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Towards a program for financial stability☆

Robert E. Krainer*

University of Wisconsin-Madison, 975 University Avenue, United States

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ABSTRACT

Fifty years ago Milton Friedman published a book entitled *A Program for Monetary Stability*. In it he outlined a number of suggestions for the conduct of monetary and fiscal policies that he thought would contribute to monetary stability and *pari passu* to price stability and a greater degree of output/employment stability. In this paper I review some of his policy prescriptions in light of the financial and economic crisis of 2007–2009. From the perspective of financial development the world today is much different from the world that Friedman knew in the late 1950s. In what way would his policy recommendations have to be modified to account for these changes in financial development? To stabilize the banking system we argue that his proposal for 100 percent reserve banking merits serious consideration in current policy discussions. To stabilize asset markets we propose two policies that Friedman would not likely endorse. The first is to reinstate selective credit controls in the areas of the securities markets, the real estate market, and various commodity markets. The second policy designed to dampen excessive variability in the stock market is for the Central Bank to carry out some open market operations in an index fund of equities.

1. Introduction: Friedman's program for monetary stability

Over a half of a century ago Milton Friedman gave a series of lectures at Fordham University that were subsequently published under the title of *A Program for Monetary Stability* (1959) with a new preface added in 1992. In it he outlined a number of suggestions for the conduct of monetary and fiscal policies that he thought would contribute to monetary stability, and *pari passu* to price stability and a greater degree of output/employment stability. In this paper I review some of his policy prescriptions in light of the financial and economic crisis of 2007–2009. The goals of policy are the same today as they were in his day. The question is whether any of his policy recommendations in the late 1950s would have prevented or substantially blunted the financial and economic crisis that began to unfold in 2007. Of course from the perspective of financial development the world is very different today compared to when Friedman wrote. Would the financial development that has taken place between then and now render his policy prescriptions obsolete? In what ways would his policy proposals have to be modified to account for these changes in financial development? These are interesting questions that deserve further attention alongside the Dodd-Frank legislation, Basle III, and other proposals that have recently been offered by financial economists to further regulate our financial system.

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* Tel.: +1 608 263 1253.
E-mail address: rkrainer@bus.wisc.edu

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Friedman made a number of suggestions for policy reform in the *Program for Monetary Stability*. Some of his suggestions were subsequently adopted, but most were not. Interesting examples of the latter, in light of the current crisis, include eliminating discounts and advances as an instrument of monetary policy, requiring banks to hold reserves equal to 100 percent of their deposit liabilities,[1] and having the Federal Reserve (through open market purchases of government securities) follow a steady *k*-percent per year (or preferably a1/12th *k*-percent per month) rule of increasing the money supply. An equally interesting example of the former is having the Federal Reserve pay interest on reserve balances held by the member banks. This policy change was implemented in October 2008 and revised in December 2008.

The three controversial proposals for monetary reform that were not implemented had as their objective the reduction of the volatility in the growth rate of the money supply. According to Friedman business cycles were caused by uncontrollable outside disturbances and very controllable disturbances in the money supply. For him the modest objective of monetary policy, as far as business cycles were concerned, should be to reduce the inter-temporal volatility in the money supply which in turn would reduce the controllable part of the volatility in real output and employment. He thought that 100 percent reserves against deposits and the *k* percent steady growth in the money stock would help achieve this goal. What has actually happened with respect to these three suggestions since Friedman gave these lectures? In terms of the financial crisis of 2007–2009, discounts and advances – which he advocated should be eliminated – actually played a key role in the Federal Reserve's strategy to liquefy the financial system. Elements of this strategy included lowering the investment quality of the collateral the Federal Reserve accepts from eligible borrowers and broadening the types of enterprises (both financial and nonfinancial) that would qualify as eligible borrowers. The end result of this strategy to combat the crisis was that the assets of the Federal Reserve rose dramatically from $870 billion before the financial crisis to $2 trillion on April 3, 2009 and $2.7 trillion as of May 12, 2011.[2] As far as the Friedman proposal for a 100 percent legal reserve requirement on bank deposits was concerned, they have in fact fallen. When Friedman gave his lectures the legal required reserve ratio on net demand deposits was 18 percent for Central Reserve City banks, 16.5 percent for Reserve City banks, and 11 percent for Country banks. The three categories of banks were subsequently reduced to one (as recommended by Friedman) and presently the requirement is 10 percent on demand deposits over $44.4 million for all depository institutions. Furthermore the effective reserve ratio is actually smaller due to the fact that banks are allowed to sweep portions of their customer demand deposits into investment accounts (for which the required reserve ratio is -0- percent) overnight and on the weekends.

Finally, what about his *k*-percent rule designed to stabilize the growth rate of the money supply?[3] From 1959 when the lectures were originally published to 1992 (when he appended an additional preface) the average percentage growth rate and standard deviation of the growth rate for M1 were respectively .063 and .036. From 1992 to 2007 the average growth rate and standard deviation of the growth rate for M1 were .028 and .051. On average the Federal Reserve reduced the growth rate in M1 but increased its volatility in the later period compared to the earlier period. According to Friedman and the quantity theory of money the 55 percent reduction in the average growth rate of M1 should be reflected in a roughly 55 percent lower average inflation rate.[4] That in fact turned out to be approximately the case. The average rate of change in the GDP deflator as a measure of price inflation was .044 over the period 1959–1992 and fell to .022 for the period 1992–2007 for a reduction of 50 percent providing some support for the quantity theory of money. Moreover the standard deviation in the growth rate of the GDP deflator fell from .025 over the period 1959–1992 to .006 in the period 1992–2007. Thus an over 40 percent increase in the standard deviation of the growth rate in M1 was accompanied by an over 75 percent reduction in the standard deviation of the GDP inflation rate. This may not be consistent with the quantity theory. In any event the actual average inflation rate was both lower and on average more stable in the period 1992–2007 compared to the period 1959–1992.

What about real output as measured by real GDP? Recall that the objective of the *k*-percent rule was to stabilize monetary growth which according to Friedman would reduce that part of the business cycle caused by monetary instability. What actually happened? The average growth rate in real GDP was .035 in the period 1959–1992 and then fell slightly to .031 in the period 1992–2007. The variability of real GDP growth also fell between the two periods which is seemingly at variance with Friedman's prediction based on the increased variability in the money supply that actually occurred in the later period. The standard deviation of the real GDP growth rate was .023 in the period 1959–1992, and fell to .011 in the period 1992–2007. Many financial economists during the latter time period argued that the reduction in the volatility of real GDP (a proxy for macroeconomic risk facing companies) ushered in a new era of economic stability thereby warranting an increase in financial leverage and financial risk for households and firms. Unfortunately many financial and non-financial enterprises acted on this advice with disastrous consequences in the crisis period 2007–2009. While neither of Friedman's policy reforms on reserve requirements or the *k*-percent rule designed to stabilize monetary growth were actually implemented, inflation and output growth on average behaved as if they were right up to the beginning of the financial crisis. But the whole story is not told by merely comparing averages for 1959–1992 and 1992–2007. The average quarterly growth rate for M1 over

[1] Earlier advocates of the 100 percent reserve requirement were Simons (1934) and Fisher (1935). In Friedman's version the 100 percent reserve requirement would apply to all deposits; checking accounts, retail money market mutual fund accounts at banks, savings deposits, and small time deposits.

[2] This balance sheet data was obtained from a speech given by the Chair Ben Bernanke at the Federal Reserve Bank of Richmond 2009 Credit Market Symposium on April 3, 2009. For 2011 the balance sheet data was obtained from http://www.federalreserve.gov/releases/h41/current.

[3] All (M1) data obtained from: http://www.federalreserve.gov/releases/h8/data/m/b1048a.txt.

[4] All real GDP and GDP deflator data obtained from various issues of the Economic Report of the President.