

BOOK REVIEW

BANKING AND MONETARY POLICY FROM THE PERSPECTIVE OF AUSTRIAN ECONOMICS

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The editors are to be heartily congratulated for putting together this book, which covers an impressive range of topics in monetary economics from an explicitly Austrian perspective. Most of the twelve essays are of a very high quality and one will learn much about money and related topics by a careful reading of them. The chapters range from an insightful interpretation of Austrian monetary theory as a rehabilitation and development of classical monetary theory to novel applications of the theory to current issues such as inflation targeting, the consequences of unconventional European Central Bank (ECB) policies, and cryptocurrencies. In addition to its ambitious scope, this book stands out because most essays take an unabashedly Austrian approach to their topic. It is a great pleasure to read a volume on money and banking that so liberally cites Mises, Hayek, and Rothbard. Ironically, the one

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minor drawback of the book is that it does not contain an index for someone interested in the number and location of text references to these and other Austrian monetary theorists.

Guido Hülsmann presents an excellent overview of Mises's monetary theory that emphasizes its deep roots in the classical approach to money formulated by Ricardo and the British Currency school. As Hülsmann (p. 26) demonstrates in his essay, Mises "rebuilds classical monetary theory on a completely new and more solid foundation [i.e., the subjective theory of value], thus awakening it out of the slumber into which it had sunken after 1844 and making it relevant again for political decision-making." Now, this story has been told before, but the subtlety and clarity of Hülsmann's presentation mark it as an indispensable introduction to Mises's monetary theory and perfectly suit its position as the opening essay of the book.

The merits of this essay are not purely expository, however, for Hülsmann makes an important doctrinal discovery. Standard accounts of the transition from the views of the sound money Currency school to what Hülsmann labels the "New Orthodoxy," based on the previously discredited Banking school, have always focused on the alleged policy failures of the "currency principle" but have been hazy or mute regarding its doctrinal aspects. Who, exactly, was the central figure (or figures) in the recrudescence of the "banking principle"? The latter principle asserts that issuance of fractional reserve bank notes and deposits convertible into specie are indispensable to ensuring economic stability and accommodating economic growth. Hülsmann fills this gap in the literature by identifying the prolific Scottish banker and economist Henry Dunning McLeod as the pioneer of this movement. He argues that Schumpeter, Keynes, and the early L. Albert Hahn all accepted the New Orthodoxy and developed their respective theories of money under McLeod's influence. Hülsmann makes a very plausible case for McLeod's key role in overturning classical monetary theory. But his case would be more compelling if he offered textual evidence from Schumpeter, Keynes, et al. to support his argument, because McLeod was lightly regarded by his contemporaries and dismissed as a monetary crank by later writers. In any event, Hülsmann has uncovered a lacuna in the history of monetary thought that at least needs to be addressed by further research.

Brendan Brown's essay "What Is Wrong with the 2% Inflation Target" presents what I consider the definitive refutation of inflation targeting. Brown approaches his topic by upholding the classical gold standard as the standard by which to evaluate the nature and performance of modern fiat money regimes. In doing so, Brown provides an excellent analysis of the merits of the gold standard. Brown eschews the artificial constructs of aggregate spending flows that contemporary macroeconomists fixate on. Instead, following Mises, Hayek, and Rothbard, he focuses his comparative analysis of monetary regimes on general movements of concrete money prices, which naturally emerge in an economy in which money and goods are inextricably entwined in individual exchanges.

According to Brown, under the gold standard, gold served as high-powered money and was the "pivot" of the monetary system, because it enjoyed a "large stable demand" for use as transactions media, bank reserves, and as an industrial input. Since the supply of gold was determined by market forces, it tended to be relatively fixed and inelastic in the short and medium runs while in the long run responding elastically to changes in its real price (i.e., in terms of the quantity of commodities a gold unit could purchase). Thus, although the "well-pivoted" gold standard confined the movement of overall prices within definite bounds, it provided the necessary flexibility for the scale of money prices to move upward or downward naturally and spontaneously in response to changes in real conditions over short or medium periods. Indeed, it is precisely the accommodation of these natural price fluctuations that for Brown constitutes the essence of sound money and sharply distinguishes it from modern fiat money regimes, which "target" stability of statistical constructs such as the price level, inflation rate, or nominal income. As Brown (p. 87) incisively states:

Under a system where a high-powered money is at the pivot, as in a gold money regime, there is considerable scope for prices to fluctuate under real influences, and in a way, which aids the invisible hands in their job of steering the capitalist economy in an efficient manner. Indeed stable prices over the short and medium-term would indicate a defect in the price-signalling mechanisms of a capitalist economy under sound money.

Brown (pp. 87–88) gives three instances in which sound money facilitates the "natural rhythm of prices." During a recession,

sound money promotes rapid recovery by facilitating the natural tendency of prices to fall below the perceived norm “for the cycle on average[,] caus[ing] consumers and businesses to bring forward spending (so contributing to the business recovery).” Likewise, sound money poses no obstacle to price declines that reflect increases in real incomes caused by spurts of productivity growth. Lastly, a sound-money regime would not conceal and exacerbate the effects of severe (negative) supply shocks emanating from an interruption of energy supplies or crop failures, because prices would rise rapidly above anticipated levels, revealing and smoothly rationing the scarcer commodity supplies in the short run and encouraging consumers to postpone their purchases until prices return to perceived normal levels in the longer run. In all these cases, inflation targeting, if rigidly followed, would suppress the natural rhythm of prices and thereby disrupt the economy by either initiating asset bubbles (the first two cases) or by exacerbating real scarcities (the third case).

Furthermore, Brown (p. 90) argues, under a regime in which the price level or the inflation rate is targeted by the central bank, “the link between money and prices or nominal incomes [becomes] loose and unpredictable.” The monetary pivot is thus “dislodged” and the natural rhythm of prices gives way to price inertia and institutionalism. This means that, at least in the short and medium runs, inflationary expectations become unmoored from monetary fundamentals and a tendency develops for the inflation rate to persist at the level expected. In addition, expectations themselves come to be dominated by real side institutional factors such as the behavior of labor unions or the state of the national budget or trade balance, etc. Of course, in the long run, monetary forces reassert themselves, but in the meantime resources are misallocated, financial markets distorted, and asset bubbles begin to form.

Brown’s essay is also instructive in explaining the historical origins and dissemination of the 2 percent inflation standard. Brown (pp. 99–100) concludes by presenting a bold, populist program—and the challenges thereto—for demolishing the inflation-targeting regime and reestablishing sound money short of the restoration of the classical gold standard:

Reserves at the central bank, like gold, must not pay interest. Obstacles to a vibrant use of cash in the economy should be demolished (...)

[including] issuance of high denomination notes to satisfy demand for these as medium of exchange). Bank demand for reserves (which would be held voluntarily not as a legal reserve requirement) would be boosted by the curtailing and ideally the abolition of too big to fail, lender of last resort and deposit insurance....The vast balance sheets of the central banks accumulated during the Grand Monetary Experiment would have to be shrunk such that the monetary base would be freely demanded at zero interest rates at the start.

Arkadiusz Sieroń's "Hayek and Mises on Neutrality of Money: Implications for Monetary Policy" outlines the uniquely Austrian understanding of the nonneutrality of money, which emphasizes the role of Cantillon effects. In particular Sieroń (p. 153) focuses on Mises's and Hayek's writings, "as these two authors presented the most far-reaching criticisms of the neutrality of money." Mainstream macroeconomists, in contrast, argue that although money is nonneutral in the short run, a proportional adjustment of nominal variables to a change in the money supply ensures that the effects on real variables vanish and neutrality of money prevails in the long run. For Mises and Hayek, Cantillon effects, also known as "first-round" or "injection" effects, refer to the fact that the emission of new money into the economy under any monetary regime is inevitably distributed unevenly among economic agents. This initial redistribution of monetary assets among households and firms causes an alteration in the structure of relative demands for different kinds of goods and a consequent change in the pattern of relative prices and the allocation of resources. Furthermore, the prices of some goods—those purchased by the first recipients of the new money—naturally rise before those of others, causing further changes in the relative price structure and, therefore, in the distribution of money incomes and cash balances. By the time this step-by-step process of adjustment to a change in the money supply comes to an end, the entire system of relative prices has been revolutionized, resulting in a permanent change in resource allocation and the distribution of wealth and income. The sequential and time-consuming operation of the monetary adjustment process, during which the array of money prices changes at different times in different proportions (and even directions), is thus an inherent feature of a money economy. As Sieroń (p. 159) trenchantly puts it:

For Hayek, changes in relative prices in response to monetary disturbances are not frictions, lags, or market failures occurring due to price rigidity, incomplete information, or irrational expectations, but the natural and inevitable consequence of monetary impulses. This is because new money enters circulation only through specific channels and some people receive the additional money earlier than others.

In comparing Mises's and Hayek's views on neutral money, Sieroń (p. 161) makes another important observation. Mises went "much further than Hayek" in his critique of neutral money, for Mises pointed out that money is nonneutral even if it is supposed that Cantillon effects are absent because every agent's cash balance is somehow increased in equal proportion. In fact, although Sieroń does not note this, Mises (1971, pp. 140–41) went even further than this and supposed a situation in which the new money is distributed among individual cash balances in such a way that the relative (monetary plus nonmonetary) wealth of all remains unchanged. Mises insisted that in this case the nonneutrality of money also holds. The reason is that as the wealth of individuals increases, their subjective marginal utility rankings of different goods and money will change and alter their relative demands for goods and cash balances. The outcome of this mental experiment is a permanent reconfiguration of relative prices and resource allocation and a lack of proportionality between the change in the money stock and the scale of money prices—the long-run nonneutrality of money, in short.

Sieroń concludes that the Cantillon effect, as conceived by Mises and Hayek, has momentous implications for the ongoing discussion of the efficacy of monetary policy, which has intensified since the financial crisis. In particular, once the injection effect is recognized, monetary policy is exposed as an important cause of business cycles and asset bubbles and their international transmission, as well as a contributing factor to greater income inequality.

Jesús Huerta de Soto brilliantly debunks the fallacious arguments against deflation in his chapter "Anti-deflationist Paranoia." He recognizes three distinct kinds of deflation and perceptively analyzes their consequences. He points out that one type of deflation stems from an "error of institutional design" in the form of fractional reserve banking. This "institutional deflation" is part of the regular recurrence of expansion and contraction of the money supply that is an inherent feature of a fractional reserve banking system. It is

the inevitable outcome of an inflationary boom fueled by previous bank credit expansion that falsifies the interest rate and causes malinvestments and distortion of the production structure. Indeed, this built-in tendency toward deflation is so powerful that the fractional reserve banking system's "survival depends on a lender of last resort (or central banker)." Beyond preventing a wholesale collapse of the banking system, Huerta de Soto (p. 198) argues,

there is relatively little central banks can do. At most they can keep private banks from failing by providing them with all sorts of loans and assistance. And that is about it. However a process of monetary contraction (i.e., a process of deflation) is inevitable.

Now this assertion that institutional deflation in the sense of an actual contraction of the money supply is an inevitable outcome of a fractional reserve banking system appears to be in conflict with the facts, at least since World War II. Certainly the Fed and other central banks successfully prevented their money supplies from contracting during the 2008 financial crisis with resort to unconventional methods of printing base money, such as zero interest rate policy (ZIRP), quantitative easing (QE), forward guidance, credit easing, etc. Nor did the money supply contract in the US after the dot-com bubble burst in 2000, or even during the severe "double-dip" recession of 1980–82. I may misunderstand the author on this point, and he may be referring to a powerful deflationary *tendency* that is present in fractional reserve banking and that actually manifested itself when central banks operated only as lenders of last resort. But if this is the case, it would have been instructive for the author to indicate how modern central banks, focused on stabilizing prices or targeting inflation, routinely neutralize institutional deflation and what the consequences of their doing so are.

Huerta de Soto also engages and demolishes the main arguments against the kind of deflation that is caused by increases in productivity induced by capital accumulation and advances in technology. I do, however, have one minor reservation with respect to his rebuttal of the contention that a fall in prices due to an increase in real output that outstrips the increase in the money supply constrains economic growth and leads to a cumulative economic contraction. Huerta de Soto counters the argument by pointing out that a fall in prices will spur entrepreneurs to reduce costs by: 1. renegotiating

input prices downward and 2. substituting at the margin relatively cheaper capital goods for laborers, who are now receiving higher real wages, thereby increasing the demand for capital goods and causing laid-off laborers to migrate to capital goods industries (i.e., the Ricardo effect).

If I have understood the argument correctly, it puts the cart before the horse, for it is the increase in saving and investment in capital goods that *initiates* the process of productivity growth. Increased investment causes workers to shift from the consumer goods to capital goods industries. Eventually this movement increases the supply and lowers the prices of capital goods, making it profitable to implement new and more productive technical methods in the consumer goods industries. Thus, even with nominal wage rates unchanged, costs of production decline as labor productivity increases. The prospective profit margins on consumer goods therefore expand. This stimulates consumer goods firms to increase their supply and the increased competition causes prices naturally to fall. In short, during the process of economic growth initiated by net saving and investment, labor productivity and costs of production fall *in advance of or in step with* the decline in product prices. Furthermore, laborers shift from industries closer in time to consumers to ones more temporally remote from consumers at the very beginning of the growth process rather than at its end, as Huerta de Soto contends. Thus there is no need to renegotiate nominal wage rates or to lay off workers in response to deflation due to real output growth. But this is a minor emendation to a fine essay.

Due to space constraints I can only give brief notice to several other excellent essays in the book. Two of these essays focus on the nature and consequences of errors in ECB monetary policy. These are “Unintended Consequences of ECB Monetary Policies in Europe,” by Andreas Hoffman and Nicolas Cachanosky, and “The Failure of ECB Monetary Policy from a Mises-Hayek Perspective,” by Gunther Schnabl. The authors of these essays have been pioneers in the application of Austrian business cycle theory to analyzing the international dimensions and transmission of asset bubbles and the ensuing financial crisis. Their essays in this book display deep scholarship and a familiarity with an enormous range of theoretical and empirical literature, both Austrian and mainstream. The significance of their essays lies not merely in identifying the flaws in ECB

monetary policy leading up to the financial crisis, but in utilizing innovative theoretical models and masterfully employing data to explain how ECB policy in the aftermath of the crisis has led to a weak and protracted recovery in the euro area. These essays also serve as exemplars for future research on the global transmission of national or supranational central banks' monetary policy errors.

Two of the essays addressing the Austrian view of cryptocurrency are "The Reconsideration of Hayek's Idea on the Denationalization of Money: Taking the Growing Tendency of Digital Currency in Consideration" and "Cryptocurrencies from an Austrian Perspective," by Chikako Nakayama and Alistair Milne, respectively. These essays are not as tightly formulated as other essays in the book and tend to be wide-ranging reflections upon the linkages between Austrian monetary theory and cryptocurrencies in their various aspects. But they are extremely valuable nonetheless, because they stimulate thought about the problems and potentialities of a radical approach to denationalizing money and implementing a sound, market-based money regime.

This book is indispensable reading for anyone who has a professional or vocational interest in the Austrian approach to money, finance, and business cycles.

REFERENCES

- Mises, Ludwig von. [1912] 1971. *The Theory of Money and Credit*, trans. J. E. Batson. New York: The Foundation for Economic Education.