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Competition and Finance: A Reinterpretation of Financial and Monetary Economics
Kevin Dowd
New York: St. Martin's Press, 1996, 572 pp.

Dowd reviews the rationale of various forms of business finance—equity, short-term and long-term debt, debt with covenants, and callable or convertible debt. Information problems and moral hazard come into the story. All that leads into discussions of corporate management and the market for corporate control, the rationale of bankruptcy provisions (and the asserted inexpediency of allowing an unsuccessful management to continue running a firm during reorganization), and the rationale of limited liability and extended liability. Because no contracts can cover all possible contingencies in complete detail, borrowers', lenders', and investors' *reputations* are important; Dowd thus illuminates one link between economics and ethics. He further discusses financial intermediation and banking in particular, omitting tedious details of institutions in particular times and places.

Along with several other contemporary economists, Dowd advocates abolishing government money and allowing banks, disciplined by competition, to issue notes and deposits denominated in a dollar defined by a comprehensive bundle of goods and services. For everyone's convenience, the banks would redeem their issues not directly in those miscellaneous goods and services but *indirectly*: a $1 note would be redeemable in whatever amount of some convenient redemption medium (perhaps gold or specified securities) had the same actual market value as the standard bundle.

Some early expositions of this scheme spoke of "separation" of the unit of account (UA) and medium (or media) of exchange (MOE). Dowd objects, stressing the convenience of MOE denominated in the UA instead of fluctuating against it. "Separation" was a misleading term. It meant that the UA is not defined by any MOE (unlike the current fiat U.S. dollar, which is defined by nothing other than the coins, banknotes, and deposits issued by the Treasury and Federal Reserve). Instead, the UA is defined *separately*—by the bundle of goods and services. Competition in serving the public's convenience forces issuers of MOE to denominate their issues in the UA so defined, yes; but the various MOE thus link themselves to the unit without defining it. (One exception verging on literal separation is still conceivable: Banks might allow checks denominated in the UA to be drawn on equity mutual funds that *would* fluctuate in value against the UA.) Unlike the U.S. government, private competing issuers cannot expect the public to continue regarding their dollar bills as being worth—and even as defining—one dollar, regardless of how they may mismanage their issues.

The indirect redemption described so far might still be awkward in various ways; so Dowd, building on hints by W. William Woolsey and Scott Sumner, proposes achieving essentially the same result through what he calls "quasi-futures contracts" (QFC). Here is how I understand—or misunderstand—this unfamiliar scheme.

Money-issuing banks would stand always ready to make contracts whereby one party delivers $1 currently and the other party undertakes to repay, a specified number of months later, $1 + interest, all multiplied by the price index prevailing at that future time (whether it turns out to be 1.00, 1.06, 0.98, or whatever). (The initial $1 payment reflects the target price level of 1.00, corresponding to the bundle definition of the UA and to the indirect quasi-redemption of money in the standard bundle.)

The banks thus stand ready to accept bets on the price level placed in either direction in unlimited amounts by members of the public. (Banks will presumably obtain adequate guarantees of their counterparties' creditworthiness.) If arbitrageur-speculators expect the future price index to stand above 1.00—perhaps because the current index already does—they pay $1 currently in hopes of receiving a future amount increased by more than the interest. Their current payments, which are in effect presentations of money for redemption, remove money from circulation, tending to have an antiinflationary effect and to keep down the expected future price level. If, conversely, arbitrageur-speculators expect the future price index to stand below 1.00, they opt to receive current payments from the banks in hopes of repaying a correspondingly reduced amount. Meanwhile, the banks' current payments expand the money stock, tending to have an antideflationary effect on the price level.

Such QFCs in either direction, as appropriate, would tend to maintain the current and expected future price levels always close to the target stable level. The deviations and corrections mentioned above would probably not be sizable; they merely serve an expository purpose in explaining the stabilizing forces at work. In effect, the public's bets on inflation or deflation, with the banks committed to being counterparties, forestall both inflation and deflation. Dowd reviews various objections to money of stable purchasing power and answers them to his satisfaction (and almost to mine).

One potential objection to QFCs seems not to be decisive after all: Wouldn't issues of new money to cover banks' betting losses destroy the scheme by making an incipient inflation even worse? Hardly. A bank so behaving would worsen its adverse balance at the clearinghouse. Such a danger would compel the bank instead to cover its losses and redemptions of money by contracting its loans and deposits—by shrinking in size. Such contraction, generalized, would exert appropriate antiinflationary pressure. In the opposite situation of incipient price deflation, any issues of new money to cover QFC losses would have an appropriate antideflationary effect.

Dowd supposes that the central bank would initiate the issue of QFCs and then be abolished, leaving the scheme to "the banks" (p. 37, chap.

14, p. 473). He leaves crucial details unexplained. Would the private banks operate the QFC scheme independently or collectively? It is understandable why each bank, under competitive pressure, should commit itself to redeeming its own already issued notes and deposits in QFCs. But what reason does an individual bank have to make QFCs in the opposite direction, issuing new money of its own even at the instigation of noncustomers?

Furthermore, an individual bank would hardly find prices quoted separately in its own and other banks' notes and deposits. Nor, probably, would its own issues circulate at an exchange rate other than par against the issues of other banks. Either they circulate at par or the bank defaults in settling its clearing balances and suffers the consequences. Why, then, should any one bank among many concern itself with the general price level? Perhaps the individual bank feels appropriate pressures from deficits or surpluses at the clearinghouse rather than directly from the price level; but how, then, do QFCs come into the story? Dowd's answers to questions like these should be illuminating. (Lawrence White and Roger Garrison, "Can Monetary Stabilization Policy Be Improved by Using CPI Futures Targeting?", forthcoming in *Journal of Money, Credit, and Banking*, should also be helpful.)

Echoing what he has written before, Dowd argues for "option clauses" whereby issuers of redeemable banknotes (and deposits?) might postpone redemption in times of difficulty, meanwhile paying a penalty rate of interest. He ignores published arguments about why, especially under modern conditions, the option clause would be unattractive for both banks and their customers.

Summarizing Knut Wicksell's presentation in 1919 of what later became known as the "paradox of indirect convertibility," Dowd curiously cites an English-language article whose title refers to a quite different topic and that does not appear in the cited volume of *Ekonomisk Tidskrift*. He omits citing the Swedish-language article in the same volume where Wicksell *does* present the supposed paradox. This and occasional other slips, as in a few of the symbols, keep me from testifying to the accuracy of everything Dowd says. (By the way, I urge publishers not to allow (or require) fragmentation of the discussion between text and lengthy notes, with the notes inconveniently located at the ends of the individual chapters.)

Still, my overall assessment of the book is strongly positive. Dowd defends the method of conjectural history. He employs it to reason out how the monetary and financial system might have evolved without government control. Understanding how things would work out under laissez faire is logically prerequisite to intervention to modify their working. If mainstream theory may legitimately build models of imaginary worlds—of identical, immortal persons interacting under perfect competition, and that sort of thing—surely it is legitimate to theorize about how things would work out under conditions that have never yet existed.

Karl Popper said that we hatch rival theories and try to shoot them down, tentatively accepting ones that withstand attempted refutation. We make our theories die in our stead. Similarly, we may hatch rival institutional reforms and use economic theory to try to shoot them down, sparing ourselves the pains of regimes that would prove flawed in practice. Coming early in the book, Dowd's embarkation on a conjectural history of almost complete financial laissez faire provides a convenient preview of subsequent chapters and whets the reader's interest in just how Dowd will argue for his announced conclusions and recommendations.

As for the supposed political impossibility of the recommended reforms, Dowd ends with a ringing denunciation—is he echoing Clarence Philbrook and W. H. Hutt?—of scholars' practicing "political realism." "Economists should not accept the role of courtiers, only willing to tell those in power what they want to hear." The job of scholars is to speak the truth as they themselves understand it.

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