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Manifesto for a Second Monetarist Revolution

The long playing drama of US monetary instability through its various distinct acts since 1914 has had only few intermissions, all of brief duration. The actors and the plot change over time. Some acts are epic and global in scale. Others are monotonous and largely uneventful. There is no script but perpetual improvisation. And from early on (though not right at the beginning) a wide array of critics have been passing comment, some from the vantage point of live spectators, others as researchers of the historical record. Some of the critics have identified themselves strongly with particular schools of monetary economics. They take issue with the false doctrines or lack of doctrine on the part of Federal Reserve policy-makers responsible for the given (actual or historic) monetary turbulence.

The founding officials of the Federal Reserve (Benjamin Strong, Paul Warburg, and Adolph Miller, in particular) realized that they were improvising. They had arrived at their posts expecting that monetary control would remain on automatic pilot under the international gold standard. Instead, within a few months, the automatic pilot system broke down as the outbreak of war destroyed the gold-based international monetary order. In fact, as we saw in Chapter 1, these Federal Reserve officials carried on at first much as if the still functioning dials on the otherwise broken automatic pilot system had their old meaning, allowing the monetary base thereby to explode in line with massive wartime gold sales in the US by the Entente Powers. After the war, as the Federal Reserve improvised monetary policy with most of the automatic control mechanisms of the pre-war international gold standard no longer operating (or if operating at all it was in new untried ways), the monetary machine rapidly got out of control, becoming the proverbial monkey wrench in all the other machinery of the US and global economy.
In an ideal world the US Congress would have set up a panel to determine what should be the way ahead for the Federal Reserve and for US monetary control now that the situation was so different from that envisaged by the founders back in 1913 and with such poor results. Unfortunately that is a task that Congress has never taken on, deferring instead to the experts in the Federal Reserve albeit subjecting them to ill-defined broad mandates which make sense only within the context of, in fact, highly controversial Keynesian economics. Perhaps the complexity of designing ideal monetary control systems beyond the demise of the international gold standard has been too daunting. And in any case the highly unpredictable political pay-off (in itself notoriously hard to identify) for good work done would be potentially well beyond any electoral cycle.

In particular, the contention, (put forward especially by critics influenced by the ‘Austrian school’) that monetary instability can show itself up in asset (including commodity) and credit market temperature swings – together with the related spurts of mal-investment – not just in broadly defined goods and services price inflation or deflation, is controversial amongst economists and has not become common sense wider afield. Congressmen looking for culprits find easier and more effective targets in the financial institutions, which periodically go wild, than in the central bankers who lay the essential monetary seeds to ensuing economic turbulence.

Moreover the work of monetary system design occurs in a climate of academic opinion at the time. Certainly, a Congressional Committee in the 1920s could have called on the leading monetary economist at the time in the US, Irving Fisher, but he would have advocated price level stabilization with all its pitfalls. Alternatively the Committee could have commissioned a leading Austrian economist. But Hayek or von Mises would surely not, as a matter of principle, have helped re-design a central bank which they saw as anathema to monetary stability. In any case, they had no blue print to hand for establishing monetary stability in the US or globally in the context of a dollar standard world with a new institution, the Federal Reserve, having discretionary control over the growth of the monetary base. Rather they looked back to the Golden Garden of Eden and wished for a return.

How a Keynesian virus infects congressional control of the Fed

Beyond the early 1930s the virus of Keynesianism with its soft populist messages had infiltrated the US political arena and had also made a good