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BOOK REVIEW

Money and the rule of Law

Book review: Boettke, P., Salter, W., and Smith, D. (2021). *Money and the rule of Law: generality and predictability in Monetary Institutions*. Cambridge University Press, pp: 193. ISBN 978-1-108-79084-0 Paperback

Pablo Paniagua[1,2]

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1 Introduction

Recently the entire world, and particularly the United States, has been experiencing the worst levels of inflation in nearly 40 years (Blanchard, 2022). This new reality could be quite surprising for economists, since now we know how the economy in the 70 and 80 s worked, and what caused the high levels of inflation during that time: massive expansions of the monetary base through discretionary monetary policy (Friedman, 1977; Meltzer, 2005). Yet here we are again: the phantom of inflation has crept back into our economic system, despite our knowledge of its causes and consequences, as well as how to avoid it (Goodfriend, 2007). So, whilst a lot of economists are (justly) worried about inflation, there is a more fundamental question that very few academics are asking: how is it that central bankers are so bad at their jobs, despite of all the knowledge that we have accumulated?

This is a pertinent question that has been sidelined recently in economics, but is precisely the pressing issue tackled in *Money and the Rule of Law*. The authors suggest that, “money does indeed change everything. And since it does, we had better get our monetary and financial institutions right. We argue that getting them right depends on making monetary policy consistent with the rule of law” (Boettke et al., 2021, p. xiv).

The book’s crucial proposition is simple and easy to grasp for scholars well-versed in James Buchanan’s work on Constitutional Political Economy (Brennan

✉ Pablo Paniagua
pablo.paniagua_prieto@kcl.ac.uk

1 Universidad del Desarrollo (UDD), Santiago, Chile

2 Research Fellow at the Centre for the Study of Governance & Society (CSGS), King’s College London, London, England

& Buchanan, 1985), and Public Choice (Buchanan & Wagner, 1977): mainly, what truly matters in determining outcomes are *the rules of the game* (Buchanan, 2008). Consequently, if you have flawed rules—meaning, those that generate bad incentives and poor knowledge processes—then you will get bad outcomes. Instead, if you have sound or robust rules—meaning, those rules that generate better incentives and superior knowledge—then you will get better outcomes (Pennington, 2011). Despite all its macroeconomic refinement and high levels of technicality, monetary policy cannot escape this fundamental fact of economic nature; this is because both monetary policy and banking processes will always be dependent on the institutional structure in which it operates (Paniagua, 2021). Thus, the set of rules or institutions of the 'monetary game', whether for good or bad, will ultimately determine the outcome of monetary policy.[1] In other words, institutions and rules dominate *over* the quality of people and their expertise. Under this constitutional way of thinking, the current problem of inflation and other monetary malaises are ultimately a *problem of bad rules*.

2 A brief overview of the book

The book comprises seven chapters. The introduction sets the stage through a brief review of the most recent example of monetary mismanagement: the period of 'Too Loose' (2003–2006) then 'Too Tight' (2008–2009) monetary policy, which ended in the Great Recession. The authors borrow from Selgin (2016, p. 282) to distinguish between pseudo-rules and genuine monetary rules. A pseudo-monetary rule, "is one that is either not well enforced or not expected to last" (Ibid.). Monetary rules that allow discretion, but *do not specify conditions* for when deviations are permitted, are "mere guidelines for monetary policy too vague to be operational" (Sevensson, 2003, p. 3).

Chapter 2 provides an account of the "knowledge problem" in monetary policy. The authors suggest that there are insurmountable knowledge and informational problems inherent in discretionary monetary policy (see also Paniagua 2016a; 2016b). It is not merely difficult for central bankers to maintain aggregate nominal stability (or a sort of monetary equilibrium) by discretionary means; it is *impossible* given the existent information processes and the knowledge-generating mechanisms inherent in discretionary central banking.

Chapter 3 delineates the incentive problem and the political problems inherent in central banking practices. The chapter reminds us that central bankers, after all, are bureaucrats under a politically influenced institution (see also Adolph 2013). They are thus particularly susceptible to the standard forms of non-market, political, and non-competitive incentives well-known in the public choice literature. These non-market incentives usually result in phenomena such as status quo bias and "mission

[1] Institutions are "the humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive [and epistemic] structure of societies" (North, 1994, 360).

creep." Furthermore, central banks are susceptible to political interference (Meltzer, 2009). Taken together, these incentive and political problems, "prevent us from uncritically assuming that central banks can advance the public interest so long as they retain discretion" (Boettke, et al., p. 16).

Chapter 4 focuses on the risk of financial catastrophes. The notion of taming banking crises and preventing them from ruining the financial system are among the strongest arguments employed to guarantee a higher degree of discretion in monetary and banking policy. By drawing on the evidence and literature on last-resort lending, the authors maintain that true stable and fixed rules for last resort lending can better deal with both nominal instability and financial insolvency.[2]

Chapter 5 engages in a form of intellectual reconstruction of the monetary and banking insights of three Nobel Laurates: James Buchanan, Milton Friedman, and F.A. Hayek. The chapter delineates how their monetary insights relate to each other and how their vision on money, rules, and constitutions can be fruitfully combined into one coherent analytical framework. Even though these economic thinkers arrived at different institutional solutions to the central banking problem, the chapter unveils how they thought about it in similar ways, thus sharing a unified *way of thinking* about monetary institutions.

Chapter 6 is the most normative chapter, as it reintroduces the ideal and normative view of the rule of law as something valuable and necessary for society, detailing its pedigree within liberal political economy and constitutional theory. The authors claim that this normative vision, "underlies the justification for all institutions of public importance in constitutional democracies and that central banks cannot meet this standard so long as it retains discretion in its operations" (Boettke et al., 2021, p. 16). Empirically driven monetary theorists and pragmatist political economists may be unconvinced by this chapter.

Chapter 7 reflects on money and liberalism and how we can carry forward the liberal research agenda in banking and money into the 21st century. The message goes to the heart of readers of this journal: "if monetary economists and macroeconomists want to make lasting contributions to the quest for economic stability […] they must think 'constitutionally" (Ibid.). The technical dimensions and tools of monetary policy are important; however, fixing our monetary *meta-rules* by both eliminating discretion and by predictably governing the use of such tools is surely the vital precondition for a sound monetary order.

3 Discretionary monetary policy is inherently unstable

The book's main point conveyed to readers is twofold: first, that rules in the long run will always work better than unconstrained discretion that relies on fallible human beings, and second, that our existent monetary institutions are defective at a foundational level, since they rely on "constrained discretion as the preferred operating framework for central banks" (Boettke et al., 2021, p. i). The post-Great Recession

[2] Concerning the 'lender of last resort' debate, and how to avoid systemic bank runs in a stable manner, see also Paniagua (2017; 2020).

monetary consensus revolves around the peculiar notion of "constrained discretion", despite the lessons learned from the "rules vs. discretion" debates decades ago (Taylor, 2012).

The notion of "constrained discretion" is the idea that central bankers will adhere to some sort of 'rule-like behavior' during normal macroeconomic times, but reserve the right to act, in a discretionary manner, during extraordinary times or during macroeconomic turbulence.[3] Bernanke (2003) and other central bankers have suggested that this approach is the best of both worlds, since it combines the discipline of monetary rules, with the flexibility of unconstrained discretion to act when necessary. Readers of this journal, well-versed in constitutional theory (Mueller, 2014), might find this notion of "constrained discretion" oxymoronic, because if central bankers have the liberty and unchecked freedom to call the shots and decide when to intervene and apply discretion, then that it is not really an enforceable rule at all. Paraphrasing Hobbes, covenants without swords are nothing but words, and "constrained discretion" is really discretion with a palatable cloak of verbosity.

The main point is that, despite central bankers' best intentions, discretionary monetary policy is *inherently unstable* and prone to generate macroeconomic instability (such as inflation, recessions, etc.) due to unsolvable institutional fragilities at the core of discretionary policy, caused by *both* incentive and informational (or knowledge) problems. In simple terms, central banks cannot have all the relevant information and knowledge necessary to enact stable monetary policy. Even if we assume that they could possess such knowledge and data, they would still lack the right incentive structure (e.g., rewards, transparency, monitoring, and punishment mechanisms) to correctly enact policy based on such knowledge. Central banking policy is a highly opaque and *inherently political* job with little oversight, prone to political pressure, and with ample room to make mistakes based on either *knowledge problems* or *incentive-political problems* (Meltzer, 2009). Thus, Congress, the President, other politicians, private banks and financial institutions all exert *some degree of influence* on central banking decision-making (Adolph, 2013), making it, at best, prone to serious mistakes or, at worst, to advance private interests above the public interest.

The framework proposed in this book for analyzing monetary institutions, such as The Federal Reserve System (Fed), is extremely useful to understand the *chronic cycle* of central banks' errors and oversights throughout their history. For example, it is well acknowledged by banking scholars that the Fed's mistakes were a major component of the Great Depression (Friedman & Schwartz, 1963; Hetzel, 2012). Due to both knowledge problems and a lack of accurate information, and given a lack of incentives to act on the cascade of banking failures, the Fed's inaction and omissions were catalysts of the biggest economic crisis in recorded human history.[4] Similarly, due to strong political pressures (wrong incentives) and knowledge problems (i.e.,

[3] In short, "constrained discretion" is an approach that allows monetary policymakers *considerable leeway* while responding to economic events, financial disturbances, and other unforeseen developments—such as pandemics. However, they will allegedly remain somewhat constrained by 'verbal commitments' to keep inflation low and stable, to anchor expectations.

[4] This has been recognized even by the 14th Chair of the Federal Reserve, Dr. Ben Bernanke: "I would like to say to Milton [Friedman] and Anna [Schwartz]: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again" (Bernanke, 2002, p. 10).

having the wrong economic model to interpret the world), the Fed paved the way for the period known as the Great Inflation (1965–1982) (Meltzer, 2005). It is also recognized that the 2007–2008 Great Recession was also greatly exacerbated by the Fed's inactions in monetary policy due to a lack of information and knowledge problems (Hetzel, 2012; Paniagua, 2016a). All these errors pile up on us in present day, to a new period of double-digit inflation in which the Fed has fallen significantly behind the curve (Blanchard, 2022).

It is not by chance that, in less than a century (1929–2022), the Federal Reserve has been involved in an endless cycle of mistakes and omissions, which have created severe economic turbulence and inflation, undermining the long-term process of wealth creation in the United States (Selgin et al., 2012). This book suggests that what all these periods have in common is the underlying fact that, as they are currently designed, central banks are fragile or weak institutions: "contemporary monetary institutions are flawed at a foundational level" (Boettke, et al., p. i), since they are based on discretion rather than being rooted in sound monetary rules binding central bankers.[5] The bottom line is that discretionary monetary policy is *institutional and inherently unstable*, and it will always generate, to some degree, wealth-destroying cycles. As Friedman (2007) warned us,

> One of the great defects of our kind of monetary system is that its performance depends so much on the quality of the people who are put in charge. [...] That raises a question about the desirability of our present monetary system. It is one in which a group of unelected people have enormous power, power which can lead to a great depression, or which can lead to a great inflation. Is it wise to have that power in those hands?

In contrast to these fragilities, the authors argue that a general and predictable rule for monetary policy will provide a better foundation for macroeconomic stability, economic growth, and human prosperity. The book offers a novel framework of analysis combining political economy, constitutional political economy, banking history, and monetary theory.[6] I can thus highly recommend the book to scholars and students interested in enriching their analysis at the intersections of politics, philosophy, and economics, while maintaining a high level of intellectual rigor. Ultimately, the book delineates a valuable way forward for developing relevant political economy studies in the fields of macroeconomics and banking.

To conclude, *Money and the Rule of Law* is a welcome contribution to the intellectual road and research agenda at the intersection of political economy, banking theory, and monetary institutions. The book is a great reminder of the fact that while economics might be a science, political economy and monetary policy are worldly

[5] This applies also to inflation-targeting 'rules' since they are not really enforceable rules. Recently, inflation-targeting has not prevented central bankers from moving way beyond their often opaque official responsibilities. Those forms of guidelines fail because they are "pseudo rules" and thus easily worked around, modified, or ignored.

[6] For a similar approach combining political economy, banking history, and monetary theory, consult Paniagua (2016a; 2016b;2017).

arts[7] that require prudence and nuanced understanding of how institutions are constructed. The knowledge we require to build better monetary institutions for the future lies at the intersection of these fields. This book has made a strong contribution in illuminating it and has paved the path forward.

Author contribution Pablo Paniagua Prieto wrote the entire manuscript text

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[7] As Blanchard (2006, p.1) reminds us, "Monetary policy can pretend to be close to science if it can be conducted using simple and robust rules. […] They may not be perfect, but they have to be robust, i.e., to do well especially when things are bad. Monetary policy must be closer to art if it is frequently confronted to new, poorly anticipated and poorly understood, contingencies".

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