and in all of that period, on the average, there is about a two year gap between the rate of change of money and the rate of change of inflation. The low rate of inflation in the second quarter of 1983 reflected a relatively low monetary growth rate in 1981. From 1982 to 1983, you had the fastest monetary growth rate in the postwar period. Fortunately, part of that, a considerable part of that, was offset by the change in regulations; particularly the Super NOWs which made it more attractable to hold cash. So you did have a decline in velocity, but let me explain to you how I get these forecasts; I don't pick numbers out of a hat. I have tried to investigate the effects of these various changes on inflation and on velocity. They produced about an 11 percent drop in velocity. That is to say, that quantity of money people wanted to hold (all other things the same) went up about 11 percent because of the availability of deposits in which interest was paid on these deposits. That's after allowing for the typical change in interest rates on the holding of money. Of that 11 percent, I estimate that 3 to 4 percent was absorbed by a lower level of real output. And about 7 to 8 percent was absorbed by a lower level of prices. What I have done is to take the money figures since then and correct them by taking 8 percent less than they actually were. Then I've taken the multiple correlation equations I use for prices now related to monetary growth four quarters ago, eight quarters ago, 12 quarters ago. And I've extrapolated that using, not the actual money figures but the adjusted money figures. That's what gives the predictions that I've been citing. Essentially, the answer to your question of what's producing the inflation is the speed up in monetary growth from 1981 to 1983, which is producing a speed up in inflation, from 1983 to 1985. What happens from 1985 on depends on what happens from here on out. Since November 1983, [the] money supply has been going up at about 7 percent. If that were to continue, if the Federal Reserve

continues at 7 percent for 10 years, then inflation after going up to something like 10 percent in 1985 would ultimately settle at something like 6 to 8 percent. That's too high, and so when you ask about monetary growth, I think it ought to be brought down. It ought to be lower than it is now.

Question: You spoke earlier of the fact that we all, political as well as private business, tend to act in our private interest. How about the Secretary of the Treasury, on the assumption that he was now responsible not only for the ordinary business of that department but for monetary policy as well, is he not involved in a conflict of interest? As an agent of the administration, he has to meet the deficits that Congress and the administration may hoist over him. He's got to meet the deficit. On the other hand, he's also being made, under your assumption that the Federal Reserve is under the Treasury, responsible for the maintenance of the stability of [purchasing] power. It seems to me there's a conflict of interest in there. You can do one or the other, but you can't do both. And we've had that situation during World War II and up to 1951.

Friedman: Let me say two things about this. First, that conflict of interest is there now, but it's between the Treasury and the Federal Reserve.

Question: But they're independent.

Friedman: Are they independent? They're independent in one sense but not in another, and it's in the self-interest of the Federal Reserve to blame the Treasury. It's in the self-interest of the Treasury to blame the Federal Reserve. And I would rather have the right hand of the Secretary of the Treasury blame the left hand than to have him blame somebody else.

Question: No, we have it in the open. In this case, it would all be buried.

Friedman: No, it wouldn't be buried at all. It would be in the open; the numbers would be there. The results would be there, and there would be only one man to go to. What happens to you people in Congress? Mr. Volcker comes up and testifies to you, and you ask what in the world have you been doing? He says, "Oh, don't blame me. It's those terrible deficits you and the Treasury are producing." Secretary Regan comes up and testifies before you, and you say why are you producing this high interest rate? He says, "Don't blame me. It's the Federal Reserve that's been producing our high interest rates." Surely it's better to have one man on whom you can put

responsibility for both than it is with each one passing to the other. I'll now tell some experience.

One advantage of having studied history is having past examples of the world. Until 1934, the Secretary of the Treasury was an ex-officio member of the Federal Reserve. I have gone through the minutes of the Federal Reserve Board in those earlier periods though I was able to get them only by accident. The Federal Reserve Board wouldn't let them out. One of the achievements that Anna Schwartz and I are very proud of is that after we published our *Monetary History*, the Federal Reserve wanted to provide ammunition for a counter attack. So for the first time they made their minutes available after a five-year gap. The only way we ever got to go through the minutes was the accident that George Harrison, after he retired as governor of the New York Federal Reserve Bank, deposited his papers in the Columbia University Library. They accidentally included minutes of the open market meetings. That's the only way we could get them. As I have gone through that record, I would say that on the whole the Secretary of the Treasury was a voice of prudence on that committee.

Short-Term Interest Rates

Question: Based on what you've said about money supply growth and prices, I can understand how you might explain the current rise in long-term interest rates. How do you explain from a monetarist viewpoint what's happening with short-term rates?

Friedman: I agree with you that there's more of a puzzle with short-term rates than long-term rates. I'm glad, needless to say, that you bring this up because obviously I've thought about it. Let's take them separately. So far as long-term rates are concerned, my interpretation is perhaps a little different than most. I start with the observation that we do have a market measure of real interest rates in Great Britain. Great Britain has been wise enough, and we have not been, to issue purchasing power securities. That is to say, securities in which both the principle and the interest payments are adjusted for inflation. For example, in dollars, suppose you issue a $1,000 purchasing power bond now. It's a 10 year bond, and suppose that 10 years from now prices are double what they are now. The person gets back $2,000 not $1,000. And year-by-year, the interest coupon is adjusted in dollars for inflation. So the yield on those bonds is a market measure of real interest rates. The British reintroduced those

originally only on a very narrow basis—available, I think, only for superannuated people. But they were so popular that the issue was broadened. What hasn't been done is always impossible; what you have done is optimal. We've been fighting this for 25 years trying to get the Treasury to issue purchasing power securities.[1] And everybody says you can't do it, and here's Britain doing it. So now, they've got to think of a different reason. At any rate, the real return on those securities has been running at about 2 to 3 percent. In our study of interest rates in the United States and Great Britain over the past century, we found that on the average real interest rates, after allowing for inflation, were about 1 to 1.5 percentage points higher in the United States than in Great Britain. So I conclude that the real interest rate in the United States has to be something like 3 to 4 percent. If we take, say, 13 percent rate on a long-term security and take 4 percent off that, you get 9 percent to explain. Most estimates of most peoples' judgments about expectations for future inflation run to about 6 percent. That leaves 2 to 3 percent to explain. That, I believe, reflects the fact that these prospects are highly uncertain. Long-term bonds have become one of the most speculative investments there is. The interest rate may now be 13 percent. On the one hand, it's possible that five years from now it'll be 2 percent. On the other hand, it's possible it'll be 32 percent. And, therefore, borrowers have been very hesitant to borrow long, and lenders have been very hesitant to lend long. These two balance. You would think that they would all flow into the short-term market, and you'd just have a big short-term market. But I believe there's an asymmetry partly due to the U.S. Treasury Department.

The U.S. Treasury Department erroneously continues to borrow long. I think that's a terrible mistake. The U.S. Treasury Department is talking out of both sides of its mouth. If you listen to what the administration says, it says we're going to have zero inflation in the future; we're heading for low inflation. If you look at what they're doing, they are selling long-term bonds. That makes sense only if they expect high inflation. Now, do you believe what they say, or do you believe what they do? I believe what they do, not what they say—and I believe the market joins me in that. As a result, the Treasury continues to borrow long. There are few other borrowers who are

[1]The U.S. Treasury introduced Treasury Inflation-Protected Securities (TIPS) in 1997 (ed.).

required by law to borrow on that fixed interest form—some insurance companies with pension funds and so on. As a result, I think there's some asymmetry and that the remaining interest rate percentage is in the sense a premium that has to be paid to overcome the uncertainty. You know, the actual amount of borrowing has to equal the actual amount of lending. But how do you encourage these reluctant lenders to lend? Only by paying a higher interest rate. And I believe that's the major reason why the differential between the long and the short securities is as high as it is.

Comment: That gap disappears once you plug in a tax rate.

Friedman: Well, we'll come back to the tax rate. I'm going to talk about the tax rate in a moment. You're right, and I was leaving out the tax rate at the moment. Because in our historical studies, we've never really allowed for a tax rate. If I did, I'd get a different historical basis.

Let's turn to the short term, and this is where I was going to bring in the taxes. Short-term rates are something like 10 to 11 percent depending on what you look at; say 10 percent. Now, there is a real tax problem. How much of a tax rate do you allow? If you look historically at the difference between tax exempt and taxable securities, that implies a marginal tax rate of about a third. If you look at it currently, you have a bigger marginal tax rate than that. The differential between one-year taxables and one-year tax exempts is more than 30 percent. However, I think that's a fluke because the differential should be less than that given the changes that have occurred in marginal tax rates. That 30 percent marginal differential prevailed when the top tax rate was 70 percent. Now it's 50 percent; it ought to be less. Say it's 30 percent. Then you've got about a 7 percent short-term rate. If you take now that 7 percent, you've got the inflation rate running about 4 percent. That leaves you about 3 percent of the real rate. That is high for this stage of the business cycle. Typically, in a period of inflation and rising inflation, short-term real rates are zero or negative. So I come out with the conclusion that short-term rates are relatively high. The problem is of much smaller dimension than I believe that most people suppose, but nonetheless I don't have a good explanation as to why short-term rates are that high. I've heard various explanations; all of which make sense, such as the fact that the changes in the tax law [increased returns on investment and], therefore, made the people willing to pay a higher real rate. And that makes some sense. Now if we go back to this short-, long-term

comparison, as you'll see if you allow for tax effects on the long term as well, you still are left with [an] abnormally wide margin between long and short rates at this stage of the cycle. And that I think is attributable to this uncertainty I was talking about. I don't know if that gets to your point, but at least that's all I know.

Targets for the Monetary Base

Question: How do you improve the congressional process? As you know, they send us a report to the banking committees in the House. We have Chairman Volcker up here. We say, "Thank you much." We ask a few questions. We're supposed to file a report and send a story. Last time the House Banking Committee didn't even file a report required by law. It wasn't signed off by the members. How do you go back and examine the process to hopefully improve the process?

Friedman: First of all, I'm not the right person to answer this. I have never served in Congress, never been a congressional employee. I really am not an expert on the operations of Congress. I'm looking at it strictly from the outside. I think the thing that would improve the congressional process most would be to have Congress ask the Federal Reserve to state its targets for the monetary base and nothing else for a year from now. Then ask them to report quarter-by-quarter how they're coming on that making no change in the target once they have adopted it. Now, let me explain.

M1 is more closely related to business activity than is the monetary base. From the point of view of controlling the economy, M1 is marginally more important. However, the Federal Reserve cannot make excuses about the monetary base. There is no doubt that it controls it. The monetary base is the only thing you can really hold them accountable for. And the real problem in my opinion is to make them accountable. Currently, when you ask them for their target, they give you M1, M2, M3 and now they've introduced a credit aggregate. It's very hard to pin them down. So I think the best improvement would be to simplify and get it down to one target. The view that they should be required to say what their forecasts are for real income is a mistake. They cannot control real income. The one thing they can control is the monetary base. And, therefore, they should answer for it.

Question: There are people around here who are not sure we can get the Congress to take some of your suggestions. There are others

who, while talking to the Republican Research Committee, suggest that we ought to go back and do some things that we're done before. There are those who recommend that we go back to a gold standard. Other people who are certain that is the way to go suggest that an alternative might be to have a competitive money system to keep the Fed honest, the commodity basket or whatever. Will you comment on that?

Friedman: I'll be glad to. The Gold Commission demonstrated that the supposed support for a gold standard is nonexistent, when you try to pin down what you mean by the words "gold standard." Lots of people favor a gold standard. But when you probe them, they all mean different things. The only person in the Congress and the only person on the Gold Commission who was in favor of what would be regarded as an honest-to-God real gold standard was Ron Paul. Appearances are very misleading with respect to a gold standard. There is negligible support for any particular version of the gold standard. People who say they're for a gold standard vary from people at one extreme, like Ron Paul, who is for an honest-to-God gold standard in the sense that gold would be the medium of exchange and nothing else would have legal tender status. That's an honest-to-God gold standard, and I may say I would not be against such a standard. That would work very well, but there isn't a chance of a snow ball in hell of your getting it. I'm not unaccustomed to being in favor of politically unpopular or unreasonable ideas, but there's a limit. At another extreme, you have people like Art Laffer and Lew Lehrman who are in favor of a system under which the Federal Reserve would operate its discretionary monetary policy by looking at gold as a criterion. They would introduce a monitoring range for the price of gold like the present monitoring range for the monetary base. Now again, whether that's good, bad, or indifferent, [there is] an enormous difference between that and what is called a gold standard. You have people everywhere in between, those who want a fractional gold standard, those who want a gold exchange. Next, any kind of gold standard only makes sense if it's international. If there's any country in the world that you would think would be in favor of a gold standard, you think it would be South Africa. They could adopt a gold standard all by themselves. Have they made any moves in the direction? No, I believe that people who are talking about having a gold standard are really talking about something that is not going to exist.

Let me add more; the gold standard as it operated in the 19th century had some virtues. It did maintain a relatively stable price level. It did put restraints on government discretion, but it was very far from an ideal situation. There were wide fluctuations in prices. Much more important, it was possible to have it then because the federal government was spending 3 percent of the national income. It was possible to have it then because there was a widespread public mythology about gold. The tendency for gold to leave the country was an important thing, and the public at-large would support very severe measures in order to stop it. Neither of those conditions exists today. I'm not saying it won't happen if you have a worldwide catastrophe, if you have hyperinflation in every country of the world, the kind that you are shortly going to have in Israel and might have in Argentina. If that happens in the United States, Great Britain, France, Germany, and Japan, then you conceivably might have a gold standard, but I believe that the chances of that are fairly remote. So, I believe it's an utterly false issue for people to raise.

The other notion that you're raising is not to have a gold standard, but rather competitive money. I'm all in favor of competitive money, but that has nothing to do with a monetary standard. It has to do with banking regulations. We have moved some direction in that way. These two are linked to the gold standard. You could have a gold standard by purely private action. There's no reason why people shouldn't decide to buy and sell goods in terms of gold, and in fact there's a gold standard bank in Kansas City. Anybody here who wants to have a gold deposit can have a gold deposit there. He can transfer that to somebody else by writing a check on it. There's no reason why private people could not conduct their operations on a gold standard base. The problem is that there are tax difficulties in the way. If you own gold and the price goes up and you've sold it, you're subject to a capital gains tax on that difference. I would be strongly in favor of eliminating any such barrier to using gold or anything else as an alternative. I am strongly in favor of changing the laws in such a way as to permit competitive banking. As an economist and student of money, I would predict that none of those competitive monies will displace the official government money unless there is really extreme mismanagement by the government. That doesn't mean I'm not in favor of it; I'm in favor of it. Maybe I'm wrong. And if I'm wrong, I'd like to see it operate. I'd like to see it have the opportunity. But it's not going to get through Congress.

Question: How do you see the transition from our present situation to one in which we freeze high-powered money as far as the Banking Committee, the stock market, commodities market, and bond market [are concerned]?

Friedman: That is a very good question.

Question: Also, would you guess that there would be calls for reregulation and reinstatement of the Federal Reserve in this situation?

Friedman: So far as the banking community, the stock market and so on, they would be unaffected. Consider two scenarios: one scenario under which the present Federal Reserve System operates in such a way over the next five years that inflation comes down from its present level to zero and stays at zero. That would have identically the same effect on all these other groups. In an alternative scenario, you abolish the Federal Reserve System but set a definite pattern that you're going to increase high-powered money 6 percent next year, 5 percent the next year, 4 percent and so on, until you get down to zero and then hold it. Those two would have identically the same effect on all the institutions you mentioned, the banks, the stock market and so on.

The second question that you asked is whether there will be pressure for reintroduction of the Federal Reserve. It is just as relevant to ask the question whether you would have great pressure for the Federal Reserve to expand the money supply. And the answer is yes, of course, you would, but I do not think that once you got into a regime in which you had zero growth in high-powered money that there would be any strong movement to reestablish the Federal Reserve. I shouldn't be talking politics to you people; you people know the political system better than I do. It's hard enough to establish an institution of any kind. It's 10 times as hard to get rid of it because once you establish an institution, there is a vested interest in retaining it. If you once got rid of the Federal Reserve, it would be a very hard thing to reestablish. On the other hand, it's very hard thing to get rid of any such institution, including the Federal Trade Commission.

Question: I would like to explore your preference for putting the Federal Reserve either under the Treasury or as a creature of Congress. David Meiselman has done some interesting work on political monetary cycles. And it would seem to me that that suggestion would make it much more political, and I could think of some

interesting scenarios where the Congress being one party and the administration being another coming up with a monetary policy to put that administration out.

Friedman: I said before that either bringing it under the Treasury or putting it under Congress would give you more small mistakes. It would worsen monetary policy from month to month, or even year to year, but it would prevent major disasters. You would not have had the Great Depression; you would not have had the inflationary roller-coaster of the last 20 years. Going back to David's political cycle, he and I have some differences about the statistics. I was very much interested in his article in the *Wall Street Journal*, and so I fed into my computer all the figures I could get going back as far as I could. And I found that my computer did not give me the same answer as his did.

Meiselman: I didn't use a computer; I used the eyeball.

Friedman: I know. And the eyeball is a more valuable instrument, but it needs to be checked by the computer and statistics. And when I checked, I found that the events that your eyeball found were not outside the range of what random fluctuations might have produced. So I am not persuaded that there is that kind of a political cycle. After all, the political cycle did not prevent the Federal Reserve from defeating Jimmy Carter. I mean that more literally. In the case of Jimmy Carter, you had a very severe recession in the first half of 1980. The fact of the matter is that the notion of the political cycle assumes a greater capacity on the part of the Federal Reserve to figure out what the consequences of their policy will be than they have.

Question: In your fixed monetary base for high-powered money, aren't you assuming a declining reserve base or are you assuming something else? Will the private banks be willing to come in?

Friedman: Sure, because you'll have an increasing sophistication in the use of high-powered money; you'll have more use of deposits and less use of currency. Even with a fixed reserve rate, you could have it. If you look back at the record, the record is first of all that the velocity of circulation—that is, M1 [velocity]—has been going up for the last 30 years at about 3 percent a year. The velocity of the money multiplier, the money [supply] versus high-powered money, has been going up about 1 percent a year over the last 30 years. I think the 3 percent [for M1 velocity] is an overestimate for the future because the 3 percent was based on the period when what was called M1 had no interest bearing deposits. So I expect that the increase in

velocity of M2, of our present M1 which is essentially equal to the earlier M2, will be somewhat lower than 3 percent, maybe 2 percent a year. If you put that together with the money multiplier, you have a 3 percent per year growth in what [we] can expect in total spending. Now, I may be wrong. But you know the world would exist very well, it would be a very fine world, if prices were going down on the average of 1 percent a year or 2 percent a year. So that's not what I would call a disaster. The crucial thing is that you would not have major increases or major decreases in prices. You would not have the kind of fluctuation that you now have. I believe that the Federal Reserve does a large part of its harm by its continuous fine-tuning in the market. It's in and out, in and out. It's introducing an additional uncertainty in the market that need not be there. The Federal Reserve itself can do a lot better than that and cut out this fine-tuning it's engaged in. But if it did, it would lose its influence and importance so it isn't going to do it.

Question: The prime minister of New Zealand, Prime Minister Muldoon, wants to reconvene the Bretton Woods to address the debt problem in their countries. He found himself in a lot of trouble in New Zealand. What's your assessment of that? Do you see a favorable outcome to the country?

Friedman: There's not going to be a reconvening of Bretton Woods, and I don't know what the outcome would be if there were. Everybody complains about the present system, but nobody really wants to change it. It's going to last indefinitely. In New Zealand, Mr. Muldoon's former head of the central bank, whose name I've now forgotten, rediscovered the tabular standard. He wrote a whole series of articles that were published in the bulletin of the central bank. But what did Bretton Woods do? Is there really anybody who wants to go back to fixed exchange rates? I don't think so. Some people want to talk about it, but talk is cheap. The situation with Bretton Woods would be the same as with the gold standard: everybody would agree you ought to do something, but everybody would want to do something different.

Question: I was also asking what the banks or the countries should do about the debts—specifically, like Brazil.

Friedman: Oh, that debt! There's no doubt in my mind what should happen. The government should stay out of it and let the banks make their own deals with those countries any way they want to. That's their business. They made the loans; let them take

care of it. We have no business bailing them out. As you may know, I was strongly opposed to the increase in quotas for the IMF. The IMF has, in my opinion, been a very damaging institution. You know, there are quite a number of people who have some doubts about how well a central bank within a single country works. They should contemplate how a world central bank would work. What has the IMF been doing with respect to these various countries? It's been encouraging them to do the wrong things. I'm not talking, as most people are, about the question of whether they've been trying to cut their deficit. The problem, in my opinion, in the underdeveloped countries is primarily excessive government control of the economy.

Whom does the IMF deal with? Have you ever heard the IMF make a deal with a private Brazilian company? The IMF deals with governments. What does it do in the process? It strengthens the government vis-à-vis the private sector. Well, what's the problem in those countries? The government is already too strong vis-à-vis the private sector.

Why is it that nobody ever talks about the countries that aren't in trouble? How come the IMF isn't having to do something about Hong Kong? Now there's a country that's really in trouble. Here's Hong Kong with no resources at all; it has a population that has multiplied 10-fold in the past 20, 30 years. It's got an enormous neighbor that's threatening to take it over, and as a result, there is a tremendous flight of capital out of the country. And yet, they don't seem to be needing the IMF. How come? Why is it the IMF hasn't had a problem with Singapore, with Taiwan, with Japan? You know, the funny thing is that a few years ago, Japan was an underdeveloped country. The reason the IMF hasn't had any problem with those countries is because those are all countries that have relied primarily on the market to organize their activities. Every single country, to the best of my knowledge, with which the IMF has a problem, is a country that has relied primarily on the government to organize and control its economy. That's why I think that the IMF is an instrument for harm, not for good. It strengthens governments. That's also why many, many years ago I was opposed to U.S. foreign economic aid because it has the same effect. We strengthen the government; we destroy the private sector. A recent piece in the *Wall Street Journal* said something about destroying private agriculture in India. I saw that happening in India when I was there 20 odd years ago. We give them wheat; wheat is fine, but the effect of that is to destroy their

own agriculture. So I don't think we want to strengthen the IMF. The only thing I could see coming out of [a new] Bretton Woods that would be good would be abolishing the IMF.

Question: Both houses of the banking committees are engaged in a great debate on how the banking system ought to be restructured, going back and looking at the Banking Act of 1933. What are your comments on how the system ought to be restructured, particularly . . . deposit insurance?

Friedman: There is a gentleman, whose name I've now forgotten, who has written a very good article proposing to restructure the system which makes an enormous amount of sense to me. The essence of his argument, and I think it's correct, is that you have to distinguish between two problems: the liquidity problem and the solvency problem. The liquidity problem is something no insurance system can handle. And that's the problem the Federal Reserve has to handle, should handle, can handle. But the solvency problem, given that you have a firm commitment to handle the liquidity problem, the solvency problem is one that could be handled by strictly private insurance. What you ought to move is to dismantle the Federal Deposit Insurance Corporation and establish private insurance companies that will provide private insurance to banks and other institutions. Let me pin that down a little more and talk about Continental Illinois because what people don't recognize is the order of magnitude of the liquidity problem on the one hand and the solvency problem on the other. Continental Illinois had deposits of $25–50 billion. Given the scare about Continental Illinois, there was a demand to draw out $40–50 billion. No insurance company is going to be able to handle that. On the other hand, suppose you stop the liquidity problem, suppose you stop the drain. Then the difference between the going value of Continental's assets and the going value of its liabilities, in excess of the stockholder's equity, was probably in the area of $1–2 billion. That can perfectly well be handled by a private insurance fund. Private insurance companies handle much more than [that].

In our study of the monetary history of the United States, there is a similar comparison about the Great Depression. The problem during the Great Depression was not the loss of capital in the banks that failed; it was the effect of the failure of banks on the total quantity of money. In the same way, the problem with the liquidity run on Continental was the problem of what it might do to the entire

monetary structure if it weren't stopped. And I may say under present circumstances, unaccustomed as I am to approving anything that any federal agency does, I believe they did the right thing in stopping that run on Continental by guaranteeing all the depositors. It was not a very good thing to do from one point of view, but I think it was the right thing to do under the circumstances. From the long-run point of view, what we ought to have in mind is private fund insurance plus a firm commitment by the Federal Reserve that it will prevent and stop any liquidity run. The FDIC has proposed . . . differential rates on risk, but I believe government is in no position to consider risks. On the other hand, private insurance companies would be in a position to graduate the rates—to charge various rates according to the risks involved.

Question: Could you comment on the current proposals before Congress, or at least being talked about, such as Kemp-Lott? There are two bills. One is to have immediate disclosure of Fed actions; the second is to adopt an unspecified form of commodity standard.

Friedman: I've always been in favor of immediate disclosure of Fed action. There is absolutely no justification whatsoever for the Fed waiting a month before they disclose what they said and what they have decided at these meetings. I have always felt that the Fed should hold an open market committee meeting on Thursday or Friday so that they use Saturday and part of Sunday to check the minutes—they have to check the minutes with the members to make sure they're accurate—and issue the minutes on Sunday. Now, the problem there is that it isn't going to do anything because the minutes will be vague. They'll write the minutes in such a way that they won't say anything; they come as close to that now as they can. And they would be even more vague. But at any rate, I see no justification for keeping any of that secret. In fact, I would be in favor of publishing transcripts of the discussion at open market investment committee meetings. So I'm all in favor of immediate disclosure.

On the other, I am not in favor, as you can see, of any monetary proposal as I understand it. As I understand the proposal—maybe I don't—but my impression is that they propose that the Fed should operate its discretionary policy by looking at various price indexes, whether it's gold or simply a commodity price index. And I think that—entirely aside [from the] fact that it's almost impossible to do—it would not achieve their objectives. There are many objections,

but fundamentally they're barking up a bad tree. Let me explain. Many people are saying that the problem we face is deflation not inflation because many commodity prices are going down. And that's true. Now I ask all of you to consider what fraction of the total GNP is made up of those commodities, raw commodities? It's a trivial fraction. Some years back, I had what I thought was a fine idea of how to get a market measure of inflationary expectation[s]. We had futures market[s] in a wide variety of commodities. These markets show what people expect the price to be six or nine months from now. Why not, I thought, combine all of those in an index to get an indication of what people expect inflation to be. I had a student who was exploring for a PhD topic go into this. The first thing I had him do was to calculate an index of such commodities for a past period and compare it with the actual behavior of a broad-range index on consumer prices. There was essentially no relation between the months. That's because the commodities constitute a small fraction of the total basket of goods, and they're not a representative sample by any means. Similarly, with current so-called sensitive price [commodities]. As a result they are not a very good indicator of price movements. Therefore, it would make no sense at all to guide your monetary policy by them even if you could.

Question: Professor, if we could freeze high-powered money, what reduces the uncertainty that people have about the monetary base, that the Fed will be consistent?

Friedman: There wouldn't be a Fed. What do you need a Fed for?

Question: What about the Treasury Department changing the numbers for the monetary base?

Friedman: As I said, my preference would be to have a constitutional amendment. After all, that's what the original Constitution does. We have forgotten that the original Congress prohibited states from emitting bills of credit and gave Congress only the power "to coin money, regulate the value thereof, and of foreign coin." As I read the original Constitution, it intended to limit Congress to a commodity standard.

As you know, Samuel P. Chase, who was Secretary of the Treasury during the Civil War, was in charge of issuing the greenbacks during the Civil War, [and after the war was] appointed Chief Justice of the Supreme Court. In the first greenback case as Chief Justice of the Supreme Court, he ruled the actions he had taken as Treasurer were unconstitutional. Perhaps you haven't read enough history to

remember that period, but most of you have read enough history to remember the famous F.D.R. court packing in the 1930s. But the first court packing case was in connection with the greenback issue. That decision was so unsatisfactory that the then president expanded the size of the Supreme Court and appointed some new members, and they reversed the greenback case. Samuel P. Chase was overruled; he was in the minority in the second greenback case. I agree more with the first; the greenbacks were an illegal, unconstitutional emission of a bill of credit. So personally, as I say, I would like to have it put into the Constitution.

Question: What role do you give to the foreign sector or to the large trade deficit in reducing inflation? Since the trade deficit is in the order of $100 billion, it's as if the foreigners are depositing $100 billion of goods in the United States. That has got to have a monetary effect on inflation.

Friedman: Well, number one I think you'll have to go a little bit more slowly. By the trade deficit, you don't mean the commodity deficit; you're including the invisibles. Over and above that, remember that some part of what is going to capital inflow is direct investment in the United States. If Datsun builds a factory in the United States, that's part of the trade deficit. If it were to buy all the ingredients of that factory and ship them out of the country and set the factory up somewhere else, it would be reported as exports. It would reduce the trade deficit. So that's what we want to do is to take that $100 billion and narrow it down still further for direct investment, and the rest of it undoubtedly does have a minor effect in making U.S. inflation somewhat less than it otherwise would be. But it's probably [a] small order of magnitude. After all, the total GNP in the United States is of the order of $3 trillion. You're talking at most of $100 billion so you're talking of $100 billion out of $3 trillion. You figure out the percentages; it's very small. So I don't think it has a major effect on the inflation rate. I think it does have a minor [effect].

Comment: Maybe 1 or 2 percent.

Friedman: I don't believe it even has that much—but at most maybe 1 percent.

Comment: But see, it does affect the strong dollar, which is part of the whole scenario.

Friedman: You mean it produces a strong dollar. The deficits are producing the strong dollar, not the strong dollar producing the deficits.

Comment: Right, I understand, but that has particularly pronounced effects on some of these sensitive commodity prices which are internationally traded. That strengthens your point about possible errors or bias in focusing on this narrow range of commodities.

Friedman: No, I agree with you 100 percent. That's why I was saying before that I thought this group of commodities that people are talking about focusing on in order to conduct monetary policy is a misleading indicator. First of all, so far as the so-called strong dollar is concerned, I'm surprised that nobody ever talks about the most obvious way to lower the dollar if you wanted to lower the dollar. Suppose you think the dollar is too strong. What's the most obvious way to reduce it? The answer is very simple. Cut out trade restrictions. Eliminate the import quota on Japanese cars which we ought to eliminate anyway. Eliminate all other restrictions on trade. That would not affect the trade deficit; don't misunderstand me. The trade deficit would remain exactly what it is. But what it would do would be to lower the value of the dollar. People have short memories. In 1931, John M. Keynes wrote a famous article which his reputation has never lived down in which he proposed a tariff because he said it was politically not feasible for the British to devalue. And while he believed that devaluation would be preferable to a tariff, the tariff was an indirect form of devaluation. Two months after he wrote that, Britain devalued. Economists are lousy political prophets as you can see. But if a tariff is a substitute for a devaluation, then taking it away is equivalent to devaluation and will lower the exchange rate. The import quota on Japanese cars is utterly inexcusable and should never have been adopted. But with all the talk about the strong dollar, why don't you people say that the way to make the dollar less strong is to eliminate restrictions on trade. People believe that would make the deficit worse, but it wouldn't.

The deficit is produced by the fact that there are people abroad who would like to have U.S. dollars. The only way a foreigner can get U.S. dollars is through, on net, the U.S. having a trade deficit. There's no way in which a man in Germany who has marks can get dollars except by persuading somebody to sell him the dollars. But somebody sells him dollars, receives marks in exchange. What's he going to do with the marks? Eat them? He doesn't want to eat them. If he holds them, there's been no net exchange. The reason he wants the marks is to buy German goods, and he imports them, and that pro-

duces a trade deficit. So the size of the trade deficit is determined by the amount by which foreigners want to add to their stock of dollar assets.

I'm exaggerating only a little because of speculative and similar short-term influences, but fundamentally the reason we have had a large trade deficit and an increasing one over recent years is because the United States has become increasingly the safest haven to hold your assets. If you're a Lebanese, you don't want your assets in Lebanon. If you're an Argentinian or a Brazilian or a Mexican, you have already gotten your assets into the United States. We talk about the debt problem of the LCDs, it's a government problem. Mexico's debt is some $80 billion, something like that. It is estimated that the citizens of Mexico used some $30 billion of those dollars to get assets in the United States. Private people were getting their money out because of their lack of confidence in their own government. And we were putting money in there because we did have confidence in their government. But my main point is that wherever you go in the world today, there are real questions about whether you want to hold your assets there. The Germans worry about the Russians, about the increased troubles there. In Lebanon, in Iran, in Iraq, anywhere in that part of the world you don't want your assets there; you'd rather have them in the United States.

To get a sense of proportion, foreign asset holders have to want to transfer only a very tiny part of their total portfolios into dollars to produce an enormous trade deficit in the United States. Consider the United States. Nationally, income is something like $3 trillion. Total assets must be something like $10 trillion. The GNP of the rest of the world, Europe alone, is greater than the United States. So worldwide, total assets must be in the order of $20–30 trillion. You only have to shift a little bit of that to produce a $100 billion deficit in the U.S. balance of payments. If holders of assets around the world would like to have one-third of 1 percent more of their assets in the United States, you have a $100 billion U.S. deficit. So that the idea that somehow or other this $100 billion deficit is something we ought to be worried about—or is very large and so on—is a question of confusing stocks with flows. And tell me what harm has it done? What's the deficit doing, that trade deficit? Number one: it's building factories. Number two: it's buying U.S. government bonds so it's holding interest rates down. Number three: it's buying securities in the stock

market so it's holding stock market prices up. Number four: it gets invested in bonds of private enterprises. It's contributing to the flow; it isn't costing any jobs. I don't think there's any statement that is more nonsensical than the statement that is repeated so often that somehow or other the trade deficit is costing us three million jobs. It's utter nonsense. It isn't costing us a single job. What it's doing is providing us with goods that we otherwise would not have.

Book Reviews

America's Fiscal Constitution: Its Triumph and Collapse
Bill White
New York: Public Affairs, 2014, 539 pp.

When politicians write policy books, they are often shallow affairs full of party talking points. Bill White's *America's Fiscal Constitution* is different. It is an excellent and scholarly book.

White was mayor of Houston from 2003 to 2009, a candidate in the 2010 Texas gubernatorial election, and a Department of Energy official under President Bill Clinton. He is currently chairman of Houston Banking and an advisor to Lazard. I don't know where White found the time to author a fiscal history of the United States, but he has done so in a detailed and polished manner.

White begins his history in the early years of the Republic. Debates over fiscal issues were as central to politics back then as they are now. In the 1790s, battle lines were drawn between anti-debt and small government advocates led by Thomas Jefferson and the relatively pro-debt and big government advocates led by Alexander Hamilton.

White quotes Jefferson explaining to George Washington in 1792: "This exactly marks the difference between Colonel Hamilton's views and mine, that I would wish the debt paid tomorrow; he wishes it never to be paid, but always to be a thing wherewith to corrupt and manage the Legislature." White's book generally takes the Jeffersonian side on debt.

Since 1790, federal debt as a percentage of gross domestic product has spiked during the Civil War, World War I, the Great

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Depression, and World War II. There were also smaller debt bumps during other wars and recessions. In all cases, the debt was paid back steadily in the years following the crises—that is, until recently. White's book traces the ups and downs of federal debt and discusses the politicians and economic forces at work in our fiscal history.

White's main theme is that early American leaders developed an "informal constitution" for federal fiscal management, which he variously calls the "Fiscal Constitution" or the "American Fiscal Tradition." The main component of the tradition is that if debt is issued during crises, such as wars or deep recessions, it should be paid back fairly promptly. During normal times, the federal budget should be balanced.

White points to other budget traditions that have served the nation well. For example, budgets should use clear accounting, an idea going back to Jefferson's Treasury Secretary Albert Gallatin. Also, wars should be partly funded by current taxes, not just by debt. Jefferson favored a constitutional limit on federal debt, which would force politicians to raise taxes for new spending and, as one beneficial effect, help put a leash on the "dog of war."

White argues that the general anti-debt stance of policymakers—the Fiscal Constitution—lasted from 1790 through Bill Clinton's presidency, but then it "collapsed" during the presidency of George W. Bush. Bush fought expensive wars entirely funded by debt, and he pushed for tax cuts when the government was running large deficits.

My view is somewhat different. Bush was a fiscally irresponsible president and a big spender, but that's true of numerous presidents since the frugal Calvin Coolidge occupied the White House in the 1920s. I've calculated that between 1790 and 1929 the federal budget was in surplus 68 percent of the years, but between 1930 and 2014 it was in surplus just 15 percent of the years.

So I would place the real historical divide in U.S. fiscal policy at about 1930, not 2000, as White does. Two developments during the 1930s that shifted the government toward profligacy were (1) the rise in Keynesianism, which informed politicians that deficit spending was good for the economy, and (2) the creation of "entitlement" programs, which allowed for automatic spending increases without politicians having to vote for them.

In the post-1930 era, White points to President Dwight Eisenhower for his anti-debt governing philosophy. But, while Ike

expressed concern about debt, he also ran deficits for five of his eight years in office. More importantly, Ike was a big spender. Aside from defense, total nondefense spending more than doubled during his tenure, from $23 billion to $48 billion.

White focuses almost exclusively on debt and deficits in assessing the soundness of fiscal policy. But there is a huge divide in federal spending policy before and after the 1930s. To steal White's phrase, a central part of "America's Fiscal Constitution" before the 1930s was low spending. From 1790 to 1929, total federal spending averaged just 2.7 percent of GDP. From 1930 to 1980, the spending share quintupled from 4 percent to more than 20 percent, and it has gyrated around that higher figure ever since.

All that said, I very much share White's—and Jefferson's—loathing of federal debt, and it is sad that so few politicians today work to reduce it. White reminds us that balancing budgets and reducing debt used to be a bipartisan affair. During the post–Civil War period, for example, the government balanced its budget every single year from 1866 to 1893.

The divide between the parties back then came on the spending side. White notes that "before the 1920s Democrats—not Republicans—were generally identified with the cause of smaller government." Republicans, for example, supported extensive spending on "internal improvements" and overly generous veterans' benefits. Meanwhile, Democrat Grover Cleveland was a defender of fiscal prudence and limited government during his two presidential terms in the 1880s and 1890s. He sought to cut spending even when the budget was already balanced.

White concludes his book with some ideas on reforming the budget process. Unlike many Keynesians today, who want deficit spending now but claim to want restraint later, White wants restraint now: "Long-term 'deficit reduction plans' that push hard choices into the distant future are no substitute for plans to balance the budget within several years. . . . In common life experience, few pressing problems are best solved slowly over decades." White further rejects Keynesianism when he says, "American economic history does not support the idea that a strong economy depends on chronic federal borrowing."

White's book is a great read with many interesting facts. For example, did you know that the federal government's debt has been completely paid off only once in American history? In his first inaugural

address, Andrew Jackson promised to "extinguish" the debt. He succeeded in 1835, and then threw a big party to celebrate. White provides other interesting details on America's monetary history, the creation of the income tax, battles over tariffs, civil service reforms, and many other things.

In sum, the strength of White's book is not the soundness of his "Fiscal Constitution" theme. Rather, it is the lively and informative history of two centuries of fiscal policy written in a fair-minded and concise manner.

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The Great Debate: Edmund Burke, Thomas Paine, and the Birth of Right and Left
Yuval Levin
New York: Basic Books, 2013, 296 pp.

The French Revolution changed politics forever—in part, of course, because nearly everyone believes that it did and because we have generally acted accordingly. Since 1789, Western political views have been understood to fall into two broad camps: The left bases its claims on reason, a universal notion of human rights, and the pursuit of direct, immediate reform; the right privileges tradition, the continuity of the social order, and change only when absolutely necessary for that order's upkeep. Both profess to love liberty. Post-1789, one can hardly do otherwise.

Yuval Levin's *The Great Debate: Edmund Burke, Thomas Paine, and the Birth of Right and Left* is a product of, and a commentary on, this admittedly fertile terrain. The book traces, with copious reference to original source material, the sharply divergent worldviews of Thomas Paine and Edmund Burke, writers who have since become avatars of left and right. Anyone who wants a thoughtful, well-organized picture of these two remarkable public intellectuals should pick up Levin's book, which maps their disagreements in a set of clear, thematic chapters ("Nature and History," "Justice and Order," "Choice and Obligation," and so on). Levin's lucid exposition shows even the casual reader why left and right have been such intellectual touchstones. Here you will find a powerful set of tools for analyzing both the French Revolution and the world of today.

Libertarians, of course, dispute the left-right paradigm. Whatever its strengths, we find that, at best, it tells only part of the story; at worst, we find that it obscures the really fundamental questions. We worry that limiting our discourse to left and right leaves no general and principled rejection of state power in favor of voluntarism. On this view, we may like to think that Burke and Paine alike were foes of tyranny, which they surely were, and that, because they were friends of the American Revolution, both were not so far from us. So if libertarians have affinity for Burke and Paine, then where are we on the left-right continuum? The middle? That doesn't seem right.

Thus, one libertarian critique of Levin's work nearly writes itself: What if, in politics, there are—or should be—more choices than two? Why this arbitrary classification?

A more subtle libertarian critique might run as follows: What if the French Revolution didn't work as big a change as either side believed? What if not very much changed at all—apart, that is, from our vocabulary? Classical liberals commonly alleged as much. In particular, Alexis de Tocqueville famously recast the French Revolution as beginning with a state with concentrated power and ending with a state with even more concentrated power. What if *he* was right?

Burke and Paine were fine thinkers, this critique runs, and both must be understood by anyone who wishes to comment on modern ideology. But the same can be said of Tocqueville, and his approach complicates things considerably. Much of the real action again lies well off the one-dimensional left-right continuum.

Now, a book on Burke, Paine, *and* Tocqueville would be a very different one from the volume Levin wrote, and it's never a completely fair critique to fault an author for not having written the book one would wish to have read. I don't mean to do so here, so I shall have to look for other faults, few as they are.

On the question of how the lessons of Burke and Paine should apply to today's politics, some reviewers have wished for more. Levin offers much about their own time, but quite little about anything thereafter, and almost all of it is confined to his conclusion. As for me, I suspect that a reasonably well-informed reader can fill in the blanks well enough. Perhaps also we are better off when left to do this work ourselves, considering that Yuval Levin's characterization of what it means to be a Burkean today will differ from, say, Andrew Sullivan's. And Levin's portrait of Paine is likewise not the Paine we find in the

work of the late Christopher Hitchens, which itself differs from the Paine often quoted approvingly by Cato adjunct scholar George H. Smith. But great thinkers leave us room to argue, and one of the virtues of both thinkers is their versatility.

It is likewise a testament to this book that the faults of its subjects show through as well as their virtues. We are apt to find Burke more than a little toadying, even in Levin's sympathetic portrayal. When Burke refers to the "great families and hereditary trusts" as "the great oaks that shade a country," we can't help but think that Paine's critique of hereditary aristocracy was spot-on. As Paine might have replied, we can count on the oak to bear mighty offspring, but we can't do the same with human families. For his part, Paine certainly comes across as the starry-eyed dreamer, which is, regrettably, a fair assessment. It takes a special kind of naïveté to travel to a foreign country and participate in its revolution while not speaking the language. If he'd been a bit more level-headed, his reputation might be better.

Despite their faults, Paine and Burke are valuable for the questions they make us ponder: When is a social or political wrong amenable to gradual reform? When does it take a revolution? How do we know when political change has gone from incremental, wise, and likely to succeed to radical, foolish, and likely to end in a bloodbath? How much of society are we really supposed to reform in our short time here on earth? And in what direction? Neither Burke nor Paine gave a fully satisfying answer to those questions. Each of them was disposed in one direction, but going by disposition in a sense begs the question. Of course conservatives favor conservatism.

Yet meaningful tests of the two dispositions abound. How would Edmund Burke have reacted, not to the revolution of 1789, but to the revolution of 1989, when the Berlin Wall fell and it became clear that Soviet domination of Eastern Europe was no more? Here was, if any, a revolution nearly as comprehensive as the French one. Here were whole societies reforming themselves as quickly as possible, from a corrupt and evil state of affairs, Soviet communism, to liberal democracy.

Would Burke have been a revolutionary in 1989? It would be hard to take him seriously if he would not have been, and yet it is hard to think of 1989 as anything other than a very comprehensive revolution. I would suggest to Burkeans that the French Old Regime was a

similarly corrupt and sclerotic system, and it could not be counted on to reform itself gradually. Perhaps a revolution really was necessary.

This is not to say, though, that every idea in the heads of the revolutionaries was a good one. Far from it. Many of them were awful and, in practice, they bore awful fruit. The negation of a bad regime is frequently a worse one. The French Revolution replaced a traditional system based on prerogatives and customs not with a limited and liberal government but with a nearly all-powerful government, one that dictated religious policy, reassigned land and wealth willy-nilly, decreed prices and requisitioned goods, curtailed the civil liberties of mere suspects, and waged total war.

Renouncing these measures does not mean renouncing all revolution. Perhaps some revolutions are still worth our endorsement—that is, if they begin with proper principles. Yet these principles were hardly known and almost nowhere in evidence in the late 18th century. The American republic was itself an untried experiment that only partially answered to Paine's ideas, and hardly at all to those of the French radicals. And the democratic and free-trade reforms that Britain would later enact were likewise quite radical, and nearly unknown, to the 18th century.

I am reminded of medicine during the same era: In the absence of almost any useful medical knowledge, many doctors favored "heroic" treatments, including bloodlettings, laxatives, vomiting, blistering, sweating, and mercury. Heroic medicine was almost never effective, but it put on a good show. It made patients *feel* like something effective was happening. Meanwhile if the patient got any better, it was likely by coincidence.

In the late 18th century, perhaps political science was on much the same footing. One might develop a taste for revolutionary tumult, and one might believe that it was doing good, but calm reforms were perhaps about as likely to be effective, given the measures a revolution was apt to try. Beyond the atrocities of the French Revolution, consider also that we take liberal democracy—then, a radical cure—as a matter of course, but we would find, along with James Madison, much to fault in Paine's sketches of a good government. Whether in medicine or politics, not all radical changes are worth trying. But some clearly are. When we consider that, at the time, many key principles of economics were wholly unknown, that little data was available on which to base any sort of empirical claims, and that representative democracy was in its infancy, what's amazing about

these thinkers is not where they erred, but where they continue to offer insight, even to a world that they would hardly recognize.

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Fragile by Design: The Political Origins of Banking Crises and Scarce Credit
Charles W. Calomiris and Stephen H. Haber
Princeton, N.J.: Princeton University Press, 2014, 570 pp.

Charles Calomiris and Stephen Haber have taken on a big task in their book, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*. Their goal is to explain the double hit that economies and financial systems suffer when they experience a banking crisis and then the tightening of credit that often follows. In order to keep the final product manageable, and thus avoid having a 2,000 page book, the authors limit their case studies to the United Kingdom, United States, Canada, Mexico, and Brazil. Their time frame extends back to the 17th century. At its core, their argument is that financial crises are not random; they flow from the "Game of Bank Bargains"—that is, political deals that dictate everything in a banking system from the issuance of licenses to the means for distribution of credit.

Charles Calomiris is well-known to those who have studied financial panics and crises. He is the co-author of *The Origins of Banking Panics* and *Contagion and Bank Failures during the Great Depression*, to name just a few of his widely cited works. Stephen Haber has undertaken research predominantly on Latin American political and economic policy, with particular emphasis on Mexico.

Fragile by Design attempts to draw conclusions about a wide range of financial crises in different countries over a period of centuries and brings to mind Carmen Reinhart and Kenneth Rogoff's *This Time Is Different: Eight Centuries of Financial Folly* (2009). In contrast to the Calomiris and Haber argument that the existence of banking crises is nonrandom, Reinhart and Rogoff imply the opposite: "Banking crises remain a recurring problem everywhere. . . . The incidence of banking crises proves to be remarkably similar in both high-income and middle- to low-income countries. Indeed, the tally of crises is particularly high for the world's financial centers. . . .

Perhaps more surprising still are the qualitative and quantitative parallels across disparate income groups."

Additionally, there are some starkly contrasting definitional differences between the two works. Calomiris and Haber argue that Canada has experienced precisely zero systemic banking crises since 1840. Their underlying definition of "banking crisis" is restrictive in nature as it includes those events where the insolvency of banks or the costs of intervention exceed a stated percentage of GDP (a common definition among widely cited works by the International Monetary Fund and World Bank) or that involve widespread bank runs without significant insolvencies or interventions. In contrast, Reinhart and Rogoff impose less restrictive standards. Under their definition, Canada has experienced seven such crises since 1840.

Fragile by Design begins its case studies with the example of the UK. Calomiris and Haber demarcate two distinct periods of the history of the Bank of England, starting with a history of monopoly banking from the late 17th century to the early 19th century. The "bank bargain" at that time involved a bifurcated system whereby the Bank of England, organized by prominent Whig politicians of the period, benefited from a monopoly grant of a joint stock form, limited liability ownership, and exemptions from limitations imposed on the broader swath of private banks, such as usury laws and the tax status of stock holdings. The strength of the granted monopoly allowed the Bank of England to finance a war machine in the ever-present squabbles with France. But the structure was not good for providing credit to the private market: "The industrial revolution was financed out of the pockets of tinkerers and manufacturers, not through bank lending . . . the Industrial Revolution happened in spite of the revolution in public finance, not because of it." The authors briefly note the contrasting system of Scotland, which they characterize as one of "free chartering of banks" that was "the very model of competition, innovation, accessibility to credit for the private sector, and stability—all the things the English banking system could have been, but was not."

This system in Britain transformed in the early 19th century into a more competitive system (although not to the extent of the Scottish system), spurred on by changes in suffrage rules and the reduced need to provide war funding in the wake of the defeat of Napoleon, according to Calomiris and Haber. In chapter 5, the authors detail the transition of the Bank of England to a banker's bank and lender

of last resort, notwithstanding the determined efforts of those in the bank to preserve its previous, more privileged status. This chapter includes a well-told narrative of the historical development of the bank as lender of last resort, which has been a model for central bank functions through current times. The case study of Overend & Gurney, which was allowed to fail on the Bank of England's watch during the crisis of 1866 because it was in fact insolvent rather than just illiquid, and the ensuing financial stability after its failure, should be required reading for modern-day bankers. The stability in the banking system from the 1860s through the current time is attributed to "the Bank of England's new tough-love lending policy."

One disappointing aspect of chapter 5 is the cursory review of the turbulence in the financial system from 2007 to 2009. A reader would expect a discussion of how this period fits into the historical context, but the authors cover this period in a mere page and a half. This is in sharp contrast to the nearly two chapters subsequently dedicated to the political "bank bargain" aspects of the U.S. banking system and the resulting crisis during the same period.

The chapters on the U.S. banking system break the time frame into three eras: The "elite" era from the Revolutionary War to the early 19th century, a tight regime of chartering that neglected to direct credit to small business and farmers; the "unit banker" and "agrarian populist" era from the early 19th century to the 1980s, a period harshly described by the authors as "unstable, noncompetitive and inefficient in its allocation of credit"; and the current era of "megabanks" and "urban activists," which gave us the subprime crisis of 2007 to 2009. They outline the evidence of the pattern of instability through the Panic of 1907:

> From 1800 to 1861, there were five major banking crises: 1814–16, 1825, 1837–39, 1857 and 1861. From 1873 to 1907 there were six. Three of those crises (1873, 1893 and 1907) saw widespread suspensions of the convertibility of bank deposits. . . . In the other three crises (1884, 1890 and 1896) suspension was avoided through collective actions by clearinghouses.

The authors argue that the true causes of this instability were "the lack of diversification of risk within banks, the pyramiding of the banking system's reserves in New York City, and the difficulty of

coordinating responses of banks to liquidity crises," but that reforming these causes would have been "politically infeasible." Instead, we were given a central bank in the wake of the convening of the National Monetary Commission. The undiversified unit banks that remained after the creation of the Federal Reserve were ultimately a significant contributor to the thousands of failures during the Great Depression, especially those in agricultural communities. Removing the barriers to intrastate and interstate branch banking finally came through a combination of demographic, technological, and market forces which culminated in the passage of the Riegle-Neal Act of 1994.

Given that their primary focus is on the underlying political bargains that lead to crises, Calomiris and Haber do not spend much time on the response to the 2007 to 2009 U.S. financial crisis. They commit a significant share of their book (about 15 percent) to the "bank bargain" that followed the passage of Riegle-Neal and the cocktail of leverage combined with regulatory and governmental failure that was the genesis of the crisis. In so doing they set forth two preconditions for a crisis to develop: (1) banks take on a critical mass of risk, and (2) they have inadequate capital on their balance sheet.

The authors make a compelling case that the strange bedfellows of megabanks and activist groups came together to make the risk possible through a "bank bargain" that "promoted the expansion of risky mortgage lending to poor and inner-city borrowers." Between banks desiring to expand in the wake of Riegle-Neal and the Community Reinvestment Act (CRA) allowing the activist groups to extract lending commitments from the banks to benefit "their memberships and constituencies," the timing was perfect. Additionally, Fannie Mae and Freddie Mac supported the scheme through mandates that required them to stand ready to purchase mortgage loans made to these "targeted groups." The authors set out a range of supporting statistics on directed credit commitments: the correlation between CRA examinations and institution lending and default risk; the ever-increasing mandates placed on and high-risk mortgages accepted by Fannie Mae and Freddie Mac; and the parallel shrinkage in the typical down payment for home purchasers.

On the bank capital side, the regulatory agencies could have forced the government-sponsored enterprises and banks to recognize this riskier state of affairs and impose capital ratios to recognize the concomitant risk. But, as the authors point out, that would have

"raised the cost of taking on increased mortgage risk" and that was a cost that the participants in the "bank bargain" were not willing to recognize. The authors favorably cite the work of Barth, Caprio, and Levin on matters of regulatory failure. They also run through a range of other failures, from the structure of the rating agencies to the distortions in the Fed's monetary policy during the period preceding the crisis (citing John Taylor's work). Not surprisingly, their assessment of Dodd-Frank is quite pessimistic: "Like the earlier reforms, so far Dodd-Frank does very little to address the root causes of the crisis that inspired it." They close by highlighting the expansion of the Fed's power and note that this occurred "in spite of its failure to supervise and regulate effectively in the years leading up to the 2007 to 2009 crisis."

To contrast the U.S.'s situation, Calomiris and Haber offer the historical experience of Canada, which they argue is a preferred model for structuring a banking system. The ink committed to the Canadian case study is about one-third of that committed to U.S. experience, primarily due to the previously noted fact that, under the definition applied by the authors, Canada has not had a banking crisis since 1840. Thus, there is no need for narratives about the causes of Canadian banking crises. They highlight the fact that, for the first 100 years of this period, Canada did not even have a central bank. Although Canada did create one in 1935, the authors argue that it "had little effect on the commercial banking system: there simply wasn't much broken that needed fixing." They attribute this stark contrast to the fact that the United States has been historically dominated by fragmented state-level decisions regarding bank chartering (no nationwide branching), while in Canada authority over banking was centralized. The initial system of a small number of very large banks with nationwide branches was never frittered away by political bargains. The Canadian system withstood the Great Depression, when no banks failed, while nearly 10,000 U.S. banks (mostly unit banks) failed between 1929 and 1933. Finally, the authors note the "dull" banking practices of Canada in the 2000s, such as their avoidance of the risky practices of the United States (such as subprime loans), and the equally dull graph of mortgage delinquencies in Canada from 1991 to 2011 (flat-lined).

The case studies conclude with a section on authoritarianism and transitions to democracy in Mexico and Brazil (two chapters each). This section closes the loop on a concept raised in one of the early

chapters and illustrated in a figure contrasting chaos, autocracy, and democracy with government-banker partnerships, banking systems, and outcomes. Finally, the authors pull it all together in the concluding section of the book by applying their methodology to broader international experiences. They compile a group of the "very successful six" (Hong Kong, Singapore, Malta, Australia, Canada, and New Zealand) and then a broader list of the "successful thirteen." The common characteristics of these countries are that they are "city-states, islands or democracies with institutions that limit populist currents."

Fragile by Design is an elite example of those books that draw lessons from the recent financial crisis. Thankfully it is not written by insiders who are leveraging information asymmetry to engage in a self-serving defense of crisis interventions. Nor is it written by a journalist focusing more on the people and personalities of the crisis than on the substantive policy. At its core it is a methodology presented with clear supporting case studies and extensively documented citations to underlying factual bases with a clear focus on the policy choices that can be made to avoid future crises. As compared with *This Time Is Different*, if you want a database of cross-country experience with some cursory definitions of the differing types of crises, then Reinhart and Rogoff's tome is useful. But, if you want a methodology for drawing conclusions about the genesis of crises and an explanation for the differing experiences among countries, *Fragile by the Design* is the winner hands-down.

Vern McKinley
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Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State

Ralph Nader
New York: Nation Books, 2014, 224 pp.

Ralph Nader's new book, *Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State*, seeks to craft a left-right alliance capable of challenging corporate welfare. Given the media's focus on cronyism and the ire over continued bipartisan support of special favors to special interests, the book is timely. America, as James DeLong has noted, is becoming a "special interest state," and

the time may well be right to restore the constitutional focus on the "general welfare of the electorate."

Nader, sadly, does not address the roles played by the full array of special interests groups, concentrating only on business. Rather than using the "special interest state" language of DeLong, Nader talks only of "corporatism." But many other labels have been suggested: cronyism, crony capitalism, crony socialism (coined by Cato Institute President John Allison), and crony statism (the term preferred by Americans for Tax Reform President Grover Norquist). Whatever label it goes by, it should end.

Economic subsidies or competitor-crippling regulations not only weaken our economy, they also undermine the rule of law and threaten the moral basis of capitalism. Profit-side capitalism and loss-side socialism merit strong disapproval from both left and right, and perhaps a successful joint effort against corporate welfare might encourage a broader effort against subsidies to other interest groups. That possibility offers some hope that Nader's appeal might have a bright future.

That appeal, however, is made less likely by Nader's anti-business views. He consistently places most blame for crony socialism on corporations, refusing to see the role often played by ideological groups and governmental agencies. Moreover, his critique of corporate welfare soon expands into a general attack on the corporation. In Nader's view, corporations are rapacious institutions, seeking only to maximize their power to the detriment of consumers and the citizenry. But the modern corporation evolved from the voluntary, bilateral exchange arrangements championed by Adam Smith. The corporation is simply a more complex array of multilateral, voluntary exchanges. It's true that corporations—like earlier economic arrangements—too often fall into cronyism. Still, the power of even the largest firm is disciplined by competition and pales in comparison to that of Leviathan.

Nader's argument that Adam Smith himself was critical of the "corporation" fails to note that his ire was directed at the East India "Corporation," more a government-sponsored enterprise (GSE) than a modern firm. Few conservatives view GSEs as examples of the free market. It is worth noting that, until the Joint Stock Companies Act of 1844, all joint stock companies in Great Britain required a special charter from the crown. Until general incorporation statutes, the ability to form a corporation was an elite privilege.

In his most helpful chapter, Nader outlines the difficulties that must be overcome to realize a left-right alliance. I've participated in such coalitions and found his list insightful. His first point is that ideologues are passionate and find it difficult to work with those holding conflicting priorities. Moreover, right/left group leaders will likely face internal resistance to any cooperation with "the other side." Also, strange-bedfellow alliances are complex and fragile, thus risky. Time is needed to develop the necessary trust for any alliance to coalesce—time that may not be available in the fast-paced world of politics. Even in the best of circumstances, alliance participation will require some diversion of resources that might sideline some long-term commitments of the group. Finally, unless handled carefully, a group's participation in such alliances may antagonize its allies and donors. I'd also add one more challenge: the fear that a victory for an agreed upon goal might still selectively strengthen the ability of one's opponents, enabling them to advance policies one opposes.

In light of these difficulties, Nader suggests a new type of organization, one composed of individuals who've successfully worked with those holding diverse values. And, perhaps, it would be helpful to create such an "arbitration-style" group to clarify each participant's core values and craft policies designed to advance them all. Still, the point is clear that left-right alliances are hard to achieve.

With these difficulties in mind, perhaps *Unstoppable* should be read less as a prescriptive road map than as an opening bid at a dialogue. Greater interaction, more face-to-face conversations, exploration of specific reform ideas, and a greater willingness to explore creative policies that might advance the values of both sides—all may reveal areas for cooperation not obvious at this time.

While Nader does reach out to free-market types, he is a bit too quick to reject the reasons we so often disagree with our friends on the left. One example was his interaction with Ed Crane, then president of the Cato Institute. Crane, in response to a Nader request to join in an anti-corporatist campaign, noted that, while he was indeed anti-corporatist, he was anti-statist first. Nader saw Crane's response as a too-quick rejection of an effort to reach agreement on a narrower issue. Crane, I suspect, was reasonably cautious about signing on to what might well have been seen as "anti-corporate." Indeed, that is one of the difficulties that Nader himself has recognized.

Nader should have dug a bit deeper into how free-market types view corporatism. Free-market economists see cronyism as an aberration, not a characteristic, of capitalism. Moreover, such policies are viewed as the result of an often complex interaction between governmental agencies and economic and noneconomic interest groups. Finding ways to disentangle this array of forces is a complex undertaking of sorting out the "good," the "bad," and the truly "ugly."

Bruce Yandle, a groundbreaking public choice economist, has attempted this sorting-out task through his well-known description of Bootlegger/Baptist alliances. He derives this term from the debate over the pros and cons of repealing alcohol prohibition policies. The visible moral voice for supporting prohibition came from religiously inspired activists (the "Baptists") who sought to eliminate the temptation of alcohol in order to make the country more virtuous. The less visible economic voice for retaining prohibition came from the black-marketers (the "Bootleggers") who found these policies profitable. While the motives of the two could not be more different, they both worked in parallel to advance and protect Prohibition.

Bootlegger/Baptist alliances, or economic/moral-intellectual alliances, are—for good or bad—dominant features of policy changes in our market democracy. Sometimes the result is cronyism. Corn farmers, for example, worked closely with alternative fuel activists to enact renewable fuel mandates and subsidies. But, on occasion, corporate subsidies were curbed by similar alliances, such as opposition to the Clinch River Breeder Reactor subsidy program in the early 1980s, which Nader describes in the book. Such alliances are powerful because they combine economic clout with moral fervor. Which alliance partner is more significant, whether such alliances yield "good" (or "bad") results is an open, fact-specific question. The point remains, however, that strange-bedfellow alliances are an integral part of America's political system.

Nader's goal of curbing "corporatism" would have been stronger had he recognized that noneconomic groups (Baptists) are often just as important as for-profit corporations (Bootleggers). While he does criticize right-of-center groups for blindly supporting business interests (sometimes true), he spends little time critiquing left-of-center groups who, for ideological reasons, reflexively support government agencies or specific businesses. That selective view of interest groups—right groups being seen as naïve or even corrupt, leftist

groups being seen as idealistic and farsighted—isn't helpful to building alliances.

And, indeed, Nader partially recognizes this reality. He argues that, while governmental agencies like Fannie Mae and Freddie Mac championed irresponsible homeownership policies, they also had the "hefty approval of the home builders and realtors." He might also have noted the bipartisan support for policies promoting homeownership. Republicans believed that "homeownership encouraged virtue," while Democrats argued that "homeownership was a right." He also neglects the critical role of housing advocacy and antipoverty groups like ACORN.

In democratic market economies, the moral cover provided by ideological groups may be more important than economic incentives. If reforms of the type Nader envisions are to become realities, then an alliance including both Bootleggers and Baptists will be necessary. It is strange that Nader, an ideologue himself, assigns so little prominence to the role of the "Baptists" in promoting the "special interest state." Libertarians find this neglect worrisome. Does anyone really believe that the major regulatory interventions of the last century, from the FDA to the EPA, to Dodd-Frank and Obamacare, were initiated by business?

Of course, business—once a regulation seems inevitable—will push for special solicitude. This may simply be defensive, making the rules less damaging to the firm and to the economy, or it may aim at crippling a competitor. Yet, in many cases, while Big Business is a factor in the details of the final legislation, the initiating role was played by Big Ideologues.

Nader includes a list of 25 reform targets that he believes *should* gain broad support. A few seem promising, including auditing the Department of Defense, limiting war powers, expanding civil liberties, addressing the "too big to fail" attitude toward financial institutions, and rethinking the war on drugs. Agreement on any of these, of course, would depend upon the details of the reforms proposed. But he also includes among his proposals many that free marketers would reject, including ending corporate personhood, restricting campaign finance, dramatically expanding "citizen" standing to sue corporations, and protecting children from "commercialism." A shorter list focused on less bread-and-butter progressive goals would have strengthened his alliance appeal.

As a longtime political advocate, Nader focuses on policies rather than values. While interest-group politics alone may prove decisive when a policy has attracted little public attention, the citizenry must be engaged if we ever hope to resolve major, bipartisan issues. If public opinion rejects a reform idea, it is unlikely to become law. Thus, in a world of "rationally ignorant" citizens who have little reason to become politically informed, Nader might have discussed the disparate values that motivate the left (fairness, justice) and the right (freedom, independence). Those disparate values make agreement on any policy less likely unless most citizens see a reform as advancing core values. Successful alliances will have to craft polices and narratives to communicate to the public. Nader spends too little time discussing that challenge, claiming instead that "we all want" reform.

Since many on the right clearly disagree, he can only offer conspiracy-theory style explanations for why so many conservatives resist progressive reform ideas. According to Nader, corporate interests have deviously manipulated the media (and thus the political process) to thwart the will of the people. A better explanation would involve understanding how different people perceive various policies as either advancing or threatening their core values. Focusing on values can more effectively communicate the virtues of policy solutions on which there is broad value agreement.

Consider one of Nader's policy recommendations, "prioritizing the protection of the environment." In his view, making environmental protection a higher priority means giving more authority to the Environmental Protection Agency, the Department of Interior, the U.S. Forest Service, the Fish and Wildlife Service, and other agencies. As usual, he favors strong government intervention, and he gamely endeavors to convince conservatives (and at least some libertarians) that they should as well.

Nader's arguments rely on a highly selective citing of "conservative" authority figures. He first reminds readers that Theodore Roosevelt (a Republican!) appointed progressive Gifford Pinchot to a key natural resource protection position. He notes: "Over a hundred years ago, they were the activists who established the national forests." Presumably readers are supposed to agree that if government ownership of forests was good enough for a man whose face is on Mount Rushmore, then it should be good enough for conservatives today. Putting aside the questionable track record of the U.S. Forest Service in actually protecting forests, it is a significant leap

from Teddy Roosevelt's national forest initiatives to EPA's current micromanagement of much of the nation's economy.

In his attempt to seduce conservatives on environmental policy, however, Nader enlists an even more powerful proponent: Russell Kirk, whom he calls the "grand savant of modern conservatism." Nader provides a strong (and rather amusing) quote from Kirk that seems to address *Unstoppable*'s exact premise: "The issue of environmental quality is one which transcends traditional political boundaries. It is a cause which can attract, and very sincerely, liberals, conservatives, radicals, reactionaries, freaks, and middle class straights." Nader is not the only one making this point; contemporary conservative writers like Rod Dreher and David Frum have cited Kirk's work when arguing that political conservatism is entirely compatible with environmentalism.

So should conservatives (and their libertarian allies) be signing up for Greenpeace memberships? If all you have is Nader's selective summary, perhaps. But there is a lot more to sound environmental policy than simply liking forests and wanting clean water. There's also the question of what kind of legal framework will deliver those desired results with the fewest undesirable side effects. Free market advocates have long argued that environmental protection is better advanced when property rights are strong and are extended to resources such as water, forests, and wildlife.

In effect, we reject the "government is better at protecting resources" argument, opposing the view that trees should have legal standing (that is, appointed government protectors) in favor of the view that behind every tree should stand a private owner who, by protecting her property, protects part of our planet. Nader's and his allies' preferences for state control violates conservative and libertarian principles. Given that the EPA has become one of the most powerful of the federal regulatory agencies, and the one most threatening to economic liberty, recommending enhancing its power—in a book seeking alliances—is strange.

Nader's approach to persuading people on the right (he seems largely content with the views of those on the left), both on environmentalism and many other issues, is of the confident technocrat who says, "See, we all really want the same thing. Just agree with me on the goals and I'll figure out the details for both of us." But even assuming many will agree on final goals, not every path to a virtuous goal is a wise one. The surface-level agreement on ends that Nader

emphasizes masks a much more fundamental disagreement on means. Libertarians are not primarily utilitarians—we value freedom and that value is too often threated by arguments that "a national unified state approach is most effective."

Nader is deeply suspicious of corporate power, while conservatives and libertarians are more critical of state intervention. We agree that businesses influence policy, but we also emphasize that ideas matter and that ideological groups have played a critical role in advancing the current size and scope of government. Big Business is sometimes seduced—or terrorized—into submission by Big Government, and they often support initiatives championed by statist intellectual groups. Yet this underscores the classical liberal view that one can have good government and one can have big government but one cannot have good, big government.

Thus, it is no surprise that the rather large set of policy areas where Nader hopes left and right can collaborate will not attract many right-of-center individuals. Still, a dialogue between left and right about strategies to fight the specific issues of corporate welfare (or crony socialism) would be a welcome consequence of Nader's effort. *Unstoppable* should be viewed as an opening bid in the negotiation process.

Fred L. Smith Jr.
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Edited by Tom G. Palmer

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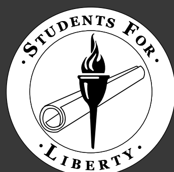

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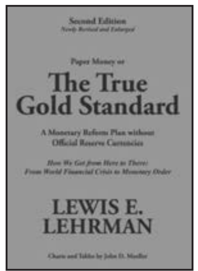

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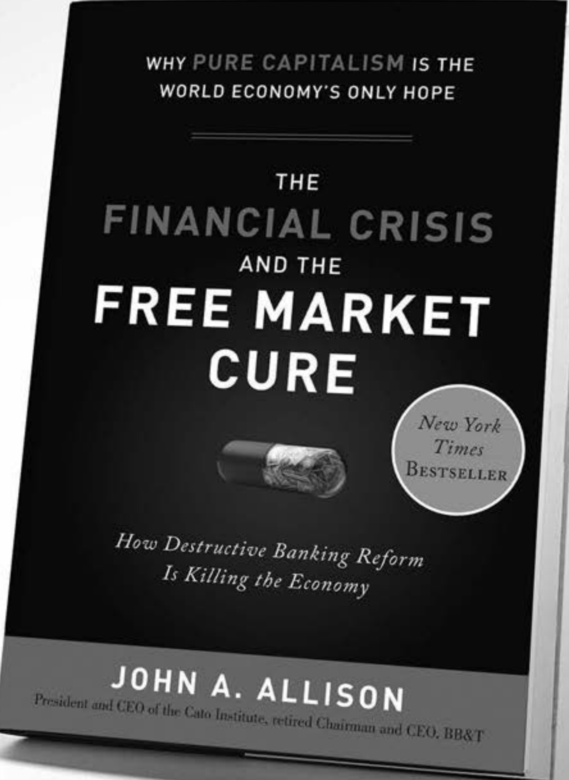

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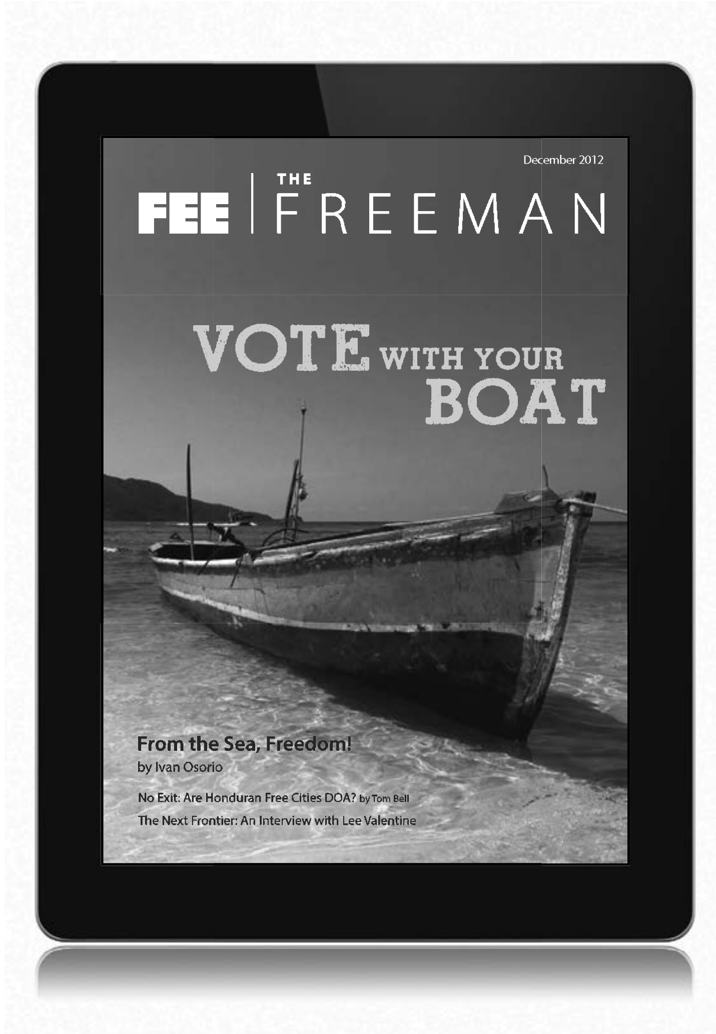

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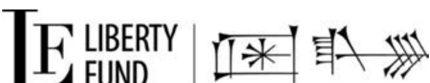

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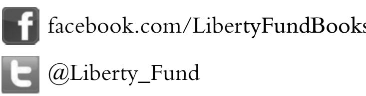

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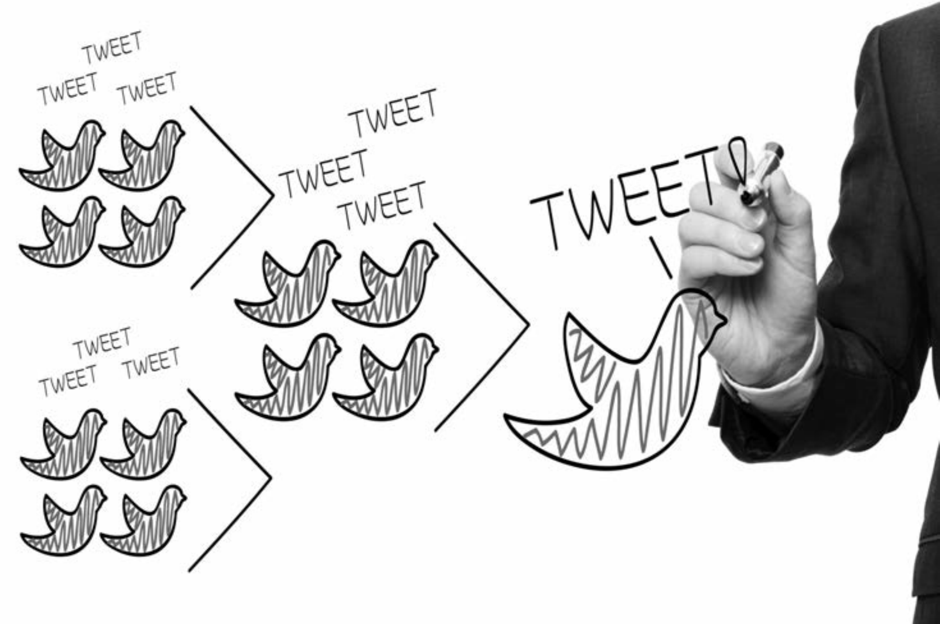

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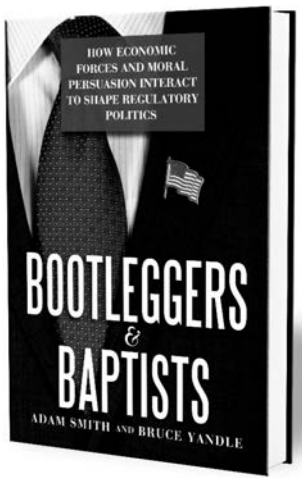

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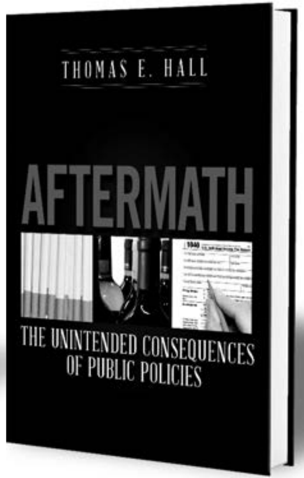

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(New York: Harcourt, 1980): 139.

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