The Journal of Private Enterprise 29(3), 2014, 29–42

The Role of the State in Finance and Money: Implications for Economic Stability

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Abstract
In theory, the State ensures that a country's financial and monetary regime provides a foundation for stable economic growth; however, the reality is much different. The self-interest of the State is to use the regime to maintain and expand power, pursue industrial objectives through crony capitalism relationships, support fiscal imbalances, and so on. Public education plays an important role in sustaining an activist State in the regime, and while the conflict between the State and market forces will for short periods slow the State's role, it will only be through education that the next generation of leaders may be able to reverse the pervasive role of the State.

JEL Codes: H1, E5, N1, A2
Keywords: Finance, Money, Financial and monetary regime, State policy failure, Market failure, Education

I. Introduction

This paper considers the relationship between the State and the country's financial and monetary regime. The financial and monetary regime consists of private financial institutions and markets, government financial institutions, government sponsored enterprises, financial regulatory and supervisory government institutions, and the central bank. These components vary widely from country to country depending on its stage of economic development, history, national goals, and political institutions, but in all economies, the regime is theoretically responsible for facilitating the savings and investment process, providing a stable financial environment by limiting liquidity crises, preventing disintermediation and rapid shifts from higher forms to lower forms of money, and providing a stable monetary environment by stabilizing the value of the nation's medium of exchange. The State from the beginning has assumed some role in the financial and monetary regime, but from the beginning of the twentieth century to the present, the State's influence has rapidly increased.

The responsibilities of a financial and monetary regime are so obvious and necessary for economic growth that they require no further discussion; however, what is not emphasized sufficiently is that the State is less concerned with ensuring that the regime's responsibilities are fulfilled and more concerned with expanding its own role in finance and money, influencing the flow of funds to support industrial policies, and using the regime to accommodate the State's bias toward fiscal imbalance. In this process, the State establishes a complex feedback mechanism between the private and public sectors that satisfies the State's incentives to maintain and enhance its power and, at the same time, provides incentives to crony capitalists to support the State. The outcome is not only an inefficient allocation of capital over time, but at discrete points in time, financial and economic crises. The financial and economic crises arise from the discretionary power vested in individual agencies or authorities that more often than not generate policy failures. They also arise because the State creates incentives for the private sector to engage in imprudent lending and investing (see e.g., Robinson and Nantz [2009]; DeGennaro [2009]; and Block, Snow, and Stringham [2008]). The incentive structure established by the State is not limited by standard budget constraints; that is, spending other people's money is inherently inefficient. That the State's role is inefficient and destabilizing is not, however, the conventional wisdom.

In contrast, the conventional wisdom emphasizes market failure as the cause of economic and financial distress and offers the State as the means to resolve market failure. This view emerged as a dominant theme in the post-World War II period as a result of the Great Depression and the success of the State's victory over Germany, Japan, and Italy. It was partially interrupted for about a three-decade period in the latter part of the twentieth century as much of the world embraced liberalization to varying degrees. This was a remarkable period in historical perspective that some refer to as the Age of Milton Friedman (Shleifer 2009), but by the end of the first decade of the new century, the conventional view returned stronger than ever both in terms of attitude and policy. The Great Recession in the United States, Japan's third lost decade, and the International Financial Crisis of 2008–2009 are widely attributed to excessive liberalization, especially financial liberalization, while at the same time, the success of China's State-directed market economy is viewed as the model of the future.

It is remarkable how rapidly the enthusiasm for liberalization has waned in light of the historical record of policy failures like the Great Depression, the Great Inflation, and now the Great Recession, as well as the theoretical and empirical contributions of public choice economics. A good part of the answer is to be found in public education, which has an inherent incentive to present a market-failure view of periods of economic and financial distress and to either ignore or downplay the State's role in policy failure. Most students are educated in government schools and taught by government employees, most of whom are members of a public-employee union. The fact that most voters, journalists, and politicians are the product of this educational system partly accounts for the receptive audience to the conventional view of the State's role in the financial and monetary regime.

This paper discusses how that role has generated economic instability and interfered with the regime's ability to fulfill its legitimate objectives. It also discusses why the deregulation and liberalization efforts in the latter part of the last century have met so much resistance.

These themes are developed in the following sections: Section II emphasizes that a large body of research suggests the three most important periods of economic and financial distress in the United States—the Great Depression (1929–1941), the Great Inflation (1965–1985), and the Great Recession (2006 to the present, attributing the start to the collapse of housing prices in early 2006)—are *at least* equally the result of State policy failure as they are of market failure. Of the three, the Great Depression is the most significant in terms of the expanded role of the State and, as such, this section illustrates how public education presents a misleading interpretation of the Great Depression and establishes a receptive audience for the conventional view of the State's role in money and finance. Section III outlines the financial reform process at the end of the last century that helps explain why financial liberalization emerged, why it was resisted, and why it was less than successful, and it discusses to what degree and under what conditions the State's role might be reduced or possibly divorced from a country's financial and monetary regime. A short concluding section ends the paper.

II. The State and Economic Distress in the United States

The conventional wisdom by any standard is not consistent with the historical record of the State's role in the financial and monetary regime. In some cases, the State improved the regime's stability; for example, regulation and supervision over the level and type of capital held by financial institutions, transparency in financial markets, minimum reserve requirements, and even deposit guarantees of small deposits prevented what Friedman called the "economic equivalent of counterfeiting" (Friedman 1959). However, these improvements pale in comparison to other motives; for example, the 1864 National Banking Act was designed more to further the federal government's political objectives of unification and financing the Civil War than to resolve a nonexistent "wildcat banking system." There are other examples. Much of the federal government's regulation of financial institutions has been designed to support the social contract to expand home ownership. The most recent Dodd-Frank legislation was designed to strengthen crony relationships between the government and large financial institutions to provide greater State control over the financial system while at the same time shifting blame for the housing bubble from State policy failure to market failure, a conclusion offered by the report of the Financial Crisis Inquiry Commission (2011). There is dark humor in that Dodd-Frank was named after Senator Christopher Dodd and Representative Barney Frank, who were important defenders of subprime lending and of Freddie Mac and Fannie Mae, which, in turn, played a key role in causing the Great Recession. The establishment of the Federal Reserve did resolve some of the problems of the national banking system, but had more to do with establishing an institution to assist the government's fiscal program and influence over the financial system to support specific sectors (Cargill and O'Driscoll 2013; Meltzer 2003, 2009).

In terms of policy outcomes, the conventional view is likewise not well supported. Romer (1999), an advocate of the State's role in stabilizing the economy, found surprisingly little evidence of a significant reduction in the variation of real indicators between the pre-World War I and post-WWII periods. At the same time, Romer argues that activist macroeconomic policy is responsible for the well-established finding that recessions identified by the NBER have been shorter and less severe while expansions have become longer. This empirical fact, however, could also be attributed to other factors, such as the reindustrialization process after WWII, the dominant role of the U.S. economy in the world in the 1950s and 1960s, the liberalization process of the 1970s and 1980s, and the shift to a less activist monetary policy after 1985. In addition, Romer notes a few policy-induced recessions caused by monetary policy to disinflate the economy while ignoring that the disinflation policy in the early 1980s was due to policy errors that created the Great Inflation. Finally, Romer's paper was published in 1999 before the policy-induced housing bubble, and unprecedented activist fiscal and monetary policies by any reasonable standard have not been successful as promised. Japan also followed these policies and is now in its third lost decade, while the United States is approaching the end of its first lost decade of economic and financial development. Some might refer to this process as the Japanization of the U.S. economy.

There have been three periods of major economic and financial distress in the United States: the Great Depression, the Great Inflation, and the Great Recession. Each in large part was the result of State policy errors, especially central bank policy, with the latter two the result of monetary policy errors made in the context of flawed financial policy designed to support homeownership. This view in no way is meant to ignore other factors such as fiscal policy, trade policy, shocks, and so on; however, in the absence of these policy failures, the probability of a Great Depression, Great Inflation, and Great Recession would have been considerably reduced. Nor does this view claim an absence of market failure; rather, it suggests that any role of market failure pales in comparison to the role of State policy failure in the monetary and financial regime.

There is little disagreement following the monetarist-Keynesian debate of the 1970s that monetary policy errors were a major cause in the collapse of the financial system and the economic and financial distress for the entire decade of the 1930s. No other authority for this view need be cited than the last paragraph of Bernanke's tribute to Friedman and Schwartz on the occasion of Friedman's 90th birthday celebration at the University of Chicago in 2002 (Bernanke 2002). Bernanke reaffirmed the adverse role played by the Federal Reserve in his recent defense of the Federal Reserve's role in the Great Recession (Bernanke 2013, p. 21). Yet, as explained below, the market failure view of the Great Depression continues to be taught to high school students, continues to be emphasized in the news media, and continues to be widely held by the public.

Likewise, the evidence is overwhelming that the Federal Reserve played a major role in the Great Inflation because of reliance on the long-run Phillips trade-off between inflation and unemployment as well as a willingness of the Federal Reserve to accommodate fiscal policy (Meltzer 2009). Cargill and O'Driscoll (2013) in their review of the Arthur Burns's "secret" diary found a most telling entry about the willingness of Governor Burns to accommodate the government. In an entry dated February 29, 1972 (referring to a meeting with Nixon on February 14), Burns recounts that he told the president that "I was looking after monetary policy and that he need not be concerned about the possibility that the Federal Reserve would starve the economy" (Ferrell 2010, pp. 74–75).

The Great Inflation was also responsible for the collapse of the S&L industry, representing the largest collapse of the U.S. financial system since the Great Depression and imposing a taxpayer cost of $124 billion in nominal dollars as of December 31, 1999 (Curry and Shibut 2000). Assuming this amount was evenly spent over the period from 1990 to 1999, the taxpayer cost was $194 billion in 2013 dollars. Financial policy designed to support home ownership (Regulation Q interest rate ceilings, specialized mortgage lending status provided to the S&L industry, Fannie Mae, Freddie Mac, etc.) and inflationary monetary policy exposed the S&L industry to interest-rate, liquidity, and disintermediation risk in the 1970s that ultimately caused the industry's collapse in the 1980s. This crisis was caused by the combination of monetary policy failure, a flawed financial system designed to support homeownership, and a flawed policy response. The policy response was anchored in denial, and when denial was no longer credible, in understating the magnitude of the problem; when a policy response could no longer be avoided, it was based on forgiveness and forbearance. This policy response prolonged the distress and increased the ultimate resolution cost. Finally, when significant taxpayer funding was required to bail out the S&L industry, the emphasis shifted to blaming the market and "greedy" financial institutions to cover up the combination of Federal Reserve failure and the flawed financial policy encouraging home ownership.

The inflation and stagflation of the 1970s and collapse of the S&L industry as well as the collapse of the managed fixed exchange rate standard in 1973 contradicted the conventional view and resulted in a reevaluation of the State's role in the financial and monetary regime. The attitudinal and policy changes in the United States, Europe, and Asia represented a major reversal of the conventional wisdom. The United States embarked on a "deregulation" process to redesign financial and central bank policy to provide a stable financial and monetary regime. The "deregulation" process removed many of the previously binding restrictions on market forces by removing interest rate ceilings and expanding the portfolio diversification powers of financial institutions and was associated with a shift from activist monetary policy to policy focused on price stability now referred to as the Great Moderation.

Thus, the last decades of the twentieth century in the United States and in many other countries witnessed a reversal to some degree of the State's role in the financial and monetary regime and an attitudinal change that at least recognized State policy failure and deemphasized market failure. Despite the many successes of liberalization and price-stability focused central bank policy, support for the conventional wisdom of the State's role in money and the economy remained in the background. Critics claimed that the liberalization process was unfair, exploitive of the world's limited resources, contributed to global warming (relabeled climate change), and would ultimately generate a crisis in the financial system since less-regulated and -supervised financial systems were inherently unstable. Advocates of State policy waited for the next crisis to reestablish the primacy of the State in economic affairs.

Policy error by the Federal Reserve in the first few years of the twenty-first century combined with a flawed financial policy to support housing generated an asset bubble in real estate. The collapse of real estate prices in 2006 set into motion a series of events that led to the Great Recession and the International Financial Crisis of 2008–2009. Attitudes shifted rapidly from liberalization and the benefits of the market back to market failure as the cause of financial and economic distress and elevated the role of activist State policy in the financial and monetary regime. The policy shift is reflected in legislation like Dodd-Frank, Keynesian government spending and deficits, unprecedented quantitative easing policy, support of the mortgage market, and the appointment of Janet Yellen as chair of the Board of Governors of the Federal Reserve at the start of 2014 (Cargill 2014). Perhaps no better indicator of this shift in terms of central bank policy appeared on the front cover of an August 13, 2011, issue of the *Economist*. It used Rembrandt's famous "Lesson in Anatomy" painting of 1632 to illustrate the world economy as a dead patient on a gurney. In comes a man with shock paddles to revive the world economy, with the caption, "Stand back, I am a central banker."

The role of public education in establishing a bias toward the conventional wisdom is an important part of understanding the acceptance of the conventional wisdom and how rapidly the Age of Milton Friedman appears to have been rejected, or at a minimum, ignored. The treatment of the Great Depression in classrooms, judged by high school history textbooks and national history standards, is revealing (Miller and Rose 1993; Cargill and Mayer 1998; Cargill 2011). These papers argue that the typical textbook discussion of the Great Depression focuses on one type of market failure and ignores the well-documented role of the Federal Reserve in causing and prolonging the Great Depression. Cargill (2011) reviewed recent high school history textbooks and summarized their presentation of the causes of the Great Depression in the following manner: "(a) under-consumption due to unequal distribution of income and wealth brought about by policies of the Coolidge and Harding administrations in the 1920s; (b) over-production in the 1920s due to technology that generated great wealth for a small number of households; (c) speculation in the stock market in the late 1920s and the October 1929 stock market crash; (d) unregulated and unsupervised financial institutions and markets; (e) international events such as competitive tariffs; (f) actions by self-interested businesspersons who traded the national interest for their own profits; and (g) the flawed leadership of the Hoover administration" (Cargill 2011, p. 200).

The Federal Reserve is either not mentioned as a cause or, when mentioned, is usually described as an institution that generated the liquidity used to support consumer installment spending and the stock market in the 1920s. A few textbooks mention that the Federal Reserve made mistakes that contributed to the distress, but most ignore the role of the Federal Reserve in the 1930s by claiming it was simply ineffective. As a result of textbooks' misrepresentation the Great Depression's causes, generations of the working and voting public have been taught that a world-changing economic event was largely due to an inherently unstable market system characterized by unequal distribution of wealth, underconsumption, overproduction, and speculation, and that the solution resided in an activist government manifested by the New Deal policies of the 1930s. Politicians for decades have used this anti-market, pro-government perspective to rationalize continued expansion of activist government. The force of the argument and public acceptance became apparent in the debate of the February 2009, $787 billion stimulus. In that debate, the economic and financial distress was blamed on Wall Street self-interest that supposedly could only be addressed by aggressive government intervention in order to prevent another Great Depression.

III. Financial Reform, Liberalization, and the State

The last part of the twentieth century saw significant economic, financial, and even political institutional change toward more liberalized, open, and transparent structures throughout much of the world. The changes by any standard improved the economic condition of large numbers of individuals, though not sufficiently to silence critics of the market. The critics could point to one objective fact about the Age of Milton Friedman: the financial liberalization process was far from stable in many countries.

An International Monetary Fund study by Lindgren, Garcia, and Saal (1996) identified 130 banking crises during the liberalization process, including the collapse of the S&L industry in the United States. The IMF understated the instability because it did not incorporate the full extent of the troubled Japanese financial system in the 1990s, the Asian Financial Crisis of 1997, or the housing bubble in the United States and subsequent financial crisis. These financial difficulties were frequently attributed to liberalization when, in fact, they were due more to the private sector's unwillingness to give up its regulatory rents and resistance by the State to give up its desire to maintain and expand its role in the financial and monetary regime.

The financial transition process can be summarized by the following taxonomy: (a) The existing financial and monetary regime comes into conflict with new economic, political, and/or technological environments. The economic environment in the 1970s varied from country to country, but in the United States, high inflation combined with interest rate ceilings created distress, the political attitude toward markets became less adverse, and technological developments made it easier for markets to innovate around binding restrictions on portfolio behavior. (b) The conflicts were manifested in a variety of ways ranging from failures of financial institutions to sharp shifts in the allocation of funds among financial institutions. In the United States, the conflicts were manifested by the intense interest rate, liquidity, and disintermediation risks experienced by financial institutions, especially the S&L industry, in the context of inflationary monetary policy. (c) The resulting financial disruptions and inefficiencies stimulated market and regulatory innovations. The market engaged in financial innovation and the State enacted new laws such as the 1980 Deregulation and Monetary Control Act. (d) Market and regulatory innovations were resisted by various regulatory authorities unwilling to depart from the old regime because they viewed the transition as a potential loss of regulatory power. This was especially the case in the United States with those agencies responsible for the social contract to expand home ownership, and government resisted, in general, to any effort to reduce the level and extent of deposit guarantees. (e) Market and regulatory innovations were resisted by various private sectors unwilling to depart from the old regime because they viewed the transition as a potential loss of property rights and rents enjoyed under the old regime. This was especially an issue with the close association between housing, the government and financial system in the United States, and the issue of government deposit guarantees. (f) As a result of this resistance, the liberalization process was unbalanced and incomplete, deposit guarantees providing incentives to increase risk remained in place or were enhanced, and forgiveness and forbearance remained important policy responses to troubled financial institutions. Finally, (g) the degree of resistance from the public and private sectors and the type of monetary policy significantly influenced the liberalization process. Unfortunately, in the United States, easy monetary policy and government incentives to expand home ownership played a major role in the housing price bubble.

The end result of a flawed financial liberalization process due to policy failure, combined with easy monetary policy, was a housing bubble and subsequent financial crisis, which in turn are used as an argument to reinstate the conventional wisdom. Cargill (1998), in his review of the financial reform process in the United States, was not sanguine about the prospects for lasting institutional redesign toward markets. The State was a reluctant advocate of liberalization, had no real vision of a market-oriented financial and monetary regime, accepted liberalization only because it was politically expedient at the time, and continued to retain old elements of the preliberalized financial and monetary regime that continued to generate an inefficient and occasionally unstable flow of funds.

The future of the relationship between the State and money is evolving, but it is difficult to be optimistic. What are the possibilities? Divorce is not in the future. Arguments in favor of a return to the gold standard irrespective of its merits are not realistic; the transaction cost of such institutional change are extremely high. The web of State involvement in the financial and monetary regime is so extensive, and so many elements of society have incorporated it into their decision making, that it is difficult to foresee a return to the type of financial system that supported economic growth in the nineteenth century.

More likely, the continuing crisis and financial distress will invoke a reaction not unlike what happened at the start of the Age of Milton Friedman. Economic forces are like the wind and tide: they are ignored at one's peril. The current involvement of the State in the financial and monetary regime is inefficient and unsustainable, and it is only a matter of time before another policy-induced crisis occurs. Such a shock, or the accumulation of deadweight loss, will force a redesign of the financial and monetary regime toward market solutions. But even here, it is difficult to be optimistic. The liberalization process during the last part of the last century appears to have been short lived. The power of the State and vested interest of the State's role in the financial and monetary regime are extensive.

Despite this pessimistic assessment of the State's role in the financial and monetary regime, there is an optimistic perspective rooted in education. The State has been able to advance the conventional wisdom that State policy is preferable to markets primarily through education. Rather than rely on some intellectual breakthrough that demonstrates the inherent instability of the role of the State in managing the financial and monetary regime, emphasis is best placed on education. Education is a key to future institutional change, and we need to make every effort to present an accurate story of the role of policy and market failure in understanding economic and financial distress.

IV. Concluding Comment

The State has a vested interest in using the financial and monetary regime to expand its power, support industrial policy, support favored groups, and accommodate fiscal imbalance. The State has much less interest in ensuring that the financial and monetary regime satisfies its basic responsibilities. The State's fallback position is to blame market failure for any economic and financial distress that results from problems in the financial and monetary regime. The last century of U.S. financial and monetary history suggests that this approach has been effective. Despite much academic research identifying the inefficiency and, on occasion, financial and economic crises generated by activist State policy, the conventional wisdom persists that the State is necessary to mitigate market failure based on self-interest and short-run profit incentives. The effectiveness of this policy is significantly dependent on public education with its inherent self-interest to advance a pro-government, anti-market perspective.

A dramatic reduction in the role of the State is not feasible given the large transaction costs of institutional redesign. More likely is a slowdown in the growth of State involvement and a shift toward market-based financial regulation and supervision and a less-activist central bank policy based on simple and transparent rules of conduct. Education is a key element in this potential transition.

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