TESTIMONY BEFORE

U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

DOMESTIC MONETARY POLICY AND TECHNOLOGY SUBCOMMITTEE

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Introduction

I specialize in the economic theory of organizations—their nature, emergence, boundaries, internal structure, and governance—a field that is increasingly important in economics and was recognized with the 2009 Nobel Prize awarded to Oliver Williamson and Elinor Ostrom. (Ronald Coase, founder of the field, is also a Nobel Laureate). Much of my recent research concerns the economics of entrepreneurship and the entrepreneurial character of organizations, both private and public. Like business firms, public organizations such as legislatures, courts, government agencies, public universities, and government-sponsored enterprises seek to achieve particular objectives, and may innovate to achieve those objectives more efficiently.[1] Public organizations, like their for-profit counterparts, may act entrepreneurially: They are alert to perceived opportunities for gain, private or social, pecuniary or not. They control productive resources, both public and private, and must exercise judgment in deploying these resources in particular combinations under conditions of uncertainty. Of course, there are important distinctions between private and public organizations—objectives may be complex and ambiguous, performance is difficult to measure, and some resources are acquired by coercion, not consent.

In the remarks below I evaluate the Federal Reserve System—and the institution of central banking more generally—from the perspective of an organizational economist. While I strongly disagree with many of the key policies of the Federal Reserve Board both before and after the Financial Crisis and Great Recession, my argument does not focus on particular actions taken by this or that Chair and Board. The problem is not that the Fed has made some mistakes—perhaps addressed by restating its statutory mandate, scrutinizing its behavior more carefully, and so on—but that the very institution of a central monetary authority is inherently destabilizing and harmful to entrepreneurship and economic growth.

A central bank is a government entity in charge of the monetary system—an entity that "controls the money supply," in layman's terms—with the task of maintaining "price stability,"

[1] Peter G. Klein, Anita M. McGahan, Christos N. Pitelis, and Joseph T. Mahoney, "Toward a Theory of Public Entrepreneurship," *European Management Review* 7 (2010): 1-15.

achieving a "full employment" of the economy's resources, and other national economic performance objectives. (The Federal Reserve System is charged explicitly with achieving both price stability and full employment, the so-called "dual mandate" now challenged by proposals from Representatives Pence and Brady.[2]) The Fed, like other modern central banks, also serves as a "lender of last resort" tasked with protecting the financial system from bank runs and other panics by standing ready to make loans to commercial banks, using funds that are created instantly, from nothing, at the click of a mouse.

The central bank's job, in short, is to "manage" the monetary system. As such, it is the most important economic planning agency in a modern economy. Money is a universally used good and the loan market, through which newly created money enters the economy, is at the heart of the investment process. Ironically, though economics clearly teaches the impossibility of efficient resource allocation under centralized economic planning, as demonstrated (theoretically) in the 1920s and 1930s by economists such as Ludwig von Mises and F. A. Hayek,[3] and (empirically) by the universally recognized failure of centrally planned economies throughout the twentieth century, many people think that the monetary system is an exception to the general principle that that free markets are superior to central planning. When it comes to money and banking, in other words, it is essential to have a single decision-making body, protected from competition, without effective oversight, possessing full authority to take almost any action it deems in the best interest of the nation. The organization should be run by an elite corps of apolitical technocrats with only the public interest in mind.

And yet, everything we know about organizations with that kind of authority, without oversight, or any external check or balance, tells us that they cannot possibly work well. Just as economy-wide central planners lack the incentives and information to direct the allocation of produc-

[2] H.R. 245 and H.R. 4180, respectively. Some observers refer to a "triple mandate" that also requires "moderate long-term interest rates."

[3] Ludwig von Mises, "Economic Calculation in the Socialist Commonwealth" [1920], in Hayek, ed., *Collectivist Economic Planning* (London: Routledge and Sons, 1935); F. A. Hayek, "Economics and Knowledge," *Economica* NS 4(13): 33–54; Hayek, "The Use of Knowledge in Society," *American Economic Review* 35(4): 519–30.

tive resources, monetary planners lack the incentives and information to make efficient decisions about open-market operations, the discount rate, and reserve requirements. The Fed simply does not know the "optimal" supply of money or the "optimal" intervention in the banking system; no one does. Add the standard problems of bureaucracy—waste, corruption, slack, and other forms of inefficiency well known to students of public administration—and it becomes increasingly difficult to justify control of the monetary system by a single bureaucracy.[4] This is especially true when the good in question is money, the only good that exchanges against all other goods, meaning the good in which all prices are quoted. Mismanagement of the money supply not only affects the general price level, but distorts the relative prices of different goods and industries, making it more difficult for entrepreneurs to weigh the benefits and costs of various forms of action, leading to malinvestment, waste, and stagnation. Price inflation rewards debtors while punishing savers, just as artificially low interest rates reward homeowners while punishing renters. Instead, market forces should determine levels of borrowing and saving, owning and renting, and entrepreneurial activity. Put differently, the monetary system is so important that it cannot be entrusted to a government agency—even a scientifically distinguished, nominally independent, prestigious organization like the Federal Reserve System.

Critics of discretionary monetary policy have argued for fixed rules, such as Milton Friedman's famous recommendation of a fixed rate of money-supply growth, or Professor Taylor's more accommodating set of countercyclical rules.[5] Others debate whether inflation targeting or nominal-income targeting is a more straightforward and realistic policy for the Fed.[6] However, none of these proposals is as effective as eliminating the monetary authority altogether, and relying on the voluntary decisions of market participants to determine the money supply and interest

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[4] Anthony Downs, *Bureaucratic Structure and Decision-making.* Rand Corporation: Santa Monica, Calif.: 1966; William A. Niskanen, *Bureaucracy in Representative Government.* Aldine-Atherton: New York, 1971); Peter G. Klein, Joseph T. Mahoney, Anita M. McGahan, and Christos N. Pitelis, "Capabilities and Strategic Entrepreneurship in Public Organizations," *Strategic Entrepreneurship Journal,* forthcoming.

[5] Milton Friedman, *A Program for Monetary Stability* (New York: Fordham University Press, 1960); John B. Taylor, "Discretion versus Policy Rules in Practice," *Carnegie-Rochester Conference Series on Public Policy* 39 (1993): 195–214.

[6] Christina D. Romer, "Dear Ben: It's Time for Your Volcker Moment," *New York Times,* October 29, 2011.

rates. A commodity standard, for example, removes even the possibility of central government intervention in the monetary system. If rules are better than discretion, the best policy is to eliminate all discretion, and to achieve a monetary standard that is wholly independent of political or technocratic interference.

The Fed's performance before and after 2008

My own views on monetary theory and policy derive from the "Austrian school" of Ludwig von Mises, F. A. Hayek, Murray N. Rothbard, and other important scholars and analysts.[7] From this perspective, the cause of the housing bubble was not irrational exuberance, corporate greed, or lack of regulation but the highly expansionist monetary policy of the Fed under Chairmen Greenspan and Bernanke.[8] After the dot-com crash the Fed turned on the printing presses, increasing the monetary base by 5.6% in 2001, 8.7% in 2002, and 6.3% in 2003, while MZM rose by 15.7%, 13.0%, and 7.3% during those years. Greenspan slashed the federal funds rate from 6.5% in January 2001 to 1% by June 2003, keeping it at 1% until late 2004, a level not seen since 1954. This infusion of credit led to overinvestment in housing and other capital-intensive industries, aided by federal government policies designed to increase the rate of home ownership by relaxing underwriting standards.[9]

The correct response to the collapse of Lehman Brothers on September 16, 2008, and Washington Mutual ten days later, would have been to let these insolvent institutions fail and to encourage a massive de-leveraging of the economy and an increase in savings and investment. An

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[7] Ludwig von Mises, *The Theory of Money and Credit* (New Haven: Yale University Press, [1912] 1953); F. A. Hayek, *Prices and Production* (London: Routledge & Sons, 1931); Murray N. Rothbard, *America's Great Depression* (Princeton, N.J.: D. Van Nostrand, 1963); Douglas W. Diamond and Raghuram G. Rajan, "Illiquidity and Interest Rate Policy," NBER Working Paper No. 15197, July 2009.

[8] The monetary and financial system is one of the most regulated sectors of the US economy, and there hasn't been any "deregulation" since the Gramm-Leach-Bliley Act of 1999, which if anything mitigated the harm of the financial crisis by allowing acquisitions, such as Bear Stearns by JP Morgan Chase and Merrill Lynch by Bank of America, that shielded bondholders from losses.

[9] Marek Jarocinski and Frank R. Smets, "House Prices and the Stance of Monetary Policy," *Federal Reserve Bank of St. Louis Review* (July 2008): 339–66; Stanley J. Liebowitz, "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown," in Randall G. Holcombe and Benjamin Powell, eds., *Housing America: Building Out of a Crisis* (Oakland, Calif.: Independent Institute, 2009); Johan Norberg, *Financial Fiasco: How America's Infatuation with Home Ownership and Easy Money Created the Economic Crisis* (Washington, D.C.: Cato Institute, 2009).

economic crisis represents a misallocation of productive resources, and the best policy response is to allow market participants to redirect resources from lower- to higher-valued uses. In short, once investments are revealed to be mistakes, it is critical to let the market *liquidate the bad investments as quickly as possible* to make them available for other purposes.[10] Of course, physical and human resources cannot be instantly and costlessly reallocated to alternative uses. However, contracting parties should be allowed to renegotiate resource use without central banks getting in the way. Existing mechanisms for liquidating existing investments and organizations, such as bankruptcy, should be used where appropriate.

The Fed, working hand-in-hand with the Treasury department under the Bush and Obama Administrations, has done precisely the opposite, bailing out insolvent financial institutions and industrial concerns, driving interest rates to zero, and injecting trillions of dollars into the financial system—increasing the monetary base, for example, by an average of 33.7% per year between 2008 and 2012, a cumulative increase of 198%. In short, the Fed's philosophy has been *to prevent*, *as much as possible*, *entrepreneurs from liquidating any bad investments*—indeed, to perpetuate those bad investments as long as possible. Insolvent financial institutions, rather than go through bankruptcy and reorganization, with poorly performing executives replaced by better ones, have received billions of dollars of free money. Incompetent executives remain at the helm.

The Fed has too much power

The Fed's defenders acknowledge that its recent actions are controversial. But, they say, that is the nature of the beast. Someone has to be in charge of the monetary system, and during a crisis, leaders have to make tough decisions. If not the Fed chairman and staff—intelligent, competent, well-trained economists—who else? Who better than the distinguished Princeton macroeconomist Ben Bernanke?

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[10] Rajshree Agarwal, Jay B. Barney, Nicolai Foss, and Peter G. Klein, "Heterogeneous Resources and the Financial Crisis: Implications of Strategic Management Theory," *Strategic Organization* 7, no. 4 (2009): 467–84.

Economist Lawrence Ball produced an interesting paper in February of this year on the psychology of the chairman.[11] Ball traced the evolution of Bernanke's thinking between 2000 and 2012, arguing that, since 2008, "the Bernanke Fed has eschewed the policies that Bernanke once supported." Ball attributes to the change in Bernanke's thinking to groupthink and to the chairman's own personality, which Ball describes as shy, withdrawn, and unassertive.

Without intending to, Ball makes powerful arguments against discretionary monetary policy itself, which relies on a small, elite group of powerful technicians, interest-group representatives, and political advisers to design and implement rules and procedures that affect the lives of millions, that reward some (commercial and investment bankers, homeowners) while punishing others (savers, renters), that shape the course of world events. Under central banking, there are no rules, only discretion. Do we really want a system in which one person's personality type has such a huge effect on the global economy?

Yes, the Fed's defenders insist. It is vital, they say, that the Fed not be constrained in any way from pursuing whatever policies it deems best. Federal Reserve officials are regarded as Plato's philosopher-kings. When a group of distinguished economists expressed skepticism in 2008 about what became the Troubled Assets Relief Program—the government rescue of inefficient, badly managed financial firms, Harvard's Gregory Mankiw offered the following response:

> I know Ben Bernanke well. Ben is at least as smart as any of the economists who signed that letter or are complaining on blogs and editorial pages about the proposed policy. Moreover, Ben is far better informed than the critics. The Fed staff includes some of the best policy economists around. In his capacity as Fed chair, Ben understands the situation. . . . If I were a member of Congress, I would sit

[11] Lawrence M. Ball, "Ben Bernanke and the Zero Bound," NBER Working Paper No. 17836, February 2012.

> down with Ben, privately, to get his candid view. If he thinks [the bailout] is the right thing to do, I would put my qualms aside and follow his advice.[12]

One can hardly imagine a more dangerous perspective on government decision-making. It ignores differences in theoretical frameworks between, say, Keynesian, Austrian, monetarist, new classical, and other economists. It ignores differences in the interpretation of data, which is a matter of *judgment*, not intelligence. It ignores the possibility that key decision-makers, including Fed and Treasury officials, have private and conflicting interests. And of course it ignores normative concerns—some citizens may oppose rewarding incompetent managers with taxpayer funds, regardless of the efficiency consequences. More generally, Mankiw's argument would seemingly apply to any and all forms of government economic planning. Why have markets at all, if we can have smart, well-informed planners directing the allocation of resources?

Sadly, Mankiw is hardly alone in holding to this worldview.[13] It is the implicit philosophy underlying the institution of central banking. And, to be sure, "Ben" did exactly the wrong things. Contrary to a popular storyline that the Fed and other central banks prevented financial catastrophe, and made the Great Recession less harmful than it otherwise would have been, the Fed's actions have made a bad situation much worse, by perpetuating the very structural imbalances that brought about the Recession in the first place. The problem with the US economy today is hardly a lack of effective aggregate demand, as Keynesian economists like to say, but a structural imbalance brought about by two decades of cheap credit, imbalances the Fed is working hard to make permanent (e.g., keeping the discount rate close to zero, and promising to do so through the end of 2014). And needless to say, the issue here is not Chairman Bernanke himself, but the impossible situation he faces as Fed chair.

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[12] N. Gregory Mankiw, "If I Were a Member of Congress," Greg Mankiw's Blog, September 26, 2008 (http://gregmankiw.blogspot.com/2008/09/if-i-were-member-of-congress.html).

[13] Alan Blinder recently dismissed concerns about inflation resulting from the massive increase in the money supply since 2008: "To create the fearsome inflation rates envisioned by the more extreme critics, the Fed would have to be incredibly incompetent, which it is not."

Fed independence

In 2009 a group of economists circulated a petition in support of Federal Reserve "independence," and against Congressional attempts to exercise increased oversight and governance.[14] The idea that the Fed must be independent of any external constraint and must not be audited, governed, or supervised in a serious manner has become a shibboleth of contemporary macroeconomic policy. But it should be challenged. I declined to sign the petition, for two reasons:

First, proponents of Fed independence focus exclusively on monetary policy, as if the Fed's Congressional critics simply want to know how the Federal Funds Rate is set. But the Fed conducts not only monetary policy but fiscal policy as well, increasingly so since 2008. If the Fed can buy and hold any assets it likes,[15] if it works hand-in-hand with the White House and the Treasury to coordinate bailouts in the hundreds of billions of dollars, if it facilitates trillion-dollar deficits by buying all the treasuries the federal government wants to sell, isn't it reasonable to have a bit more oversight? (And don't forget bank supervision. Even the Fed's defenders recognize a need to separate its monetary-policy and bank-supervision roles. But as long as the Fed continues as a bank regulator, shouldn't someone should be watching the watchmen?)

Second, and more generally, the Fed is a national economic planning agency, and it performs about as well as every national economic planning agency in history. Have we learned nothing from the collapse of centralized economic planning in the Eastern Bloc, its demise in China, and its crippling hold on places like North Korea? "Independence," in this context, simply means the absence of external constraint. There are no performance incentives and no monitoring or governance. There is no feedback or selection mechanism. There is no outside evaluation. Why would we expect an organization operating in that environment to improve overall economic performance? The Fed is run by men, not gods.

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[14] "Petition for Fed Independence," *Wall Street Journal*, July 15, 2009 (http://blogs.wsj.com/economics/2009/07/15/petition-for-fed-independence/).

[15] While the Fed primarily holds US Treasuries, it is legally permitted under Section 13(3) of the Federal Reserve Act to hold other assets under "unusual and exigent circumstances," a provision liberally exploited under the Bernanke Fed. See Christian A. Johnson, "Exigent and Unusual Circumstances: The Federal Reserve and the U.S. Financial Crisis," *European Business Organization Law Review* (forthcoming).

Supporters of independence argue that Congressional or other oversight will pressure the Fed to pursue short-term goals (boosting output) at the expense of long-term performance (controlling inflation).[16] But these arguments ignore what economists, following Ronald Coase and Harold Demsetz, call "comparative institutional analysis."[17] Of course, there are potential hazards associated with Congressional oversight, but also potential benefits of stronger governance and greater transparency. For instance, exposing monetary policy (and the Fed's other controversial actions, e.g. bailing out foreign central banks) to Congressional scrutiny could put pressure on the Fed to service short-term political goals, but under the present system, the Fed can make trillion-dollar bets without any monitoring and feedback system. Unfortunately, cost-benefit analysis is usually forgotten where the Fed is concerned. Consider Mark Thoma's defense of independence: "The hope is that an independent Fed can overcome the temptation to use monetary policy to influence elections, and also overcome the temptation to monetize the debt, and that it will do what's best for the economy in the long-run rather than adopting the policy that maximizes the chances of politicians being reelected."[18]

This naive wish is simply that, a hope. Where is the argument or evidence that a wholly unaccountable Fed would, in fact, "do what's best for the economy in the long-run"? What are the Fed officials' incentives to do that? What monitoring and governance mechanisms assure that Fed officials will pursue the public interest? What if they have private interests? Maybe they are influenced by ideology. Suppose they make systematic errors. Maybe they are unduly influenced by the banking industry or other special-interest groups. To make a case for independence, it is not enough to demonstrate the potential hazards of political oversight. You have to show that these hazards exceed the hazards of an unaccountable, unrestricted, ungoverned central bank. A naive faith in the wisdom of central bankers to do what's right just isn't good enough.

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[16] See, for example, Anil K. Kashyap and Frederic S. Mishkin, "The Fed Is Already Transparent," *Wall Street Journal*, November 9, 2009.

[17] Ronald H. Coase, "The Regulated Industries: Discussion," *American Economic Review* 54 (1964): 194–97; Harold Demsetz, "Information and Efficiency: Another Viewpoint," *Journal of Law and Economics* 12, no. 1 (April 1969): 1–22.

[18] Mark Thoma, "Why The Federal Reserve Needs To Be Independent," *CBS Moneywatch*, November 12, 2009 (http://www.cbsnews.com/8301-505123_162-39740151/why-the-federal-reserve-needs-to-be-independent/).

Do We Need a Central Bank?

Without a central bank, how can a monetary system work? Don't we need a central bank to create bank reserves? Isn't the Fed necessary to maintain stable prices? Don't we need the government to create and regulate money? Actually, the reverse is true.

One of the first scientific analyses of the nature and origin of money, Carl Menger's 1892 essay "On the Origin of Money," explains how money—a generally accepted medium of exchange—emerges from the trading patterns of individual market participants.[19] Menger was challenging the then-dominant "state theory of money," which held that money must be created, *ex nihilo*, by benevolent central planners. Rather, as decades of research in monetary theory and history have shown, there is no need whatsoever for government participation in the monetary and financial system. Money—whether a physical commodity like gold or silver or their paper equivalents—is essentially a commodity that is selected and "governed," so to speak, by the choices of entrepreneurs and consumers in the market. This is as true today, in an era of paper currencies and electronic payments, as it was under the international gold standard. There is no need for a government agency to increase or decrease the supply of money. Indeed, according to the Austrian school, government attempts to control the money supply create distortions in the economy by interfering with relative prices and warping the capital structure, encouraging the bad investments that manifest themselves over the course of the business cycle. Rather, the value of money should be determined on the market, as part of the normal, day-to-day process of exchanges between money and goods and services.

How, then, is price stability to be maintained? The answer is that the economy doesn't need "stable" prices, just market prices. Some of the proposals discussed at this hearing suggest removing the Federal Reserve Act's language about "maximum employment," keeping just the part about "stable prices." Eliminating the dual mandate would be a step in the right direction, as

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[19] Carl Menger, "On the Origin of Money," *Economic Journal* 2 (1892): 239–55; Peter G. Klein and George A. Selgin, "Menger's Theory of Money: Some Experimental Evidence," in John Smithin, ed., *What Is Money?* (London: Routledge, 2000), pp. 217–34.

it would reduce the Fed's incentive to increase the money supply when unemployment rates rise beyond some arbitrary threshold. But the requirement of price stability should be removed as well. The idea that a central bank is need to maintain a stable or modestly rising price level—to prevent high levels of inflation, in other words—is based on a misunderstanding of inflation. In a growing economy, with a stable or slightly growing money supply (as under a commodity standard), prices will tend to fall, as in the US during the 19th century, when the US experienced dramatic increases in production and living standards. Price levels rise because the real economy is shrinking or—as is almost universally the case in practice—because the money supply is increasing faster than the increase in real production. Inflation is not caused by an "overheated" economy that the government needs to somehow cool off. Inflation, as Milton Friedman famously put it, is everywhere and always a monetary phenomenon. Central banks don't fight inflation; they create it.

But isn't it vital that a government agency try to control interest rates, keeping interest rates sufficiently low to generate economic growth? Not at all. Interest rates are prices, prices that clear the markets between suppliers and demanders of loans. Increasing the money supply in an attempt to lower interest rates can indeed give the economy a short-term "boost," but at the cost of channeling resources into areas—housing, for instance—where the market does not want them to go. Driving down interest rates below their market-clearing rates does not create real economic growth, but only distortions, by making it more difficult for entrepreneurs to anticipate the future goods and services that consumers will want to purchase, and thus be profitable.[20] Credit expansion shifts wealth from savers to borrowers (and, in the case of mortgage lending, from renters to owners), from less time-sensitive investment projects to more time-sensitive ones; and from those who are last to receive the new money to those who are first in line.[21] In short, activist monetary policy always, whether intentionally or not, picks winners and losers, increases un-

[20] In Mises's terminology, credit expansion that lowers interest rates, increases price levels, and alters relative price ratios "falsifies economic calculation." Ludwig von Mises, *Human Action: A Treatise on Economics* (New Haven: Yale University Press, 1949), pp. 549 and 553.

[21] Mark Spitznagel, "How the Fed Favors the 1%," *Wall Street Journal*, April 19, 2012.

certainty, and destroys real wealth.[22] We don't want a government agency setting the price of tomatoes or shoes or forklifts or computer software; why do we want a government agency setting the price of loans?

What about the need for a lender of last resort? Even proponents of central banking recognize that the lender-of-last-resort function encourages what economists call "moral hazard": banks take on more risk than they would if they had to bear the full consequences of their portfolio decisions. The presence of a central bank, armed with an infinite supply of "liquidity," ready to supply liquidity to any bank in financial distress, discourages prudent behavior.[23] Diamond and Rajan link the Financial Crisis to "the actions of the Federal Reserve earlier in the decade, not only in convincing the market that interest rates would remain low for a sustained period following the dot-com bust because of its fears of deflation, but also in promising to intervene to pick up the pieces in case of an asset price collapse—the so-called Greenspan put.[24]

More generally, a dynamic, wealth-creating market economy relies on the power of competition—what Joseph Schumpeter famously called "creative destruction"—to sort between high-valued and low-valued use of resources, including the displacement of less efficient firms by their more efficient rivals. The banking industry is no different. If a bank, like any other business, cannot profitably produce goods and services that its customers demand, it should be liquidated and its assets made available to entrepreneurs who can do a better job. Bailouts, subsidies, and other forms of special privilege for particular entrepreneurs hinder the market process of directing productive resources to their highest valued uses. As Luigi Zingales reminds us, the price of bailouts is "billions of dollars in taxpayer money and, even worse, the violation of the funda-

[22] Robert A. Higgs, "Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War," *Independent Review* 1, no. 4 (1997): 561–90; Scott R. Baker, Nicholas Bloom, and Steven J. Davis, "Measuring Economic Policy Uncertainty," Working paper, Chicago Booth School of Business, 2011.

[23] Indeed, programs such as the Troubled Assets Relief Program are forms of corporate welfare that redistribute resources from the more prudent financial institutions—for example, banks that stayed out of the market for mortgage-backed securities—to the more reckless ones.

[24] Diamond and Rajan, p. 33.

mental capitalist principle that she who reaps the gains also bears the losses."[25] Besides explicit bailouts, implicit subsidies from "too-big-to-fail" guarantees stymie the entrepreneurial selection process, not only by protecting unsuccessful entrepreneurs and entrepreneurial ventures, but also by rewarding lobbying and other forms of rent-seeking, directing investment toward subsidized activities (at the expense of consumer preferences), and discouraging entry by nascent entrepreneurs who lack political connections.

These principles apply fully to the banking industry. Of course, financial firms are closely linked through complex transactions and instruments such as derivatives and other contracts. The failure of a particular financial institution imposes costs on various counterparties, including other financial institutions. But the production of virtually every good and service in a mature industrial economy is characterized by a complex, interlocking web of transactions, mutual obligations, and contractual relationships. Banking is not unique in this regard. Yet we do not worry about contagion effects sweeping the computer hardware or retail clothing or dairy industry should one or two leading firms go bankrupt. Moreover, the extent to which parties expose themselves to counterparty risks, in banking or any other industry, depends on the protections offered by the regulatory system. If a computer hardware company knows that it is Too Big to Fail, or that a Computer Industry Resource Provider of Last Resort stands ready to supply labor, machines, and raw materials in case of trouble, that company will engage in all kinds of risky behaviors it would have otherwise avoided.

Alternatives to Central Banking

Many scholars and practitioners support the Federal Reserve System, and central banking more generally, because they cannot conceive of any alternative. "If we got rid of the Fed," they ask, "who would control the money supply?" Of course, to ask the question that way is to answer it: the market would control the money supply, just as it "controls" the tomato supply, the shoe supply, the forklift supply, and the Angry Birds supply.

[25] Luigi Zingales, "Why Paulson is Wrong," VoxEU, September 21, 2008 (http://www.voxeu.org/index.php?q=node/1670).

Exactly how a market-based monetary system would function, what form it would take, and how an economy can transition from government-controlled to market-based money, are interesting and important subjects that have stimulated large and growing academic and practitioner literatures.[26] Most proponents of market-based money favor a commodity standard, though competing paper currencies have been suggested as well.[27] All these schemes have the basic advantage of taking the value of money out of the hands of government planners, allowing it to be determined by supply and demand, as with every other good and service in a market economy.

Another advantage of a commodity standard is that it prevents allowing a central bank to monetize the government's debt by purchasing government bonds (and reducing debt payments by generating price inflation). In the interest of transparency, it is far better to require that federal government spending be financed through taxation or borrowing from the public. Wouldn't this constrain the federal government's ability to "stimulate" the economy with increased spending during times of recession? Yes, and that's exactly the point—a commodity standard imposes fiscal discipline, something the US economy desperately needs. Such discipline would rescue entrepreneurs from the unpredictable and often arbitrary whims of monetary planners, freeing them to invest, innovate, and create economic growth—not just in the long run, but in the short run as well.

Conclusion

There is an old joke about a central bank official picking up a pizza. (Perhaps it's Chairman Bernanke, on his way home after a long day of quantitative easing.) The clerk asks, "Do you want it cut in six slices, or eight?" The central banker responds: "I'm feeling extra hungry today; better make it eight."

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[26] Murray N. Rothbard, "The Case for a 100 Per Cent Gold Dollar," in Leland Yeager, ed., *In Search of a Monetary Constitution* (Cambridge, Mass.: Harvard University Press, 1962), pp. 94–136; Friedman, *A Program for Monetary Stability,* pp. 4–8; George A. Selgin and Lawrence H. White, "How Would the Invisible Hand Handle Money?" *Journal of Economic Literature* 32, no. 4 (1994): 1718–49; Rothbard, *The Case Against the Fed* (Auburn, Ala.: Ludwig von Mises Institute,1994), pp. 146–51.

[27] F. A. Hayek, *Denationalization of Money*. London, Institute of Economic Affairs, 1974.

Of course, dividing the stock of goods and services by a larger quantity of money does not create wealth. One of the most important lessons of economic theory is that the only way for a society to generate economic growth is to consume less than it produces. The surplus (real savings) can be invested in the production of capital goods (and innovation) that allows for greater production in the future. Conversely, one of the oldest economic fallacies is the idea that the economy sometimes gets "stuck" with low production and high unemployment due to a shortage of money, and that the way to get it unstuck is to print more money to increase "total spending"—to consume more than the economy produces. Some sixty years ago Ludwig von Mises ridiculed this as the "spurious grocer philosophy" (the merchant's view that his products aren't selling because buyers lack enough currency), noting that this fallacy is essentially the philosophy of Lord Keynes, the twentieth-century apostle of central banking and macroeconomic stabilization policy.

Keynes was wrong. Cheap credit does not help bring an economy out of recession (particularly when it was cheap credit that caused the recession in the first place). More generally, a monetary system controlled by an all-powerful central bank is inherently destabilizing and harmful to economic growth. The mistakes made by the Fed before and after 2008 are not isolated incidents, mistakes that can be corrected by making minor changes to the Fed's charter, structure, or independence. They are the predictable result of giving control of the monetary and financial system to a government agency. The best option is to replace the central bank and let the market be in charge of money.

The position advocated here is often dismissed as radical or extreme, a kind of "market fundamentalism" (to use a derogatory term). But it is a reasonable, pragmatic, realistic view. Economics and management scholarship teach that monopoly providers are inefficient and ineffective, and a government monopoly on money is no different. Markets are not perfect, but neither are Fed chairs. It's time to make the supply of money independent of political interference.