

POLICY MEMO

Radical Steps Are Essential to Jump-Starting the Replacement of the Flawed US Money Regime

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A previous policy memo argued that flaws in the actual US money regime are responsible for the Great Pandemic Inflation.¹ Now that reported inflation has been falling, some of us might imagine that addressing these flaws has become a non-urgent matter. After all, great supply shocks tend to come rarely. But such complacency does not fit the facts.

The case for getting rid of the present rotten monetary regime is not simply based on the argument that it has malfunctioned so severely during the pandemic and war supply shock. That malfunctioning continues into the present, where there is now positive supply side news (the pandemic dislocation is fading, and a natural gas glut has emerged despite the continuing Russia-Ukraine War). The Federal Reserve and other central banks, still trying to navigate policy in an anchorless monetary system by choosing a path

for short-term interest rates, are stumbling from one huge blunder to another, even if they have a rare lucky stretch in between.

Beyond the woes of how the 2 percent inflation standard performed during the supply shock and subsequent supply restoration, this regime should be held responsible for a range of economic and social consequences that predate the pandemic and war. These include malinvestment (poor allocation of capital due to corrupted signaling in markets), advancement of monopoly capitalism, bloated government outlays, and punitive monetary taxation (in the form of inflation tax or monetary repression tax), all of which take their toll. Instead of enjoying a top-quality money with all its benefits, individuals have had to put up with a poor money and all its related costs, particularly the ongoing danger of serious loss of purchasing power.

Actual Rate Fixing Is No Substitute for a Solid Anchor

In a sound money regime, a solid anchor tied to the monetary base would underpin confidence that the purchasing power of money will persist over the long run. What we have instead under the monetary status quo is an assurance from the Federal Reserve (or foreign central bank, as the case may be) that it will pilot the policy interest rate in a way that ensures when mistakes and adverse surprises, however big, occur along the way, recorded consumer price inflation will always return to 2 percent after a course correction. There will be no restoration, however, of purchasing power lost during the period when inflation was above 2 percent.

No one, including the regime operatives (central bankers), have much of a clue about which path of policy interest rates will bring about “the return to 2 percent”—it is all trial and error, playing out in the reality theater of monetary decision-making. Yes, the operatives, including high officials, refer to the “black arts” of their profession—the augmented Phillips curve and the Taylor rule, which together supposedly specify a relationship between neutral interest rates, actual policy rates, natural unemployment, actual unemployment, and inflation. But no one trusts them. No wonder the process of forming inflation expectations is dynamically unstable under the actual monetary regime (symptoms of instability include all the chatter about wage-price spirals or evolving expectations as highlighted in consumer surveys or in the inflation-indexed Treasury bond market).

Sure, this regime of the 2-percent-inflation standard will take full credit for any near-term apparent success. But perceptions of such relief could be dangerously short-sighted. By the law of averages, when a central bank tries to pilot its policy interest rates, it will be lucky for some time and can claim it has accomplished its dual mandate, which we now interpret as 2 percent inflation and “full employment.” Such temporary luck is essentially different from the long-run stability that

comes from a solidly anchored monetary system. This features a tightly restricted supply of monetary base made up of assets that have super-money qualities and so experience strong and broad demand with no interest paid on them.

Monetary Base Reform Is the Essential First Step to Good US Money

So what are the essential steps or “reforms” that would put the US on the road toward a good money regime and away from the present bad one?²

The basic and most important step is radical reform of the now totally dysfunctional monetary base. The aim is to open the way to the development of a solid anchoring system that restricts the supply of the monetary base so that it cannot veer persistently ahead of demand. Hence, money sustains its purchasing power over the long run, and totally free markets determine interest rates, both short and long, without government or central bank price-fixing in any form.

To understand the dysfunctionality of the actual monetary base, let’s consider how it differs from a monetary system that is solidly anchored. There are two ideal types of solidly anchored monetary systems: constitutional fiat and gold.

Under fiat regimes, the monetary base consists of reserve deposits (which banks hold, alongside possibly some other financial intermediaries, with the central bank) and currency (banknotes, essentially). The central bank issues the reserve deposits and banknotes; on the asset side of its balance sheet are mainly loans to the government (including most of all government bonds and bills, typically).

Under an ideal constitutional fiat regime, reserve deposits pay no interest. These and banknotes are in such broad and strong demand due to their intense monetary services (“super-money” qualities) that a strict control of their supply ensures that the monetary system does not lurch into episodes of

sustained disequilibrium, whether inflationary or deflationary. Individuals and institutions are happy to hold the components of monetary base at no interest because even at the margin they offer robust monetary services, especially instant liquidity and safety. Individuals are indirect holders of reserve deposits in that the safest and most liquid types of bank deposits are heavily backed by these (in the ideal regime where there is no too-big-to-fail institution and only very limited deposit insurance or lender-of-last-resort availability). Bank demand for reserve deposits is closely related to the amount of customer deposits outstanding, especially those marketed as “safe” and always instantly usable at par value.³ Banknotes offer a different mix of intense monetary services. Total demand for reserve deposits and banknotes tends to rise and fall with the aggregate level of incomes.

Solid anchoring, as in the ideal fiat regime, depends on keeping the supply of monetary base highly restricted relative to the broad demand for it stemming from the “super-money” qualities of its components. Then the interplay of supply and demand for base money, with none of its components paying interest, should underpin a tendency over the long run for the average purchasing power of money to remain constant. Over the short and medium terms, there should be significant fluctuations in purchasing power as related to the “natural rhythm of prices” (for example, episodes of resource shortages or gluts, spurts or slowdowns in productivity growth, ups and downs of the business cycle).

Sustaining the quality of the monetary base, essential to the ideal fiat regime, presents challenges. The authorities have to abandon populist fixes such as providing too-big-to-fail support for banks and generous deposit insurance. These fixes bestow benefits on an array of assets (especially bank deposits with no special backing in cash or reserve deposits) outside the monetary base. In consequence, monetary base loses the broad appeal so important to its role in anchoring the monetary system.

Another example of how populist fixes can corrupt the monetary base comes from how the “war on cash” can spill over into regulations curbing essential benefits that currency settlement can offer. Low limits on the denomination of banknotes are one example. Others include regulations preventing retailers from charging customers extra for using credit cards or payment cards compared to cash. In fact, such regulations are in tune with payment and credit card companies abusing their oligopolistic power to insist that merchants do not pass on their costs, as they would on a level playing field for competition with cash.

The Fed Should Not Pay Interest on Reserve Deposits

Reserve deposits should remain non-interest-bearing. Once the authorities bend to the “bank lobby,” or to any other force, and pay interest on reserve deposits (as they have in the United States since late 2008),⁴ then the asset’s special monetary services (super-money qualities) fade away at the margin (of holdings which in total are larger than when they are non-interest bearing). (The services are still valuable intra-marginally, but individuals extend their holdings to gain interest income up until the point where this is the whole benefit received from additions.) That damages the monetary system.

The power of changes in the supply of base money to directly influence the economy and ultimately prices requires that these changes give rise to an excess or shortage of monetary services at the margin; individuals respond to the “mental discomfort” of such imbalance by adapting their planned spending (up in the case of excess, down in shortage). That power is feeble at best when monetary services at the margin are negligible.

Paying interest on reserve deposits causes banks and others to demand much more of these assets than they otherwise would, but not as essential instant liquidity and safety providers. Instead, reserve deposits become a form of

government debt highly substitutable with other interest-paying government debt. The interplay of demand and supply for interest-rate paying reserve deposits (where the rate is fixed by the Fed) with its main influence on tiny rate spreads between T-bills and reserve deposits, cannot keep the purchasing power of money constant in the long run.

Strict Limits to Flexibility in Monetary Base Supply

In the ideal fiat money regime, authorities would not lurch into creating gluts of monetary base with a corresponding zero level of money market rates as a tool of contracyclical policy. These gluts are in any case of dubious effectiveness as they mean that at the margin the special monetary services (super-money qualities) of the base fade away. Changes in the supply of the base have then virtually no economic influence—which is another way of describing the notorious liquidity trap where monetary policy loses effectiveness.⁵

In a recession, the natural rhythm of prices would be the stabilizing mechanism under an ideal sound money regime.⁶ Weak demand translates into lower-than-normal prices for goods and services. In consequence, businesses and households have an incentive to spend more. Greater demand for the monetary base at such times, corresponding to the demand for reserve deposits and currency in times of economic and financial fragility, would go along with this, meaning there are no monetary strains. The expectation, though, would be that prices would recover over the medium term as the business cycle weakness fades—and of course the long-run stability (with flexibility) in the short and medium term of the monetary base (growing very slowly at a trend) would contribute to that pro-cyclicality.

The authorities, in managing the supply of the monetary base, would be ready to increase supply temporarily during any increase in demand due to financial stress. But this should not become a long-run program; emergency increases in

supply need to be withdrawn once the crisis is over. Such emergency increases in supply are totally different from lavish interventions—whether lender-of-last-resort or too-big-to-fail assistance—which have characterized actual crisis responses in this century, including the most recent one. Many critics focus on the “moral hazard” of these interventions, but they also dilute further remaining special services (super-money qualities) of the monetary base and thereby hinder it from ever resuming its essential role in anchoring the monetary system.

No to Fiscal Inflation

Authorities have to prioritize a constitutional prohibition against expanding the monetary base to accommodate public debt management. Crucially, even in a rising default environment, there should be no way for the central bank to issue more reserve deposits to buy debt or repay debt (including servicing). The path of the monetary base should not be adapted to suit fiscal policy or, more broadly, debt management.

In some situations, fiscal policy may add to the demand for money—such as when personal incomes are directly “stimulated.” A nonresponsive path of monetary base growth to fiscal policy would mean a tightening of monetary conditions under such circumstances (this could cause prices of goods and services to fall, at least temporarily, as money market rates rose to abnormally high levels). Fiscal theories of inflation that blame government finances implicitly assume the monetary regime cannot separate itself from government debt management.⁷

In practice, under fiat money regimes, this total independence of the monetary regime from fiscal affairs has been rare but not impossible. Two examples loom in the laboratory of history: the Fed policies that accompanied the Reagan administration’s powerful fiscal expansion of 1983–84 and then the Bundesbank policies of 1990–92 that accompanied the tremendous fiscal expansion of German unification.

Independence is more plausible under the second type of ideal monetary system with a solid anchor—gold.

A Golden Monetary Base

Under a gold money standard, base money takes the form of aboveground stocks of gold in the form of bullion or current gold coins. Sources of monetary base supply growth are new mining of the metal and net melting down of jewelry or coins into gold bullion. Geology and swings in taste for jewelry vs. bullion are such that the annual growth in monetary base is very low but variable, especially in response to demand shifts. An attraction of the gold standard is that these supply adjustments, which typically (but not always) add to the stability of the monetary system, do not depend on a set of officials making wise and correct judgment calls.

Let's give some examples of how these adjustments work. Suppose there is a prolonged spurt in productivity and real income growth. Prices of goods and services tend to fall accordingly as businesses find their unit costs falling. At the same time, demand for base money rises in real terms (in line with aggregate incomes) but not in nominal terms. Costs fall in nominal terms in the gold mining industry as well. So the monetary base growth accelerates somewhat, meaning the gains in real purchasing of money during the productivity spurt tend to fade in the long run.

Alternatively, suppose demand for base money increases (relative to incomes) for whatever reason. The shortage of base money would put some downward pressure on goods and services prices. Correspondingly, there would be some selling of gold jewelry (since its price would have risen compared to other goods and services), and the output from gold mines would increase.

Gold has certain super-money qualities that fiat money does not. This is important in explaining the strength and stability of demand for monetary base under a gold regime.⁸ There is

no substitute for gold in the periodic table, and metallic gold is a distinct asset from other financial assets, with properties including beauty, low storage costs given its density, divisibility, etc.). The public directly holds gold bullion and coins as a means of payment. The intermediaries who produce monetary assets for the public also hold gold bullion, which backs these assets (including banknotes and reserves in clearinghouses for settling current payments) by 100 percent or nearly as much.

It is harder for a government in a gold regime than in a fiat regime to corrupt the system for the purpose of financing its deficits. There is the safety valve of a gold drain. If individuals see that the government is in any way likely to turn to monetary financing (by debasing the currency or otherwise), they will step up their savings in the form of gold bullion rather than coin and shift from various forms of paper money to gold bullion. This flight to gold will create huge monetary stress in the present and likely force the government to back down. Of course, this backdown is not guaranteed. The government could quickly end the gold standard instead.

An issue with the gold standard is possibly unstable demand for money related to gold demand from outside the country or the bloc of countries “on gold.” This is less of a concern where the US itself is on gold (given the preponderance of the US and especially the dollar in the international economy) than it is for smaller countries on their own.

How to Get from Here to There?

We also have the issue of how to get from here to there—from the present anchorless monetary system to an ideal fiat or gold regime.

A key point is that the steady state demand for monetary base once the regime (whether fiat or gold) becomes established is unknowable with any precision in advance. In the case of a desired transition to a good fiat money regime, there is little knowledge about the final path of demand once the regime is

firmly in place. So how much of the clearly bloated supply of monetary base should policymakers remove at the start?

If they remove too little, then the new regime will start with a substantial rise in goods and services prices. However, if they remove too much, then the prices of goods and services will fall at the start. The same conundrum applies to the installation of a gold regime.

In fixing the gold price of the dollar, the founders of a US gold regime would determine the starting monetary base in dollar terms for the US and other countries. But how much demand there would be for this base would turn on the extent to which investors in physical gold around the world might decide to dishoard and hold dollars instead. Many who currently hold physical gold might decide, now that the dollar is convertible to gold, to convert some of these into dollar paper, meaning less demand for gold. There are the dual risks that fixing the gold price will lead to an initial excess of monetary base (an initial big rise in goods and services prices) or a shortage (and decline in prices).

The good news is that the founders of the gold regime do not make these decisions about the appropriate starting level of the monetary base on one day early in the journey to a better money. Instead, there can be a process of learning along the way.

The journey to a better US money regime needs to start, though, with a focus on restoring the monetary base to a pivotal position in the system. There should be an immediate big shrinkage in the supply of bank reserves and an end to interest payments on these. This would take place through the Fed swapping a large share of its present portfolio of bonds with the US Treasury, getting short-dated Treasury bills in exchange. The Fed can sell these into the market to mop up reserves without directly impacting long-term rate markets.

Monetary policy should shift from a focus on piloting a path for policy interest rates to setting rates free and instead focusing on setting targets for the growth in the monetary base (from its shrunken level). Because at the start there is no knowledge of the demand for monetary base, policymakers would evidently have to be extremely careful in their targeting—or willing to accept a spell of persistent price rises or falls until the new regime is established. Their judgment would be based on a view that money market rates, as determined in the market, were persistently “far too high” or far too low due to persistent monetary shortage or excess, and they would adjust the monetary base target accordingly.

The Magic of 2 percent—for Good and Bad

Keeping the monetary base scarce—a key component of the good money regime—means money rates are always significantly positive. That is consistent with the historical record of the gold standard in the pre-1914 world, when interest rates in the London money markets rarely, if ever, fell below 2 percent. Hence the quip of the legendary Walter Bagehot: “John Bull can stand many things but not interest rates of 2 per cent,” meaning if rates fell to that level or below, the Englishman would go mad and become involved in manias and bubbles. And more about 2 percent: the aim of 2 percent inflation now enshrined in Fed policy but never formally approved by Congress (rather, price stability is part of the dual mandate) should be buried.

What other guidelines should there be during the journey away from the madness of the 2-percent-inflation standard and toward a sound US money regime? Sticking to 2 percent, we could say the growth in the monetary base should average around 2 percent per year over the long run. All of this should not preclude a turn toward gold money at a fork in the road of reform sometime in the future. To underline that point, a good extra first step (toward a good US money) would be to facilitate the further development of gold as a private money in competition with the fiat dollar.

Endnotes

- 1 Brendan Brown, “A Rotten Money Regime Is Responsible for Pandemic and War Inflation,” Hudson Institute, October 24, 2022, <https://www.hudson.org/rotten-money-regime-responsible-pandemic-war-inflation-brendan-brown>.
- 2 Brendan Brown and Robert Pringle, *A Guide to Good Money: Beyond the Illusions of Asset Inflation* (London: Palgrave MacMillan, 2022).
- 3 For a description of this ideal competitive banking system, in which safe deposits play an important role, see Brown and Pringle, *A Guide to Good Money*.
- 4 For fallacy of starting justification, see Daniel Thornton, “Federal Reserve Mischief and the Credit Trap,” *Cato Journal* 37, no. 2 (Spring/Summer 2017): 263–86; George Selgin, “Interest on Reserves, Part 1,” *Cato at Liberty* (blog), December 17, 2015, <https://www.cato.org/blog/interest-reserves-part-i>; and George Selgin, “Interest on Reserves, Part 2,” *Cato at Liberty* (blog), January 5, 2016, <https://www.cato.org/blog/interest-reserves-part-ii>.
- 5 See Maria A. Arias and Yi Wen, “The Liquidity Trap: An Alternative Explanation for Today’s Low Inflation.” *Regional Economist*, Federal Reserve Bank of St. Louis, April 1, 2014.
- 6 For further discussion of this concept, see Brown and Pringle, *A Guide to Good Money*.
- 7 See John Cochrane, *The Fiscal Theory of the Price Level* (New Jersey: Princeton University Press, 2023).
- 8 For more on super money qualities, see Brown and Pringle, *A Guide to Good Money*.



About the Author



Brendan Brown is a non-resident senior fellow at Hudson Institute. He is a monetary economist whose areas of special expertise include monetarism in theory and practice, asset inflation, Austrian School monetary tradition, European monetary integration, Japanese monetary issues, the global flow of capital, and international financial history.

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