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The traditional (monetary) approach to central banks is to consider them as monopoly institutions independent of the elected government and passive agents of money holders. Any competition among central banks in a monetary union is thought to result in an over issue problem, which has its roots in the view that moneys produced by competitive central banks are perfect substitutes for each other. In the conventional set-up over issue can be overcome by granting a central bank exclusive rights to conduct monetary policy.

In this book Mark Toma explores the workings of the early Federal Reserve System as a basis for challenging the conventional wisdom. His approach is framed in the spirit of the public choice tradition, but is novel insofar as its focus is the microeconomics of the central banking industry. He develops a series of micro-based models of the banking sector which are used to explain historical developments in central banking and in the behavior of the monetary policy makers.

Professor Toma is able to show that competition among reserve banks in the 1920s did not result in an over issue of Fed money. Rather the main effect of the competitive structure was to cause reserve banks to make substantial interest payments to the private banking system in place of transfers to the US government. He argues that the Congress imposed a more monopolistic structure on the Fed in the mid 1930s in order to accommodate the increased revenue demands of the Treasury at the time. The book is unique in emphasizing the evolution of the Federal Reserve from a competitive to a monopolistic structure.

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A microeconomics approach to monetary history

MARK TOMA
University of Kentucky

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To Mattie Sue

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Preface

This book is a study of the Federal Reserve System that is motivated by what I perceive to be an important omission in most theoretical and applied approaches to monetary economics. Modern monetary economics has been first and foremost a demand-side theory. Whether the model of the monetary economy has been based on a static, single period assumption, an overlapping generations assumption, or an infinitely lived representative agent assumption, the emphasis has generally been on refining the theory of money demand. Many of the insights of the modern approach have been grounded in the marginal utility analysis of microeconomics.

The theme of this book is that a microfoundation of money supply is the missing element in modern monetary economics. I ask the monetary theorist to reflect on the truly bizarre nature of the modern approach to the supply side. Typical supply-side assumptions are of the genre of Friedman's famous helicopter money. Sometimes the money supplier is figuratively a helicopter, sometimes an unconstrained monetary dictator, and sometimes a central banker with a particular money supply preference (for example, a conservative central banker). The common thread to all of these assumptions is that supply tends to be exogenous. To be sure modest attempts have been made to introduce supply-side microfoundations into these models. But nowhere do we have an approach grounded in the microeconomics of supply that compares with the sophisticated treatment of demand. Such an approach would be very much in the spirit of industrial organization theory where concepts like competition among suppliers, cost of production, and industry structure play fundamental roles.

Because my background is as an applied macro economist, this book illustrates the supply-side approach by way of a particular historical example – the evolution of the Federal Reserve System up to 1951. I shall admit my bias up front and without apology. I tend to see competitive pressures everywhere and the search for these pressures represents the overriding motif of my interpretation of the Federal Reserve period. If nothing else, this search has much to offer as a counterweight to the prevailing

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orthodoxy which tends to cast every Fed policy as a byproduct of a discretionary Fed decision maker or else as a byproduct of a Fed reaction function which relies on numerous *ad hoc* explanatory variables. Ultimately, my approach will have to be judged by the standards applied to any economic analysis: Is it consistent with the evidence and does it further our understanding of human actions, in this case, within the realm of monetary institutions?

I would like to thank Michael Bordo for encouraging me to undertake this project. Michael's credentials as an economist who uses the latest advances in theoretical monetary economics to provide deep insights into events in monetary history are well known. What is most impressive, however, is the public goods nature of his professional activities. His feedback on my work (no matter how unorthodox my hypothesis) has often provided the basis for a fresh look at the issue at hand and always has improved the final product.

While much of the work in this book represents my latest thinking and therefore has not been previously published, some of the chapters do rely on previously published work. I thank the *Journal of Monetary Economics* for allowing me to draw from Toma (1985; 1991a), the *Journal of Money, Credit, and Banking* for allowing me to draw from Holland and Toma (1991), *Explorations in Economic History* for allowing me to draw from Toma (1989), and *The Journal of Economic History* for allowing me to draw from Toma (1992). I also thank the Earhart foundation for financial support.

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