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How to outdo Greenspan

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Do you know why the retiring Federal Reserve chairman is praised so highly? He made fewer mistakes "pricing" the U.S. dollar than some of his recent predecessors. The "price" referred to is the short-term interest rate -- the rate the Fed charges banks that borrow from the Fed.

If you think for a moment, you might find it odd that a few government officials set the "price" for short-term money. After all, markets are best at pricing such things as oranges, computers and underwear. When government officials set prices, we almost always have shortages when prices are set too low or unintended surpluses when prices are set too high. Clear thinkers who understand economic history know markets are best at setting prices, because the market price will cause the supply to correspond with the demand.

The question then arises: Should governments set interest rates anymore than they set prices for clocks?

By law, the Federal Reserve is supposed to provide us stable money; that is, a money that neither gains value (deflation) nor loses value (inflation) so a dollar today should have the same purchasing power as a dollar in the future.

Now, let's look at reality. A 12-once bar of 0.9999 pure silver produced in 1965 is identical to a 12-ounce bar of 0.9999 pure silver produced in 2005. However, one would now need aout $6 to possess the purchasing power a dollar had in 1965. If you contracted in 1965 to have 12 ounces of silver delivered to you in 2005, and you got only 2 ounces, you would cry fraud. Inflation, by stealing the value of your money, would be criminal if not perpetrated by government.

In the 20 years from 1965 to 1985, the dollar lost about three-quarters of its value; that is, a 1985 dollar was equal to a 1965 quarter. From 1985 to 2005, the dollar only lost a little more than one-third of its value, a terrible record but a big improvement over the previous two decades.

Thus we can say Alan Greenspan was a much better Fed chairman than a couple of his predecessors, most notably Arthur Burns and G. William Miller. But it is hard to objectively say Mr. Greenspan, although highly competent, did a great job.

The problem is the government has seized the right to be a monopoly supplier of money. If the government is the only money supplier, it will determine how much it supplies and hence its price. It is no surprise the government normally errs by producing too much money, which causes inflation, because the government -- as opposed to the people -- has a vested interest in inflation.

Under a progressive tax rate system, inflation results in unlegislated tax increases, by pushing people into higher tax brackets without any rise in real earnings and also erodes the government debt at the expense of the bond holders.

Now, assume a world in which government is not the monopoly supplier of money -- as in the U.S. before the 1913 advent of the Federal Reserve -- and the money supplied and interest rates were determined by the market rather than government officials. (Government only need define the value of currency it accepts for tax payments and its own expenditures.)

Over the 124-year period prior to the Fed, the U.S. did not suffer from persistently high inflation. There was a bout of inflation during the Civil War, but the overall price level in those 124 years did not change much. Private banks issued much of the currency, and the value of the dollar was most often defined in gold, silver or a combination of the two.

In 1976, the great Nobel Prize-winning economist F.A. Hayek (arguably the best economist of the last century) proposed returning to competing currencies in his book "Denationalization of Money." He argued the private market had produced, and was likely to continue producing, better money (which retained its purchasing power) than government monopoly money. Nobel Laureate Milton Friedman and other distinguished economists have made similar arguments.

Given the new technologies, it is now possible for economists to construct baskets of commodities and even services that could back money that would likely be far superior to the monopoly money government imposes on us.

Rather than engage in periodically searching for a central banker so wise he (or she) can always outguess private markets (impossible for any mere mortal), would we not be better off to remove the government monopoly on money to see what competing private parties might develop?

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