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Robust Political Economy and the Federal Reserve

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Abstract:

The economics profession not only failed to predict the recent financial crisis, but has been struggling in its aftermath to reach a consensus on the cause(s) of the crisis. While competing narratives are being offered and evaluated, the narrow scope of the debate on strictly technical aspects of monetary policy has precluded the examination of broader questions of political economy that may prove to be of greater import. Attempting to find the technically optimal policy is futile when policy is crafted and implemented in a contemporary democratic setting characterized not by omniscience and benevolence, but by fallibility and competing special interest factions. Nobel Laureates Milton Friedman, F.A. Hayek and James Buchanan each sought ways to constrain a monetary authority and each ended up rejecting the possibility of doing so. We incorporate their experiences to make a case for applying the concepts of robust political economy to the Federal Reserve. Robust political economy calls for relaxing idealized assumptions in order to seek out institutional regimes that can overcome both the epistemic and motivational hurdles that characterize contemporary democratic settings.

JEL Codes: E58, E61, P16

Key Words: monetary policy, Federal Reserve, robust political economy, current financial crisis

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"To shy away from consideration of the politically feasible has been deemed an admirable trait, but to refuse to examine the politically possible is incomplete scholarship."
-Nobel Laureate James M. Buchanan, 1962

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1 Introduction

The recent financial crisis caught the economics profession off-guard, with no immediate explanation for the cause of the financial crisis. Old hypotheses are being revived, and a few new ones advanced, but even two years after its onset, the profession is still struggling to come to a consensus on the cause(s) of crisis, let alone come to a consensus on what alternative courses of action could have been taken to prevent it. Monetary theorists have devoted a considerable amount of their scholarly attention to examining the role of monetary policy in the financial crisis, as well as examining the propriety of the chosen monetary policy measures taken in the wake of the financial crisis. These technical debates are certainly vital to sort out, especially with the reemergence of previously disbanded Keynesian remedies (see Boettke, Smith & Snow, *forthcoming*). Yet, with the debate so intently focused on calculating the technical specificities of what monetary authorities did or didn't do correctly, the profession is missing the insights that a broader perspective of political economy could bring. Friedman (1947, 415), in his review of Abba Lerner's *Economics of Control*, criticized the strictly technical focus of Lerner,

> *"…Lerner writes as if it were possible to base conclusions about appropriate institutional arrangements almost exclusively on analysis of the formal conditions for an optimum. Unfortunately, this cannot be done. It has been long known that there are alternative institutional arrangements that would enable the formal conditions for an optimum to be attained."*

While the political economy costs are often acknowledged, or at least admitted, they are not being fully absorbed into the current analyses of the crisis. From the start it is assumed that the Federal Reserve has the motivational and cognitive skills necessary to achieve the goals entrusted to them, as long as economists hand them the right theory to

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work with. From there, the debate focuses exclusively on which theory is the correct theory for the Federal Reserve to work off of. As Kane (1980) explains it,

> *"[t]his utopian conception of Fed intentions and tactics is carefully nurtured in Fed publications and official statements. Fed leaders depict themselves as waiting in anguish for the economics profession finally to develop an adequate model of how monetary policy truly works."*

Robust political economy theoretically denies politicians and bureaucrats the unrealistic assumptions of omniscience and benevolence. A consistent behavioral assumption is applied to both economic man and political man, one that accounts for his self-interest, short-sightedness and knavery. In other words, robust political economy holds that political institutions must be designed robustly for the real erring man, not designed fragilely for the nonexistent perfect man. In addition, robust political economy factors into account incentives and information, and the costs of administration, which are ignored in technical debates.

With the U.S. national debt approach $13.7 trillion, making the gross debt to GDP ratio close to 94% (see Graph 1), perhaps the U.S. has found itself in the position discussed by Adam Smith in Book 5 of the Wealth of Nations (Smith, 1981[1776]). Smith argues that once a government's debt has accumulated to a certain extent, the chances of it actually being paid off become increasingly smaller because governments will avoid politically unpopular solutions such as cutting spending or raising taxes. Instead, governments will resort to 'juggling tricks' to attempt to push the debt problems into the future. Historically, one of the favored and pernicious 'tricks' employed by governments to stave off the problems of debt into the future is through currency inflation. The monetary base in the U.S. has more than doubled in the last couple years, in November, 2009 it stands at $1.9 trillion (see Graph 2).

A fascinating window into the robust political economy of money and banking can be gleaned by a study of the evolution of the ideas of Nobel Laureates Milton Friedman, F.A. Hayek and James Buchanan on monetary policy. Though they are often seen as clashing vociferously on issues in economics despite their ideological kinship, on the question of monetary policy they all advocated versions of a monetary rule within a central bank regime only to abandon faith in monetary policy-makers and to advocate the substitution of a computer (Friedman), the denationalization of money altogether (Hayek) and Constitutionalization (Buchanan) later in their lives.

In section 2 we explore the development of F.A. Hayek's thinking on monetary regimes. We do the same for Milton Friedman in section 3, and James Buchanan in section 4. Section 5 examines the influence of public choice on monetary institution analysis. Section 6 concludes.

2 F. A. Hayek from Monetary Nationalism to Denationalization of Money

Hayek stressed the need for a central bank in his early works. Hayek (1978[1960], 324) argued that we could not rely on the spontaneous forces of the market to supply a reliable means of exchange,

> *"It is important to be clear at the outset that this is not only politically impracticable today but would probably be undesirable if it were possible."*

In a footnote, Hayek (1978[1960], 520) explained his position, stating that he was convinced that a central bank was necessary, though he was also doubtful whether it was desirable or necessary for there to be a government monopoly on note issue. Hayek (1978[1960], 325) referred to money as a sort of a 'loose joint' in an otherwise self-adjusting market economy, one that if it was not correct, could interfere with the entire

self-adjustment process of the market, and rendering a central bank was necessary. He provided three reasons for this view. First, he held that disruptions in the supply of money were far more harmful to the economy than disruptions in other commodities. Changes in the supply of money cause ripples that gradually expand throughout the economy, altering relative prices, thus Hayek argued, a monetary authority was necessary for stability.

Second, Hayek felt that a central bank was necessary because the supply of money was closely related to credit. For Hayek, a central bank was necessary to avoid recurring fluctuations by supplying or restricting credit when the spontaneous fluctuations of the market caused either an oversupply or undersupply of credit. Hayek believed, at that time, that this was a function that could not be carried out by market forces.

Third, Hayek believed a central bank was necessary because of the magnitude of government expenditures in relation to national income. While he held that the high level of government expenditure was undesirable, Hayek felt a central bank was necessary if it did exist. While Hayek argued that it would be desirable to divorce monetary institutions as much as possible from fiscal policy financing, under these conditions of high government expenditures, relative to national income, Hayek held that monetary policy needed to be coordinated with the financing of fiscal policies.

Hayek (1976a) showed a growing disillusionment over the ability of government to manage monetary affairs with the publication of *Choice in Currency*, an essay based off a speech he had delivered at the Geneva Gold and Monetary Conference,

> *"I do not want to question that a very intelligent and wholly independent national or international monetary authority might do better than an*

> *international gold standard, or any other sort of automatic system. But I see not the slightest hope that any government, or any institution subject to political pressure, will ever be able to act in such a manner."*

Hayek went on, "…money is certainly too dangerous an instrument to leave to the fortuitous expediency of politicians – or, it seems, economists." Hayek (1976b) followed up this lecture with a more in depth publication, the *Denationalisation of Money*. In it, Hayek explores the theoretical possibility and political feasibility of eliminating government's monopoly on note issue due to his frustration with government's monopoly on currency invariably leading to inflation, economic instability, undisciplined fiscal profligacy and economic nationalism.

Hayek now held that in a contemporary democratic setting, characterized by special interest groups, there will always be some group clamoring for inflationary measures that will benefit them in the short-term. Politicians, thinking not about the long-run consequences of their policies, but their next election, have the incentive to pursue inflationary policies, even if they are at odds with the general interest. These inflationary policies, along with their concomitant artificially low interest rates, which disable the free market natural interest rate brake (Hayek 1975 [1933], 94), leads to unsustainable overinvestment. Absence politically unpopular, and economic disastrous perpetual inflation, this overinvestment must eventually come to an end, leading to a recession as resources are reallocated to bring the distribution of the type of the supply of capital and labor resources into alignment with the that of demand (Hayek 1950). The control of money also assisted in the wholesale adoption of Keynesian policies in the political realm. Government has witnessed a vast increase in size, relative to national income,

since the elimination of a budgetary check on fiscal policies due to its ability to commandeer monetary policy.

Allowing competition in currency, Hayek (1976b, 100) argues, is the only way to eliminate these undesirable features of government control,

> *"We have always had bad money because private enterprise was not permitted to give us a better one. In a world governed by the pressure of organized interests, the important truth to keep in mind is that we cannot count on intelligence or understanding but only on sheer self-interest to give us the institutions we need. Blessed indeed will be the day when it will no longer be from the benevolence of the government that we expect good money but from the regard of the banks for their own interest."*

Hayek goes on,

> *"A single monopolistic governmental agency can neither possess the information which should govern the supply of money nor would it, if it knew what it ought to do in the general interest, usually be in a position to act in that manner…Money is not a tool of policy that can achieve particular foreseeable results by control of its quantity. But it should be part of the self-steering mechanism by which individuals are constantly induced to adjust their activities to circumstances on which they have information only through the abstract signal of prices."*

To be accurate, Hayek wasn't actually advancing ideas that were entirely new to him, just ones that he previously entertained and germinated but never fully developed theoretically until later in his life. Hayek (1950, 184) had entertained doubts about the ability of a monetary authority to constrain themselves prior to his arguments for the necessity of a central bank in the *Constitution of Liberty*,

> *"It was certainly wise that at a time when the scope and objectives of monetary policy were much more limited, its direction was placed in the hands of bodies not directly subject to political control. It is understandable and perhaps inevitable that once the much greater use of these powers is recognised, it should become a major political issue. But it must appear more than doubtful whether in the nature of democratic institutions it is possible that democratic governments will ever learn to exercise that restraint, which is the essence of economic wisdom of not*

using palliatives for present evils which not only create worse problems later but also constantly restrict the freedom of further action."

Hayek (1978a) released a second edition of the *Denationalisation of Money*, with the subtitle, "The Argument Refined," which expanded upon and added to his arguments in the first edition. Most conspicuously is the expansion of his "Monetary Policy Neither Desirable Nor Possible" chapter, which included an addition of a subchapter on "The abolition of Central Banks," in which Hayek argues that with the elimination of government's monopoly on money would come the elimination of the central bank, as well as, in particular, government interest rate policy. Just like any other price in the market, Hayek argued that interest rates should be allowed to develop in the free market, transmitting the myriad circumstances affecting the supply and demand of money that no central agency could ever know. Though, even under this regime, the government would still have some influence over interest rates through debt financed fiscal policies, but it could no longer artificially keep the interest rate low in order to borrow cheaply. Hayek (1999[1980], 239) argued in free market competition of currency that,

"…a private institution which must issue money in competition with others can only remain in business if it provides the people with a stable money which it can trust. The slightest suspicion that the issuer was abusing his position when issuing money would lead to a depreciation of its value and would at once drive him out of business. The constant danger of losign the customers of one's business is a better disciplining force and will be more effective to maintain the value of money, than anything else. It would operate in such a way that, at the slightest rumor that one money was decreasing in value as compared to other currencies, everybody would try to get rid of the money threatened with depreciation and exchange it for a money which inspires more confidence."

4 Milton Friedman from the Quantity Theory Restated to K% to Inflation Targeting

In his early work, Friedman (2002[1962]0, 38), argued that a central bank was necessary to "…provide a stable monetary framework for a free economy…" as part of providing a stable legal and economic framework that would allow individuals to carry out their own plans. Even in those early days, Friedman (2002[1962], 27) understood the importance of the monetary function, and the importance of properly monitoring and restraining the authority,

> *"Government responsibility for the monetary system as long been recognized. It is explicitly provided for in the constitutional provision which gives Congress the power "to coin money, regulate the value thereof, and of foreign coin." There is probably no other area of economic activity with respect to which government action has been so uniformly accepted. This habitual and by now almost unthinking acceptance of governmental responsibility makes thorough understanding of the grounds for such responsibility all the more necessary, since it enhances the danger that the scope of government will spread from ativities that are, to those that are not, appropriate in a free society, from providing a monetary framework to determining the allocation of resources among individuals."*

Friedman (1968, 12), believed that the proper conduct of monetary policy should be to pursue such policies as would ensure that money does not become a source of economic disturbance. Friedman sought to create a monetary regime that entrusted the Federal Reserve with enough discretion to achieve this goal, but also limited the ability of the Federal Reserve to generate adverse swings in policy by giving the Federal Reserve a stated and known target rate of currency growth. Friedman argued that this type of monetary regime was not only optimal, but politically feasible as well,

> *"…steady monetary growth would provide a monetary climate favorable to the effective operations of those basic forces of enterprise, ingenuity, invention, hard work, and thrift that are the true springs of economic growth. That is the most we can ask from monetary policy at our present*

stage of knowledge. But that much—and it is a great deal—is clearly within our reach."

Friedman (2002[1962], 38) argued for chartering a course for monetary policy in between two extreme views that he felt were economically and politically undesirable. The one course, which he labeled the 'Scylla' belief, held that a purely automated gold standard was the only politically feasible and economically desirable monetary regime. The other course, which he labeled the 'Charybdis' view, held that the monetary authority should be granted wide discretionary powers in order to respond to unforeseen circumstances. Both views, he believed, had failed in the past, and would likely continue to fail in the future. Friedman (2002[1962], 54) proposed doing this by a legislated rule that would mandate a specific rate of growth in the stock of money for the monetary authority. In addition, and less important, proposed additional restraints on the monetary authority's discretion in choice of methods to achieve the target rate of growth in the money stock in order to eliminate the "…the present governmental intervention into lending and investing activity…" and to turn government "…financing operations from a perpetual source of instability and uncertainty into a reasonably regular and predictable activity." This type of rule would be the "…only feasible device currently available for converting monetary policy into a pillar of a free society rather than a threat to its foundations." Perhaps Friedman's early views are best summed up by Kane (1980),

> *"…monetarism can be interpreted as a compromise movement whose principal goal is to liberate the Fed from procyclical political pressures by refocusing the Fed's intermediate policy targets from sectorally non-neutral interest rates to average rates of growth in monetary aggregates. The monetarist control strategy holds out the hope that the Fed can validate the utopian conception by loudly and steadfastly denying all responsibility for stabilizing nominal interest rates in the short run."*

Roughly 20 years later, Friedman & Schwartz (1986, 59) revealed that their belief in the desired course had moved closer to the 'Scyalla' view, and that monetary authority should be more tightly bound,

> *"Even granted the market failures that we and many other economists had attributed to a strictly laissez-faire policy in money and banking, the course of events encouraged the view that turning to government as an alternative was a cure that was worse than the disease, at least with existing government policies and institutions. Government failure might be worse than market failure…Our personal conclusion…is that rigid monetary rule is preferable to discretionary monetary management by the Federal Reserve."*

Friedman's development in his thinking on the proper monetary regime showed an even more abrupt turnabout after another 20 years. When asked if it would be desirable to turn monetary policy over to a computer, in an interview published posthumously, Friedman (2007) replied,

> *"Yes. Of course it depends very much on how the computer is programmed. I am not saying that any computer program would do. In speaking of that, I have had in mind the idea that a computer would produce, for example, a constant rate of growth in the quantity of money as defined, let us say, by M2, something like 3% to 5% per year. There are certainly occasions in which discretionary changes in policy guided by a wise and talented manager of monetary policy would do better than the fixed rate, but they would be rare.*
>
> *In any event, the computer program would certainly prevent any major disasters either way, any major inflation or any major depressions. One of the great defects of our kind of monetary system is that its performance depends so much on the quality of the people who are put in charge. We have seen that in the history of our own Federal Reserve System. Surely a computer would have produced far better results during the 1930s and during both world wars.*
>
> *That raises a question about the desirability of our present monetary system. It is one in which a group of unelected people have enormous power, power which can lead to a great depression or which can lead to a great inflation. Is it wise to have that power in those hands?"*

Friedman, even went on to suggest the elimination of the Federal Reserve,

> *"An alternative would be to eliminate the Federal Reserve System; to reduce the monetary activities of the federal government to the provision of high-powered money, that is, currency and bank reserves, and to constitutionalize, as it were, what is to be done with high-powered money. My preference is simply to hold it constant and let financial developments produce the growth in the quantity of money in the form of bank deposits, a process that has been going on for many decades. But that is, of course, politically impossible."*

5 James Buchanan From Brick Standard to Monetary Constitution

James Buchanan, sought to bring his extensive work on rule-making to bear in envisioning a monetary regime that could operate within a contemporary democratic setting. From the start, Buchanan (1999[1962]) eschewed the 'presuppositions of Harvey road' that held that economic policy would be crafted and implemented by a group of benevolent and enlightened elites. Buchanan set out to make the case for a monetary regime using comparative institutional analysis that compared monetary regimes in real, not ideal settings.

Buchanan (1999[1962]) believed that it was not so much the specific type of monetary regime adopted, but the set of rules that defined that regime. Buchanan argued that the brick standard, a labor standard, or a manager confined by well-defined rules, would all put a stop to the government growth let loose by the fiscal profligacy encouraged by the wide scale acceptance of Keynesian ideas in the political realm (see Buchanan and Wagner (2000[1977]). The brick standard, as defined by Buchanan, would be a monetary regime that allowed anyone to go to the mint with a standard building brick of a specified quality and exchange it for the monetary unit, and vice versa. As the general price level fluctuated, market forces would cause automatic adjustments as people would exchange money for bricks when the price level rose above the equilibrium

level, and bricks for money when the price level fell below the equilibrium level. Under this regime, market actors, guided by profits and losses would be the mechanism that achieved price predictability, not a government-entity entrusted with the goal of achieving it. In addition, a brick standard would, most likely, divorce domestic monetary policy from international balance of payment and exchange rate policies due to the fact that a brick standard would be unsuitable for those purposes.

For Buchanan (1999[1962], 417), it came down to a toss-up between a brick type standard and a limited manager. What mattered most for monetary predictability was that the rules that set up the monetary regime must be of the 'constitutional' variety. In other words, the rules must be set to be 'relatively absolute absolutes' in order to protect them from tampering.

After witnessing the Keynesian-inspired growth in government, Buchanan became more wary of the ability to confine a monetary authority. Buchanan (1986) "[a]t best, therefore, the truly benevolent despot can only be partially successful, even given the most clearly defined target for policy." Then criticizing the benevolence assumption, Buchanan goes on "…it is evidence, quite apart from any historical record, that the despot will find it advantageous to resort to money creation over and beyond any amount that might characterize the 'ideal' behavior of the benevolent counterpart considered above."

In the wake of the onset of the current financial crisis, Buchanan's (2009a) views have progressed even further,

> *"Critical evaluation and assessment suggests that the structure of the whole monetary economy is flawed, which points toward genuine constitutional revolution rather than either a change in participants or piecemeal adjustments in the regulatory apparatus."*

Buchanan (2009b) went so far as to assert that "…the 2009 monetary settings carries an eerie similarity to that in the seventeenth-century imagination of Thomas Hobbes concerning nonmonetary rights and claims." Buchanan goes on to argue for the constitutionalization of money,

> *"Explicit constitutionalism would also embody the requirement that the monetary authority itself be bound by the rules of basic contract. Beyond narrow limits, discretion on the part of the authority goes outside the dictates of constitutional criteria."*

5 The Public Choice Awakening of the 3 Leading Classical Liberal Thinkers in the 20th Century

Hayek, Friedman and Buchanan all set out to find a monetary regime that could be constrained. Each of them ended up rejecting the possibility, mainly due to the fact that the Federal Reserve seems incapable of being independent of the Federal Government. Since the inception of the Federal Reserve, and especially since the Great Depression, when theories about the mismanagement of the Central Bank started to be advanced, there has been the question of how independent can the Federal Reserve be in a contemporary democratic setting. Despite the façade of independence, there are key channels of influence that politicians exert over the Federal Reserve. The chief officials are nominated by the president and approved by the senate. Furthermore they are subjected to highly publicized Congressional committee hearings on a regular basis on their performance.

Given that there is a political influence exerted on the Federal Reserve, there is a line of research that seeks to discover the particular way in which this influence is manifested. Kane (1980) argues that politicians purposely foster the image of Federal Reserve independence in order to use it as a scapegoat during economic downturns. Kane

addresses the inability of the Federal Reserve to even get close to its target policies in the late 1970s, and questions the ability of target rates to rein in political influence, "[g]iven that the ranges are fairly wide to begin with and change only slightly from one Congressional appearance to the next, the Fed's failure to meet them leads one to doubt whether in any meaningful sense they are targets (or limits of 'tolerance') at all." Kane came to the conclusion that the Federal Reserve, in essence operates as a scapegoat for incumbent politicians especially in order to increase the monetary base in order to decrease unemployment. Any unfavorable economic performance is subsequently blamed on the Federal Reserve, typically illustrated by the frequent congressional hearings that the FED chairman is subjected to during economic downturns.

Political business cycles are another theory offered for how political influence is exerted over the Federal Reserve. Nordhaus (1975) framed the general political trade-off between inflation and unemployment, and theorized that politicians have the incentive to maintain fiscal austerity at the beginning of a term, and then engage in fiscal profligacy when it came time for an election. This theory was purported to be supported with empirical research done by Kramer (1971), Fair (1978) and Tufte (1975). Alesina and Sachs (1988), believing the evidence on political business cycles to be inconclusive, refine the Nordhaus model to include partisan considerations, as well as rational and forward looking expectations. Since each political party pursues a different inflation/unemployment policy agenda, during election periods, the future policy trade off between inflation and unemployment is uncertain. They offer empirical evidence to support their thesis that a partisan political business model more accurately describes the particular way in which political factors influence monetary policy.

Instead of characterizing the political business cycle as a tradeoff between inflation and unemployment, Wagner (1977), explains political business cycles as the result of politicians attempting to increase spending in swing districts. Policies that attempt to decrease unemployment across the board would be inferior to using government seigniorage to fund projects in key districts as a re-election strategy. Scholars began to more heavily question the unrealistic incentives imparted to monetary authorities. Kane (1980), eschewing the ideal assumptions of benevolence on the part of the Federal Reserve,

> *"Economist critiques of FOMC (Federal Open Market Committee) policy choices typically treat the Federal Reserve System as a sovereign decision maker, whose managers seek single mindedly to promote the public interest at every turn. From this perspective, choosing strategy and tactics for monetary control becomes a straightforward exercise in applied welfare economics, albeit one with difficult stochastic complications. With Fed bureaucracy and bureaucrats having no contending interests of their own, the central bank's policy task becomes merely to maximize the expected value of a constrained social welfare function. This utopian objective function is defined over a set of policy gods (ideal values for specific dimensions of national economic performance) and is represented as a decreasing function of squared (or absolute) deviations from these goals."*

Eventually the question scholars came to focus their attention on is not if the Federal Reserve was independent, but given that it wasn't, what mechanisms could be used to restrain it. There has been an ongoing debate as to the desirability of constraining the Federal Reserve with stringent rules or allowing the Federal Reserve the leeway to respond to changing economic circumstances. Stokey (2002) summarizes the debate after 25 years,

> *"Of course, in the long run monetary and fiscal policy are linked through the government's budget constraint. Good monetary policy is simply in-feasible without a conservative (balanced budget) fiscal policy. A government that runs substantial deficits, with no prospect of surpluses to*

retire the accumulating debt, will eventually fail in its efforts to float new bond issues. The problem is exacerbated if, as is typically the case, old debt must be rolled over as well. At some point the only feasible options are outright default, a large devaluation, or both. A government facing that situation typically finds the seignorage revenue from a large devaluation too attractive to resist, and monetary policy becomes the fiscal policy of last resort."

Selgin, Lastrapes and White (2010), using the Fed's own objectives, evaluate the record of its record, finding that since the inception of the Fed, there have been more symptoms of monetary and macroeconomic instability. Given this failure, it is perplexing that the contemporary debate on the appropriate Fed policy, especially in the wake of the financial crisis, has lead to a concentration of scholarly focus on the technical considerations of monetary theory. Once in this debate, economists lose sight of an essential wisdom of the classical political economists, as F. A. Hayek wrote,

"...the main point about which there can be little doubt is that [Adam] Smith's chief concern was not so much with what man might occasionally achieve when he was at his best but that he should have as little opportunity as possible to do harm when he was at his worst. It would scarcely be too much to claim that the main merit of the individualism which he and his contemporaries advocated is that is a system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid."

A research program in robust political economy is one that sets on an intellectual quest to find an institutional set that permits neither the assumption of benevolence nor the assumption omniscience (Boettke and Leeson, 2004). David Hume once remarked that it is a maxim that,

"…in contriving any system of government, and fixing the several checks and controuls of the constitution, every man ought to be supposed a knave, and to have no other end, in all his actions, than private interest. By this interest we must govern him, and, by means of it, make him, notwithstanding his insatiable avarice and ambition, co-operate to public

good. Without this," Hume adds, "we shall in vain boast of the advantages of any constitution, and shall find, in the end, that we have no security for our liberties or possessions, except the good-will of our rulers; that is, we shall have no security at all."

It wasn't until the adoption of public choice into economics that these postulates of Smith and Hume were more fully incorporated into the theorizing of the economics profession. Buchanan and Brennan (1981)

> *"The model of political process implicitly assumed in most orthodox discussion of economic policy has made profoundly different assumptions about individual behaviour from the corresponding assumptions made in market settings. It has only been in the last 20 years with the burgeoning of public choice that this grotesque asymmetry has been exposed, and the 'benevolent despot' model of politics been seriously queried."*

Unfortunately, these essential wisdoms have not been incorporated into monetary theory. In discussing monetary policy in the wake of the crisis there are theoretical ideas which many believe to be true which are in fact not true, and there are ideas which while true are impractical at the current moment. But there are also ideas which are only true if we permit the introduction of assumptions which should not be permitted if we want to think about robust political economy. It does us little good to assume benevolence and omniscience on the part of public policy decision makers.

Perhaps the only way to constrain monetary policy is by eliminating the state monopoly of it. Instead of seeking technical optimums that are never realized in practice due to the frailty of the Federal Reserve to the pressures and shortcomings of the contemporary democratic setting in which policy is actually enacted. A free market in banking, just as the Scottish Enlightenment thinkers realized for any free market, is robust to short-sightedness and knavery, unlike arguments for government control which so often rest on assumptions of benevolence and omniscience rending the government

institution unsuited for realistic conditions. White and Selgin (1994) in their summary of the insights found in free banking literature strongly suggest that this alternative is viable. Selgin, Lastrapes and White (2010) offer

6 Conclusion

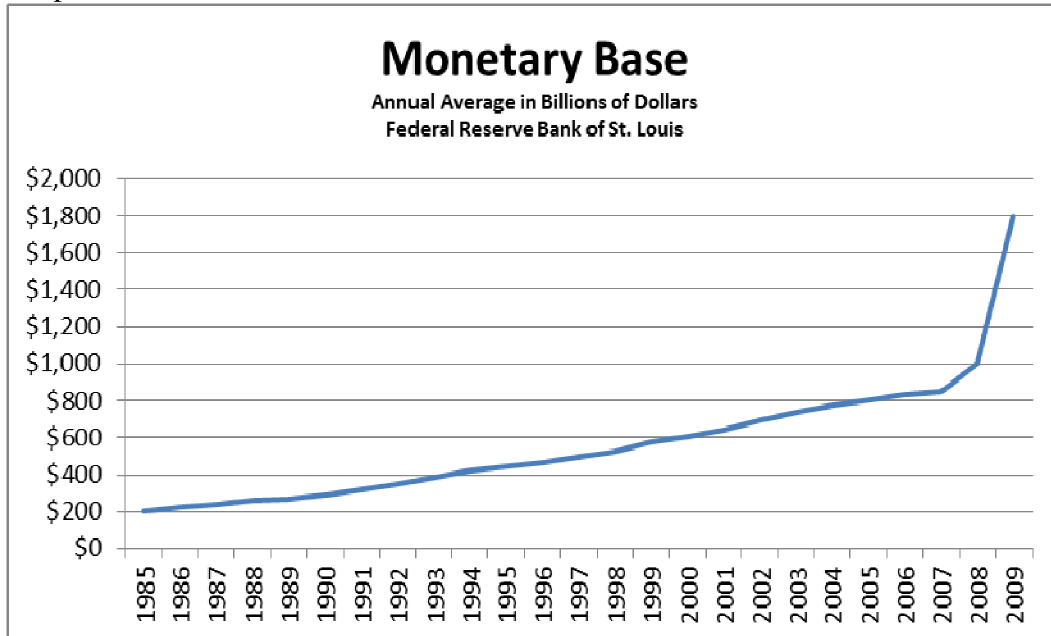
What in our contemporary history of central bank policy should give us any reason to not follow Friedman and tie the hands of the monetary authority so tightly that the bonds cannot be broken, let alone Hayek and point out that the only robust political economy option when it comes to central banking is to abolish it? While Hayek, Friedman and Buchanan lead us towards this solution through their evolving ideas and scholarship on the application of the concepts of robust political economy to monetary regimes, there has been recent scholarship that has advanced their thinking even further. White and Selgin (1994) review research in free banking. While they find theoretical case for competitive money to be quite sound, they do acknowledge that free banking is not an immediately politically feasible option. Hayek (1999[1980], 247) as well, questioned the political feasibility of eliminating the government monopoly on note issuance,

> *"But through years of further reflection of the problem have only confirmed my belief that this ought to be the final solution of our money problems. I cannot close my eyes to the fact that any hope for a voluntary abdication by governments of their present monopolies of the issues of circulating currency is utopian. Yet this is the only way in which we will ever get back to honest money again while at the same time ridding ourselves of the evils of depression, unemployment and general disorganization on the market. Governments have become dependent on their power to create money for the finance of their own activities. They regard this ability as so essential a weapon of their economic policy, that they will probably defend to the last, not merely all the explicit power the law has conferred upon them, but also any other power which they can obtain."*

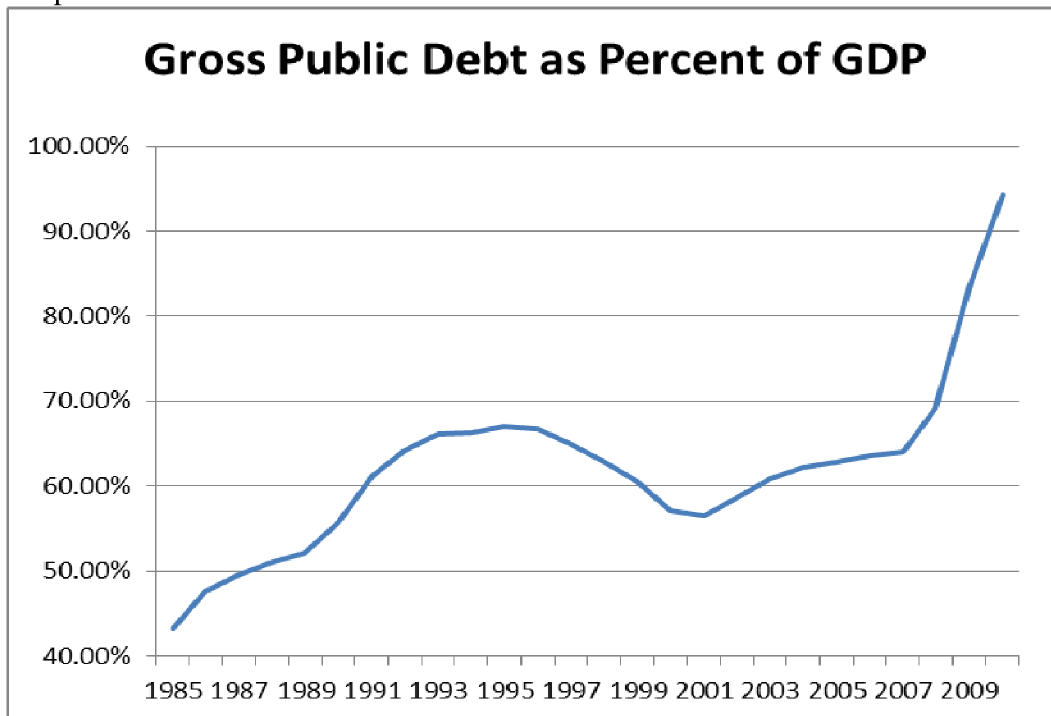
As Friedman and Schwartz (1986) explain, even if there is no current political aperture for the type of monetary regime that Hayek, Friedman and Buchanan were lead to support, it is the job of academics to have theories worked out and prepared for when they are needed. And as Selgin and White (1994) conclude, "…a verdict on the desirability of monetary laissez faire may motivate the direction taken by marginal reforms, within the constraints of the politically possible." While we admonish the monetary theorists who focusing exclusively on technical considerations of monetary theory that fall outside of the realm of the politically possible, free banking in the end, also falls outside the realm of the politically possible. The key distinction is that in the first case, political possibility refers to the epistemic and motivational constraints of man as man, and the second case, it is referring to what ideas have advanced to a stage of acceptance that would make them possible to implement in a contemporary democratic setting. In other words, it is impossible to implement a monetary regime that is based off of ideal assumptions among real men, but it is possible to implement a robustly designed monetary regime, it just takes various iterations to get people to accept the idea.

Graphs

Graph 1



Graph 2



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