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Book Review

Monetary Regimes and Inflation: History, Economic, and Political Relationships, Second Edition

Peter Bernholz
Cheltenham, U.K.: Edward Elgar, 2015, 240 pp.

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The recent financial crisis of 2007–2008 generated a debate among economists over whether the leading central banks' unprecedented monetary intervention would spark a massive inflation and depreciation of currencies in the near future. During the meltdown of the banking system, central banks engaged in enormous monetary expansion and drastically increased member bank reserves in an effort to save the financial system and stimulate the economy. Despite this, inflation, at least judged by reported consumer price indexes, has grown at a relatively moderate rate in the period since the crisis. Why is this? Have we entered into a

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special period where monetary economics is no longer valid, and inflation is no longer a monetary phenomenon? Can central banks around the world now increase their respective money supplies *ad libitum* without suffering any consequences?

Answering these questions is partly one of the justifications for Peter Bernholz, renowned historian of inflation, to publish a second edition of *Monetary Regimes and Inflation*. The first edition of the book, which was published in 2003, concentrated on providing a concise overview of various inflationary episodes over the centuries. Bernholz analyzed inflation under different monetary regimes, such as metallic (i.e. gold or silver) and fiat standards, and what caused them. He also looked at eras with either moderate inflation or hyperinflation, and how they were ended. Overall, the book is a nice, concise survey of various periods of inflation on what caused them, how they compare with other episodes, and what ended them.

With a favorable reception to the first edition in 2003, Bernholz has decided to keep most of the slim volume (roughly 230 pages) intact and add only two new revisions to the second edition in 2014 (pp. x–xi). The first is a section in Chapter 2 about the recent financial crisis and why central banks' monetary expansions have not led to present day inflation, and whether or not they will lead to it in the future. The second is an entirely new Chapter 9 about how historically stable monetary regimes (that is, monetary regimes that were constrained and did not lead to significant inflation) were eroded. Given that these are the two new additions to a book originally published over ten years ago, I will spend the rest of the review on them.

In the new Section 2.1, Bernholz tries to answer the question that everyone was asking in the years after the financial crisis: Where is all of the inflation everyone was worried about? For example, in the United States, from December 2007 to April 2014 M0, or the monetary base (currency in circulation plus member bank reserves) increased by 363.87 percent, yet the rise in consumer prices was nowhere near that amount (p. 4).

Bernholz first answers this using a number of illustrative figures. He first shows that the enormous increase in M0 in various countries led to moderate increases in M2 (p. 5). Although the rise in M0 has not led to a rise in M2 now, Bernholz concludes that it provides a permanent potential for inflation in the years to come, once banks start to engage in credit expansion (p. 8). Then, even with the current increase in M2, Bernholz argues that the rise in consumer prices was mitigated because velocity during this period fell (i.e., money demand rose) and most of the new money was not spent on consumer goods, but on goods not included in a cost of living index, such as houses and stocks (pp. 8–9). Bernholz concludes by arguing that many banks have not engaged in credit expansion because they are pessimistic about the state of the economy (pp. 9–10).

At the outset, it would have helped Bernholz's argument enormously if he not only provided illustrative figures but also numerical figures. Aside from the precise increases in M0 in the USA, the euro area, and Switzerland from December 2007 to April 2014, he only provides illustrations of M2, the M2 money multiplier, and velocity. Why not also provided quantitative estimates for them as well? For example, it would have been nice to know that from the beginning of December 2007 to the beginning of December 2013 (the latter being the last full year before the book came out), despite the enormous M0 growth of 334.99 percent (27.76 percent per annum), M2 growth in the U.S increased only 47.42 percent (6.68 percent per annum), and the CPI increased even less than that at 10.99 percent (1.75 percent per annum).[1] And so on for velocity, the money multiplier, and housing and stock prices. The figures, while helpful illustratively for understanding the big picture, are not really helpful for those interested in using this section of the book for research.

In addition, when discussing why the increase in M0 did not translate into a concurrent increase in M2, Bernholz should have also mentioned, at least for the United States, the use of the contemporary new policy tool by the Federal Reserve to pay interest on member bank deposits. With this new proviso, banks no longer have as much of an incentive to engage in credit expansion in order to earn interest and to cover the cost of inflation eroding away idle balances. Certainly this, in conjunction with the regime uncertainty and economic malaise from the contemporary political climate, goes a long way towards explaining why the equally sizable M0 increase has not translated to an equally sizable M2 increase.

[1] Data for these numbers is obtained from BLS (2015), BOG (2015), and FRED (2015).

Although not directly related to current events, the other new addition of the book, Chapter 9, seeks to answer two questions: Why did some stable monetary regimes arise when there was no large inflation beforehand to incentivize their adoption, and under what circumstances did stable monetary regimes become abolished? Bernholz answers the first question with the theory that countries enacted stable monetary regimes so they would have an international currency that could be used in foreign trade. Bernholz uses examples from antiquity, such as the Athenian drachms and Corinthian staters, and argues that the sovereigns did not engage in debasement because the long term benefits from having an internationally used currency outweighed the short term benefits of debasement. Bernholz also argues that for some time the US dollar and British pound before World War I enjoyed relative stability for similar reasons. Bernholz answers the second question by arguing that countries are able to dismantle their stable monetary regimes and engage in inflationary policies whenever there is an "emergency." Bernholz provides a brief table of various governments that suspended gold convertibility or devalued their currency with a list of emergencies, ranging from domestic and international wars, government bankruptcy, and economic calamity (such as the Great Depression). To anyone familiar with Robert Higgs' *Crisis and Leviathan* (1987), the idea that emergencies, or crises, allow governments to engage in unprecedented usurpations of economic liberties (which includes money) is unsurprising. But it is nice to see the idea being taken seriously by others. A passage on the inherent incentive of governments to call a "national emergency" is all too revealing:

> Given the inflationary bias of governments and politicians we should not be surprised that they grasped any critical situation to declare an emergency with the purpose of eroding or abolishing the factual legal or constitutional limits on their control of the currency. For it is only in emergencies that important changes appear to be warranted. As Carl Schmitt [German professor and early Nazi] pointed out: … "Sovereign is he who decides on the state of emergency." (p. 209)

Bernholz also argues that the reintroduction of stable monetary regimes has occurred when countries try to mimic other countries who have already adopted a stable monetary regime. But without a first mover, the only other reasons have historically been after the end of a war or a hyperinflation. This empirical reality is quite unfortunate for anyone who wishes to enact some form of monetary constitution that ensures price stability or deflation (such as a return to the gold standard) in the United States. Will it take a hyperinflation and destruction of the dollar in order for the public and politicians to learn that our present practices are unsustainable?

Overall, the book is informative about inflation in all periods of human history, and researchers looking for concise overviews will find much use in it.

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