

A GOLD STANDARD WITH FREE BANKING WOULD HAVE RESTRAINED THE BOOM AND BUST

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President George W. Bush famously remarked in July 2008 that during the housing boom “Wall Street got drunk . . . and now it has a hangover.” It was the Federal Reserve that spiked the punchbowl. The Fed sowed the seeds for the bust of 2007–08 by overexpanding credit, keeping interest rates too low for too long. The Fed made these mistakes despite our having been assured that it had learned from past errors and that the art of central banking had been all but perfected. A commodity standard with free banking, and no central bank to distort the financial system, would have avoided such a boom-and-bust credit cycle.

To very briefly recap the cycle, the Fed in 2001–06 kept interest rates too low by injecting too much credit (White 2008, Taylor 2009). A disproportionate share of that credit flowed into housing, channeled there by federal subsidies and mandates for widening home ownership by relaxing mortgage creditworthiness standards. The dollar volume of real estate lending grew by 10–15 percent per year for several years—an unsustainable path. Rising real estate prices bred the illusion that creative mortgages to noncreditworthy borrowers were safer than previously thought. When prices leveled off, the truth was revealed. The re-establishment of sustainable housing prices has revealed scads of nonviable mortgages.

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Alternative Regimes

The boom-bust scenario could not have happened under a commodity standard with free banking. Under that regime any incipient housing boom would have been automatically and promptly dampened, before a severe bust became inevitable.

I specify “a commodity standard *with free banking*” because a commodity standard—or even a gold standard—does not fully describe the monetary regime. There are at least three varieties of gold-standard regimes: (1) a gold standard with a discretionary central bank; (2) a gold standard with a well-behaved central bank that “plays by the rules of the game”; and (3) a gold standard with free banking and a self-organized clearinghouse system.

A Discretionary Regime

A poorly constrained central bank on a gold standard—one that can act with discretion rather than having to automatically follow the rules—could have replicated the Fed’s recent policy mistakes. During the 1920s, the United States was officially on a gold standard, but the Federal Reserve held interest rates too low for too long and created too much credit. It did so partly in a vain attempt to help Britain rejoin the gold standard at its pre-WWI sterling-to-gold parity, despite a war-inflated sterling price level that remained well above its sustainable prewar level, by keeping New York’s interest rates below London’s. Another contributor was the Fed’s adherence to the “commercial credit” or “real bills doctrine” that urged the Fed to satisfy the growing demand for credit at an unchanging interest rate. The Fed also was influenced by the view that credit creation could not be excessive if consumer price inflation was close to zero, even though an automatic gold standard in an economy of rising productivity would have had its consumer price level slightly declining. The U.S. economy boomed until June 1929, especially its interest-sensitive heavy industries (Phillips, McManus, and Nelson 1937), and asset prices rose until October 1929. The boom collapsed when the Fed used its discretion to reverse its easy money policies. The supposed gold-standard constraint on the Fed was too loose.

A poorly constrained central bank, with or without gold trappings, can cheapen credit when it thinks it expedient, or when it concedes to political pressure, to try to stimulate the economy. We are in such

a period now. Expansion of the central bank balance sheet by open market asset purchases (or by purchases directly from banks or the Treasury, or by lending to banks) makes commercial bank reserves rise. If those reserves are lent out, the broad money stock will rise, pushing up nominal spending and the domestic price level. Under a gold standard, as described by the venerable price-specie-flow mechanism, the high price level will sooner or later drive gold out of the domestic economy and into the world market where each ounce now buys more. The looser the central bank considers its gold standard constraint, meaning the longer it feels it can persist in gold losses, the longer the credit expansion can continue.

Under a fiat standard, today's regime, there is no limit to how far the money supply can expand, but even so a credit-fueled investment boom will run out of juice as the real scarcities of the economy reassert themselves. You can't fool people indefinitely into thinking that investment prospects are better than they really are.

A Ruled-Based Regime without Free Banking

A well-constrained central bank on a gold standard promptly and automatically expands (or contracts) its own liabilities—commercial bank reserves and broad money—as gold flows enlarge (or deplete) its reserves. In the event of exogenous gold inflows, a well-constrained Federal Reserve would allow U.S. commercial bank reserves and the money stock to rise. The U.S. price level would then rise until gold is no longer attracted. The Fed would not manipulate its balance sheet or interest rates to try to “sterilize” (offset) or repel gold inflows before they have re-equalized the purchasing power of gold at home and abroad. Conversely, it would not try to stop or reverse gold outflows before they have run their course and reduced the domestic price level to the world price level (see Hayek 1937).

Even a well-constrained central bank is fallible. Suppose that loan demand increases with new investment opportunities, and instead of letting loan rates rise all the way to the new equilibrium rates needed to accurately ration the limited supply of real savings, the central bank begins to expand credit to keep interest rates from rising. It may be thinking that it is only satisfying the legitimate business demand for credit. In this way it fuels malinvestments atop the new genuine and sustainable investments. It generates a boom-bust cycle by temporarily keeping credit cheaper than can be sustained. The

malinvestments are those that cannot be profitably continued when the interest rate finally rises to the new equilibrium. The economy experiences a cluster of bankruptcies, a bust.

When such a credit expansion begins under a gold standard, domestic prices will rise and gold will begin to flow out. If the central bank is well-behaved, it will contract its credit as soon as it loses gold, ending the expansion before it has gone on for very long. Credit booms will be shorter and busts less severe than under a poorly constrained central bank.

A Free-Banking Regime

To avoid credit-driven booms and subsequent busts, we need a tightly constrained system. We need free banking, where interbank competition constrains credit creation and no central bank exists to loosen the constraints. A general overexpansion is hardly possible because no one bank supplies reserves to all the rest—there is no leader in whose wake all the commercial banks follow. Let's replay the above increase in investment opportunities, but now for a system of competing banks. In response to the strengthening of loan demand, the loan interest rate *will* rise to its new higher equilibrium level. No institution exists to interfere with the re-equilibration process. The rising interest rate will curb overenthusiasm and asset price bubbles. Curbing asset prices will in turn avoid the phenomenon of consumers thinking that their paper wealth makes it rational for them to stop saving and start a consumption binge. What Hayek called “the interest rate brake” will operate in this way to prevent malinvestment and overconsumption.¹

Banks as a whole will not be in a position to expand *unless* interest rates rise, because without an interest rate rise their deposits and thus their reserves won't rise. Even then banks will not all expand at a uniform rate. Any banks that expand their loans and liabilities too aggressively will quickly lose reserves, through the interbank clearing and settlement system, to other more conservative banks. The adverse clearing process nips their excess expansion in the bud.

¹For a more detailed exposition of Hayek's “interest rate brake,” see Garrison (2006). See also Salerno (2010) on overconsumption during the boom prompted by unsustainably high house prices.

Some critics of free banking and advocates of central banking have imagined a *collusive* expansion by dozens of commercial banks, but that scenario is fanciful. If a dominant set of banks could collude, they would want to act jointly like a monopolist, *restricting* credit output to get monopoly prices and profits, rather than expanding output. That is, they would want to raise loan rates and reduce deposit rates, widening the spread, while accepting that the volume of intermediation would shrink to the extent that the supply of savings to the banking system shrinks in response to the smaller interest reward offered.

Some theorists have also imagined, fancifully, that commercial banks would respond en masse to an increased demand for loanable funds by expanding loans but not increasing interest rates.² That outcome is implausible because for each bank there is a cost to lowering its reserve ratio—namely, the greater liquidity risk of running out of reserves. Banks need to be induced by higher returns if they are going to lend more at a higher liquidity risk. But suppose with these theorists, for the sake of argument, that banks do it anyway. Now, when international gold losses begin, the losses come immediately from the reserves of private commercial banks, without any possible countervailing action by a central bank. Each bank is *compelled* to reverse its unwarranted expansion before it gets very far. It is tightly constrained by the need to preserve its reputation for creditworthiness in a competitive environment (where no “too big to fail” doctrine prevails), and by the legal penalties it would incur if it defaulted on its liabilities by running out of gold reserves (where contracts are enforced). A central bank, with a monopoly in note-issue and with sovereign immunity, faces neither the reputational nor the legal constraint. That is why well-behaved central banks, even on a gold standard, have been rare (Bloomfield 1959)—there is little penalty for bad behavior.³ Playing by “the rules of the gold standard game” really *is a game* for them. Prudent behavior is never a matter of life or death for a central bank the way it is for unprivileged competing commercial banks.

²Such theorists surprisingly included Hayek. For exegesis and criticism see White (1999a, 1999b).

³Of course, penalties are even lower and good behavior is even rarer for central banks on fiat standards.

Bailouts

The bulk of the 2008–09 bailouts came not from TARP, a mere \$700 billion not all of which was used, but from the Federal Reserve (White 2009). The Fed directly bailed out the creditors of Bear Stearns (\$29 billion) and AIG (\$180 billion). More importantly, it expanded its balance sheet by an additional \$1.5 trillion, including \$1.25 trillion spent on purchases of dodgy assets (mortgage-backed securities) from weak financial institutions. Although the Fed spent \$1.25 trillion, the assets it got were probably not worth that much. To all appearances the Fed deliberately overpaid in order to boost the selling institutions' net worth.

Under our current discretionary fiat monetary regime, the Federal Reserve has *carte blanche* to expand its balance sheet as much as it likes. It has roughly tripled its size in the last few years. One of the simple and basic virtues of a gold standard is that even a badly behaved central bank cannot expand that much before the constraint of gold losses begins to kick in.

Without the Fed, What Would Replace Monetary Policy?

Under free banking, commercial banks would return to issuing all types of money—currency as well as checking deposits. A commodity standard would regulate the quantity of money without the need for the wisdom of a Federal Open Market Committee. No less an authority than Alan Greenspan endorsed the non-necessity of central banking when he appeared on “The Daily Show” in 2007 plugging his book. Jon Stewart asked him: “Why do we have someone adjusting [interest] rates if we are a free-market society?” Greenspan replied, “You didn’t need central bank when we were on the gold standard, which was back in the 19th century. And all of the automatic things occurred because people would buy and sell gold, and the market would do what the Fed does now.” And he added, indisputably I think: “To the extent that there is a central bank governing the amount of money in the system, that is not a free market.”⁴

⁴For a fuller transcription, see <http://divisionoflabour.com/archives/004047.php>.

Conclusion

A crucial element in creating the recent boom and bust cycle in the United States, ending in financial crisis and recession, was the unconstrained monetary policy of our central bank, the Federal Reserve. The recent crisis is only the latest example of how the Fed has unwittingly done more to destabilize than to stabilize the economy during its tenure (see Selgin, Lastrapes, and White 2010). A self-regulating monetary system would better secure the economy against a similar future crisis. By contrast to the current regime, a commodity standard with free banking minimizes monetary shocks. Its strong self-regulating properties stop the banking system from overfinancing an investment surge, the way the Fed did for the housing market, to the point where it becomes an unsustainable boom full of the malinvestments that make a severe bust unavoidable.

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