NEW PERSPECTIVES ON POLITICAL ECONOMY

A bilingual interdisciplinary journal

Vol. 6, No. 1, 2010

Wolters Kluwer
Česká republika

CEVRO INSTITUT ACADEMIC PRESS

CEVRO INSTITUT
[vysoká škola]

NEW PERSPECTIVES ON POLITICAL ECONOMY

A bilingual interdisciplinary journal / Vol. 6, No. 1, 2010

New Perspectives on Political Economy is a peer-reviewed semi-annual bilingual interdisciplinary journal, published since 2005 in Prague. The journal aims at contributing to scholarship at the intersection of political science, political philosophy, political economy and law. The main objective of the journal is to enhance our understanding of private property-, market- and individual liberty-based perspectives in the respected sciences. We also belive that only via exchange among social scientists from different fields and cross-disciplinary research can we critically analyze and fully understand forces that drive policy-making and be able to spell out policy implications and consequences. The journal welcomes submissions of unpublished research papers, book reviews, and educational notes.

PUBLISHED BY CEVRO INSTITUTE ACADEMIC PRESS
IN CO-OPERATION WITH WOLTERS KLUWER CZECH REPUBLIC

EDITORIAL ADDRESS:
New Perspectives on Political Economy
CEVRO Institute, Jungmannova 17, 110 00 Praha 1, Czech Republic

Manuscripts should be submitted electronically. All manuscripts and correspondence should be addressed to nppe@vsci.cz.

Full text available via DOAJ Directory of Open Access Journals, EBSCO Publishing databases and System ASPI.

INFORMATION FOR AUTHORS

Authors submitting manuscripts should include abstracts of not more than 250 words and JEL classification codes. New Perspectives on Political Economy edits for clarity, brevity, and in accordance with the Chicago Manual of Style. Authors should use footnotes rather than endnotes or in-text references, and must include complete bibliographical information. Authors should include information on their titles and professional affiliations, along with e-mail address.

ISSN 1801-0938 (ON-LINE)
ISSN 1804-6290 (PRINT)

FREE-MARKET IDEOLOGY OR THE RESULT OF ECONOMIC CIRCUMSTANCES? AN EXAMINATION OF THE FINANCIAL DEREGULATION INITIATIVES OF THE EARLY 1980s

WILLIAM L. ANDERSON – AMIT SHAH*

JEL CLASSIFICATION: G18, G28

ABSTRACT

Nobel Prize-winning economist Paul Krugman, among others, claims that the current recession and financial meltdown is due to changes in the regulatory structure of banking and finance in the early 1980s. They claim specifically that "free market ideology" spurred on by the presidency of Ronald Reagan brought about the regulatory changes, and, thus, free markets are to blame for our current problems. In this paper, we examine the two main deregulatory acts, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germaine Act of 1982. However, we find that both bills had strong bi-partisan political support and were crafted because of problems that had come about in the banking industry because of inflation-caused disintermediation. Ideology had little to do with either bill, we find.

* William L. Anderson, Associate Professor of Economics, Department of Economics, Frostburg State University, Frostburg, Maryland, banderson@frostburg.edu; Amit Shah, Professor of Management, Department of Management, Frostburg State University, Frostburg, Maryland, ashah@frostburg.edu

1. INTRODUCTION

In the wake of the financial meltdown on Wall Street and the deepening recession in the United States, many economists and political figures are blaming changes in the regulatory structure of U.S. financial markets in the early 1980s. One of the most vociferous critics, Paul Krugman, the 2008 Nobel Prize winner in economics, claims that the source of the financial deregulation was "free-market ideology" fomented by then-President Ronald Reagan. For example, Krugman (2009) writes in a recent *New York Times* column:

> *Reagan-era legislative changes essentially ended New Deal restrictions on mortgage lending – restrictions that, in particular, limited the ability of families to buy homes without putting a significant amount of money down.*
>
> *These restrictions were put in place in the 1930s by political leaders who had just experienced a terrible financial crisis, and were trying to prevent another.*
>
> *But by 1980 the memory of the Depression had faded. Government, declared Reagan, is the problem, not the solution; the magic of the marketplace must be set free. And so the precautionary rules were scrapped.*
>
> *Together with looser lending standards for other kinds of consumer credit, this led to a radical change in American behavior. (A21)*

Krugman is not the only person blaming "free-market ideology" for financial deregulation and changing of standards in financial markets. A decade ago, economist Bruce Coggins (1998) wrote in his book *Does Financial Deregulation Work?* that governments needed to *increase* regulation, not loosen it and said that financial markets and "free markets" were not compatible.

Likewise, a number of other economists, journalists, and public intellectuals are claiming that not only is the financial deregulation of the early 1980s and late 1990s responsible for the current meltdown, but that the deregulation was the product of "free-market ideology." Robert Kuttner (2007) writes in *The American Prospect:*

> *The sub-prime mess is not so much a new crisis as it is a resumption of the saga that began with the savings and loan scandal of the early 1980s, when executives of S&Ls went on a risky lending binge with government-insured money. Then, as now, there were many individual culprits, but the real problem was the ideology of deregulation and the capture of public policy for private gain by the financial industry.*

Thus, we have a simple but observable hypothesis: Financial deregulation occurred because of a change in the ideological landscape that came about in large part because of the free-market ideology associated with the presidency of Ronald Reagan from 1981–1989. Furthermore, it is not difficult to read the literature, both academic and popular, of that time to see if that was the case.

In this paper, we look at the discussion about financial regulation that took place in the late 1970s and early 1980s, examining the passage of the two most important banking and finance bills of that era, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), and the Garn-St. Germaine Act of 1982. In looking at these legislative actions, we ask a number of questions about the political and ideological atmosphere of their passage. Were the financial deregulation bills in question championed by ideological free marketeers and opposed by so-called progressives? Did the liberal Americans for Democratic Action target these bills for defeat; conversely, did the American Conservative Union include them in their congressional ratings?

Our research finds that the notion that these two bills were passed in an ideological atmosphere seems to be overblown at best and disingenuous at worst. Instead, DIDMCA, which loosened many of the regulatory structures created by Congress during the Great Depression, was passed by a Congress that overwhelmingly was dominated by Democrats and signed by President Jimmy Carter, not Ronald Reagan.

Likewise, Garn-St. Germaine, while Reagan signed it, passed only with strong Democratic support in the House of Representatives and the Senate. We have looked for an ideological component accompanying these bills, but have found nothing that matches the current political rhetoric. Instead, as our research demonstrates, the bills primarily were a response to fundamental market changes that had occurred in the previous decade to both the banking and savings and loan industries. Whether or not they were well-structured, or if they opened the door to further problems are beyond the scope of this paper, although it is clear that in both cases, the Law of Unintended Consequences, especially following the passage of Garn-St. Germaine, seems to have been invoked.

In this paper, we do the following: first we do a survey of the current set of comments about the alleged effects of financial regulation. Second, we explain how inflation and financial turmoil during the 1970s changed the political and economic landscape, paving the way for changes in the regulatory structure of finance. Third, we look at the structure of both DIDMCA and Garn-St. Germaine, to see who sponsored and co-sponsored the bills to see if there were ideological patterns that fit the present claims about the influence of "free-market" ideology.

Fourth, we examine the literature in response to the passage of the bills to see if, in fact, there were warnings about the alleged dangers of financial deregulation. We especially look at the response of the editorial writers of the *New York Times,* which today is one of the loudest voices decrying changes in the regulatory atmosphere 30 years ago. Last, we draw a set of conclusions.

2. THE CURRENT CRITICS OF FINANCIAL DEREGULATION

Present accusations against those who parceled together the changes in the regulatory composition of the nation's financial institutions are simple and to the point: under the influence of radical free-marketer Ronald Reagan, Congress recklessly tore apart the careful New Deal-era structures that had held banking and finance together. Writes Krugman (2009):

> *There's a lot to be said about the financial disaster of the last two years, but the short version is simple: politicians in the thrall of Reaganite ideology dismantled the New Deal regulations that had prevented banking crises for half a century, believing that financial markets could take care of themselves. The effect was to make the financial system vulnerable to a 1930s-style crisis – and the crisis came. (A19)*

There is no equivocation in Krugman's pronouncement; the changes in financial regulation were ideologically-based, tied to Reagan's presidency. Deregulation critic Kuttner (2007) declares about the recent financial meltdown in the housing market:

> *...before the mid-1970s, this kind of meltdown didn't happen, because there were regulations and prudent credit standards; low-income people got government help rather than private-market scams – and there were hardly any defaults. How many more financial scandals will it take before we get back to that model?*

In fact, both Kuttner and Krugman hearken back to the days of a regulated system, presenting it in almost romantic terms. Kuttner (2007) declares:

> *During the Great Depression, the wave of foreclosures inspired the Roosevelt government to invent the long-term, fixed-rate, self-amortizing home loan. This new kind of mortgage was part of a larger strategy to spread homeownership and protect the system from catastrophic failures.*
>
> *Congress first acted to insure mortgages, then established the Federal National Mortgage Association (FNMA) to buy qualified mortgages, replenishing lenders' funds to make more home loans. The government also created federal deposit insurance to protect savers from bank failures, and restore confidence in the banking system. A new Home Owners Loan Corporation refinanced loans to prevent foreclosures.*
>
> *Here was a stunningly successful system of social invention, with a fine balance of high standards, public purpose and plentiful, targeted credit. The national rate of homeownership soared, no insiders reaped windfall gains, and the system was virtually scandal-free.*

However, he adds, the "speculators" managed to sneak into the system:

> *But any industry this big was soon irresistible to speculators. In several waves of deregulation, the industry set out to fix something that wasn't broken and managed to slip outside the bounds of government banking supervision. In each of these cycles, free-marketers promised greater efficiency and more plentiful credit, if government regulators would just get out of the way. In each episode, however, the result has instead been increased speculation followed by huge losses and costs to the public.*

Krugman's view is no less romantic. The link, he claims, between the heavily-regulated banking system and "spectacular" economic growth in the United States is clear (2009):

> *During this first era of high finance (before the 1930s), bankers were, on average, paid much more than their counterparts in other industries. But finance lost its glamour when the banking system collapsed during the Great Depression.*
>
> *The banking industry that emerged from that collapse was tightly regulated, far less colorful than it had been before the Depression, and far less lucrative for those who ran it. Banking became boring, partly because bankers were so conservative about lending: Household debt, which had fallen sharply as a percentage of G.D.P. during the Depression and World War II, stayed far below pre-1930s levels.*
>
> *Strange to say, this era of boring banking was also an era of spectacular economic progress for most Americans. (A23)*

Krugman (2008) elsewhere praises the system of regulations that restricted the activities of savings and loans:

> *...in the old system, savers had federally insured deposits in tightly regulated savings banks, and banks used that money to make home loans. Over time, however, this was partly replaced by a system in which savers put their money in funds that bought asset-backed commercial paper from special investment vehicles that bought collateralized debt obligations created from securitized mortgages – with nary a regulator in sight.*

Interestingly, not even the Democratic National Committee's 2008 platform was as sanguine on returning to the old regulatory era as have been Krugman and Kuttner. In dealing with the financial meltdown, the DNC platform (2008) declared:

> *We have failed to guard against practices that all too often rewarded financial manipulation instead of productivity and sound business practices. We have let the special interests put their thumbs on the economic scales. We do not believe that government should stand in the way of innovation, or turn back the clock to an older era of regulation. But we do believe that government has a role to play in advancing our common prosperity: by providing*

stable macroeconomic and financial conditions for sustained growth; by demanding transparency; and by ensuring fair competition in the marketplace. (Emphasis ours)

Other commentators also blame Reagan and conservative ideology for financial deregulation. William Kern (2008) writes that "financial deregulation...began under Reagan," despite the fact that it actually began during the Carter administration, but the movement did not begin because of ideology, either left or right, but rather because inflation and other problems in the U.S. economy placed pressure on the financial system that could not be ignored. We cover that issue in the next section.

3. INFLATION, DISINTERMEDIATION, AND PRESSURES TO DEREGULATE

The decade of the 1970s was one filled with political and economic turmoil. American politics saw a first: the resignation of a president. On the economic side, inflation and high unemployment, as well as uncertainty of the future made for a very fluid situation as 1980 came around.

Financial institutions certainly were hard-hit by these changes, as inflation not only forced up interest rates, but also ate away at the value of their holdings. At the same time, the weak economy limited the kinds of investments banks could make, and when new financial tools were developed outside the banking system, it was imperative that the rules had to be changed if the banks, as well as the savings and loan institutions, were to survive.

In examining the economic circumstances of the early 1980s, we first look at a number of key statistics from that era that tells a story that the modern deregulation critics seem to miss. We begin with inflation and unemployment show in Figure 1:

FIGURE 1: INFLATION AND UNEMPLOYMENT RATES, 1970–1982

YEAR	CPI CHANGES	UNEMPLOYMENT
1970	5.9	4.9
1971	4.3	5.9
1972	3.3	5.6
1973	6.2	4.9
1974	11.0	5.6
1975	9.1	8.5
1976	5.8	7.7
1977	6.5	7.1
1978	7.7	6.1
1979	11.3	5.8
1980	13.5	7.1

1981	10.4	7.6
1982	6.1	9.7

Source: Statistical Abstracts of the U.S. 1984–85

Not surprisingly, rates of interest also followed in tandem with the inflation rate, which caused further economic contractions. Figure 2 below tracks the average Prime Rate of Interest from 1973 to 1982 to demonstrate that upward trend:

FIGURE 2: PRIME RATE OF INTEREST, 1973–1982

YEAR	PRIME RATE
1973	8.2
1974	10.81
1975	7.86
1976	6.84
1977	6.83
1978	9.06
1979	12.67
1980	15.27
1981	18.87
1982	14.86

Source: Statistical Abstracts of the U.S. 1984–85

Likewise, conventional home mortgage rates skyrocketed during that same period, as is shown in Figure 3 below:

FIGURE 3: AVERAGE CONVENTIONAL MORTGAGE RATES, 1973–1982

YEAR	MORTGATE RATE
1973	8.30
1974	9.22
1975	9.10
1976	8.99
1977	8.95
1978	9.68
1979	11.15
1980	13.95
1981	16.52
1982	15.79

Source: Statistical Abstracts of the U.S. 1984–85

Certainly, savings and loan institutions were hard-hit by the deteriorating economy, as the industry net worth fell in real terms by early 1982. According to Fischel (1995) not only was the old model for the S&Ls obsolete (something we discuss later in this paper), but also that the industry needed to die or at least to be seriously restructured. Figure 4 shows how the real net worth of the S&Ls was falling by the time the recession of 1982 came about.

FIGURE 4: REAL NET WORTH, U.S. S&LS, 1973–1982

YEAR	NET WORTH (Billions)
1973	12.86
1974	12.48
1975	12.30
1976	12.91
1977	13.89
1978	14.85
1979	15.03
1980	13.56
1981	10.42
1982	9.07

Source: Statistical Abstracts of the U.S. 1984–85

To make matters more complicated, there were two important developments in American finance. First, a number of new financial tools were developed both to help consumers deal with rising inflation, and also to allow entrepreneurs to find ways to finance ventures that the regulated banking system either was not interested in funding or fell outside the scope of the industry.

Second, as Timberlake (1985) points out, the Federal Reserve System was losing member banks because of its own requirements for banks. Timberlake writes that because the Fed required member banks to hold deposits with the fed at zero interest, as inflation began to force up interest rates, banks within the FR system were losing valuable reserves. Thus, not only was the Fed being blamed for fueling inflation, but it also was in danger of becoming less relevant as banks left the system. (Such a move by the Fed would be seen as *expanding* regulation, which makes the "deregulation" claim of the bill more curious.)

At the same time, regulations dating from the Great Depression regulated what banks and S&Ls could pay on interest in their savings accounts. Because S&Ls, for the most part, did not have demand deposit services, the fact that inflation was outstripping the maximum allowable interest that the thrifts could pay to depositors was disastrous, as depositors pulled their money from S&Ls and put it into financial instruments such as money market accounts, which fell outside the system of banking regulations.

Furthermore, money market accounts were quite liquid (unlike other higher-earning instruments such as stocks, bond, and mutual funds) along with being low-risk, which made them attractive investment alternatives to bank and S&L savings accounts which did not come close to matching the rate of inflation. It is clear that banks and especially the thrifts were facing a disintermediation crisis, and if these institutions wished to remain financially relevant, it was obvious that changes in the regulatory structures that governed them needed to be made.

Congress responded with two major legislative initiatives. The first was DIDMCA in 1980, which was followed by the Garn-St. Germaine Act in 1982. In the next two sections, we examine both acts to see if their particulars were ideologically driven, or if they fit the pattern of being bills crafted to deal with the economic realities of the day.

4. DIDMCA

Despite the admonitions from Krugman and Kuttner that financial deregulation was passed within an atmosphere of free-market frenzy, one forgets that when DIDMCA was passed in March, 1980, the bill was signed by President Jimmy Carter, a Democrat. In fact, at the time, Democrats dominated both houses of Congress.

In the U.S. Senate, Democrats held a 58 to 41 edge over Republicans (with one independent who tended to vote with Democrats). Democrats had an even more lopsided advantage in the U.S. House of Representatives with a 276 to 157 edge over the GOP.

More important is the political makeup of the bill. Despite Krugman's contention that deregulation was ideologically-inspired by Ronald Reagan and the Republicans, the original deregulation acts had a Democratic stamp placed upon them. For example, airline deregulation passed Congress in 1978 and was the brainchild of Carter's "inflation czar," Alfred Kahn, with one of the main sponsors in the Senate being Sen. Edward Kennedy.

The new law could better be explained as "re-regulation," rather than *de*-regulation. That is because the most important part of the bill was to place *all* banks under the regulation of the Federal Reserve System, regardless of whether or not they were Fed members. Besides requiring banks to follow Fed directives, the act also:

- Permitted more bank mergers to occur;
- Eliminated interest rate ceilings on bank and S&L deposits;
- Permitted all depository institutions to create Negotiated Orders of Withdrawal (NOW) Accounts, which allowed them to offer interest on checking accounts;
- Raised the government's deposit insurance on bank and credit union accounts from $40,000 to $100,000;
- Effectively eliminated state interest rate ceilings.

The notion that the free-market ideology that accompanied the campaign rhetoric of Ronald Reagan's presidential bid influenced the passage of DIDMCA is questionable. First, when the bill was signed, Reagan still was competing for the Republican presidential nomination, and there was stiff opposition to him within Republican ranks, including his chief primary opponent, George H.W. Bush, and former President Gerald R. Ford. In other words, Reagan was not yet in a position in which he could influence any legislation passed by Congress.

Second, Carter faced a serious primary challenge from Sen. Edward Kennedy, who clearly was not emphasizing free markets in his campaign, but rather more state economic control, including wage and price controls. Polls at the time did not predict the landslide victory that Reagan ultimately would win over Carter in the November election. Furthermore, no one at the time could have predicted that the Republicans would take the Senate and Republicans would make large gains in the House of Representatives.

Giving further evidence that the passage of DIDMCA was not part of a "free-market movement," the *New York Times,* which is not exactly a bastion of free-market ideology, wrote a glowing editorial endorsing the bill, with an editorial entitled, "Let the Banks Compete."[1] Conversely, the *Freeman,* a conservative-libertarian publication that openly endorses free markets, harshly criticized DIDMCA, with writer Elgin Groseclose (1981) likening the powers given to the Fed to those enjoyed by the Politburo of what was then the Soviet Union.

The increase in deposit insurance also raised the issue of what economists call moral hazard, which is an action that encourages people to take the very risks that one wishes to avoid. In the case of U.S. banks, Patricia A. McCoy (2007) notes, this certainly helped create some future financial crises:

> *....when not done carefully, explicit deposit insurance can fuel bank crises by giving banks perverse incentives to take unnecessary risks. The United States learned a painful lesson in this regard in the 1980s and early 1990s, when an overly generous deposit insurance system helped trigger the largest wave of bank failures there since the Great Depression in the 1930s.*

Thus, Congress did free depository institutions from some of the regulations that had bound them since the 1930s, but it also opened the door for reckless behavior that would come back to haunt the system. Furthermore, by placing all banks under the umbrella of the Federal Reserve System, it ultimately helped to set the stage for the unprecedented financial bailouts of 2008 and 2009.

The next major change in depository institution regulation came with the passage of the Garn-St. Germaine Act of 1982. We cover the particulars of this act in the next section.

---

1 "Let the Banks Compete," Unsigned editorial, *The New York Times,* April 2, 1980, A26.

5. GARN-ST. GERMAINE AND ANALYSIS

The Garn-St. Germaine Act came about in order to try to stop the crisis that threatened to make the S&Ls obsolete altogether. In signing the act, President Reagan declared that it was "the most important legislation for financial institutions in the last 50 years" and that in its passage, "I think we hit the jackpot."

Indeed, Krugman zeroes in on the "jackpot" quote, but fails to examine the other aspects of the bill that made it bi-partisan legislation. This clearly was not a "Reagan-inspired" bill, unless one believes that Charles Schumer and Steny Hoyer, both liberal Democrats and co-sponsors of the bill, were "conservative Reaganites." In fact, the bill passed the House by a margin of 272–91 and by a voice vote in the Senate. The bill had 28 co-sponsors in the House, including a number of prominent Democrats like Claude Pepper, Schumer, Hoyer, Paul Simon, Walter Fauntelroy, Henry Reuss, and Les Aspin.

Furthermore, as in the situation with DIDMCA, the political left-of-center Americans for Democratic Action (ADA) did not include either bill as being worthy of opposition – despite the political rhetoric one hears today from prominent Democrats. Conversely, the American Conservative Union (ACU) did not include either bill as part of its rating of members of Congress. In other words, both laws had strong bi-partisan support and generally were seen as *improving* what clearly was a bad situation.

In the early 1980s, bank failures were on the rise and Congress and the president believed the only way to stop them was to lift some of the restrictions keeping S&Ls from competing with other financial institutions. For example, mortgage rates in the early 1980s were well into double-digits, as shown earlier, but the asset base of most S&Ls was tied up in mortgages that had substantially lower rates, which created real capitalization problems for the thrifts. Recognizing this situation, Fischel (1995) argues that the better thing would have been to let the S&Ls fail instead of trying to reorganize them:

> *The savings and loan crisis occurred because unprecedented high interest rates, advances in computer technology and information processing, and increased worldwide competition in financial markets ...made the savings and loan industry obsolete. Rather than let the industry fail, the government enacted a series of misguided regulatory policies designed to preserve savings and loans as viable entities even though they no longer served any socially valuable function. (190–91)*

However, Congress was not about to let an industry go under, especially an industry that had representatives in all states and nearly every congressional district. The new law had a number of provisions that supposedly would make the S&Ls more competitive, including:

- S&Ls could place up to 10 percent of their loan portfolios in commercial real estate, business or agricultural loans;

- The interest rates banks and S&Ls could offer for savings was no longer regulated by the federal government;
- S&Ls could offer checking accounts to better compete with banks;
- It permitted S&Ls to branch out their loan portfolios beyond real estate.

As Clyde Farnsworth (1988) would point out, the regulatory changes permitted the S&Ls to branch out into other areas of investment, but the problem of being overextended financially hung over the industry, and finally came to a head in the savings and loan crisis of the late 1980s. However, as Fischel (1995) and Roberts and Stratton (2008) note, tax reform in 1986 changed a number of rules regarding real estate write-offs, which quickly devalued the S&L assets, which still were heavy in real estate.

Furthermore, *Business Week* (1981) declared that the real movers in changing the rules for S&Ls came from Congress, not the Reagan administration which, according to the magazine, had

> *...dragged its heels on proposing any new reform of the nation's financial system. Now members of Congress are taking matters into their own hands and introducing sweeping legislation to give the banking industry some of the powers traditionally accorded only to the securities industry. (24)*

The fact that the initiatives came from Congress (and Democrats controlled the House of Representatives in 1982), and the fact that a number of co-sponsors were liberal Democrats seems to be counter to the arguments by Krugman and Kuttner that Garn-St. Germaine was driven by "free-market ideology." To further that point, Farnsworth (1988) writes:

> *When President Reagan moved into the White House in 1981, he promised to cut through the "vast web" of Government regulations to make life easier for Americans, and, in a speech Monday, he claimed victory on this front.*
>
> *But in the view of many experts, the spiders of the Federal Government's bureaucracy have been spinning regulatory webs faster than the Reagan Administration has been sweeping them away, perhaps even faster than under President Carter. (B10)*

Furthermore, Farnsworth clearly contradicts Krugman's present statements by outright declaring that the Democrats under Carter were more aggressive than Republicans under Reagan in its deregulation initiatives:

> *Two of the most important deregulation statutes – the Airline Deregulation Act of 1978 and the Paperwork Reduction Act of 1980 – were products of the Carter Administration.*
>
> *One of the fathers of the Paperwork Reduction Act, establishing procedures for cutting paperwork, was Senator Lloyd Bentsen of Texas, the Democratic Vice-Presidential*

candidate and a former businessman. He discussed the concept behind the legislation with Mr. Carter at Camp David over the July 4 weekend in 1979, recalled a former Bentsen aide, Jack Albertine, now a textile industry executive. Paperwork reduction then became a high legislative priority.

Charles L. Schultze, who was the chairman of President Carter's Council of Economic Advisers, said: ''We had laid a lot of the groundwork for transportation deregulation, airlines, trucking and railroads, and also tried to bring some economic sense to the environmental regulations. My impression is that every administration comes in and says it's going to do something about big government, but in the end not all that much really happens.'' (B10)

Farnsworth continues:

Many analysts hold the view that in regulatory relief the eight Reagan years have fallen short of their promise. "Deregulation was not anywhere near as significant as in the Carter years," said William A. Niskanen, a former member of President Reagan's Council of Economic Advisers. "The Reagan years represented a major missed opportunity."

In the first few months of Mr. Reagan's Presidency, he terminated two major Carter programs, price controls on petroleum and the wage and price guideline system by which Mr. Carter had sought to temper inflation. But then momentum was lost. And, in 1983, the disbanding of a Task Force on Regulatory Relief headed by Vice President Bush signaled an indefinite delay in deregulatory initiatives. The whole exercise had simply become too controversial for the pragmatists around the Oval Office – and the Vice President.

According to Mr. Niskanen's new economic study of the Reagan years, entitled "Reaganomics," the Administration was reluctant to take on powerful trucking, maritime and construction interests fighting deregulation. Environmentalists also strongly objected to proposals to weaken the Clean Air Act.

The White House chief of staff, James A. Baker 3d, now the head of Mr. Bush's Presidential campaign, decided that the benefits simply were not worth the political costs.

Meanwhile, President Reagan also drew criticism for not sustaining deregulation already in progress. (B10)

6. CONCLUSION

The financial meltdown of the past three years and the continuing moribund economy certainly invite blame, and in this paper, we examine the blame that Paul Krugman and others have laid upon the presidency of Ronald Reagan. While we hardly are defenders of Reagan and his regime, nonetheless, in our examination of the two main financial regulation bills of the early 1980s, neither one has the ideological fingerprints that Krugman and Kuttner presently are claiming.

Instead, the deregulation initiatives were bi-partisan and clearly were a response to economic conditions that were affecting banks and savings and loans. We have not made any statements as to the wisdom of these laws, and we certainly recognize that they contributed to later financial crises, and especially the Savings and Loan Crisis of the late 1980s, though, as Anderson and Jackson (2005) point out, changes in the regulatory structure were not the only culprit in touching off the crisis with the thrifts.[2]

Our focus has been more narrow, concentrating upon the efficacy of the current set of political talking points that claim that Reagan's conservative, free-market ideology somehow touched off a number of financial deregulation initiatives that turned out to be disastrous. This is something that certainly plays well in a political speech or on the Internet.

However, researchers do not have the luxury of depending upon talking points to find conclusions. Instead, we must examine the historical record to find if the current political *zeitgeist* is true or is simply political rhetoric. In this case, we find that the statements by Krugman and others do not reflect careful research of what really happened with the passage of DIDMCA and Garn-St. Germaine.

---

[2] In that paper, the authors argue that Rudy Giuliani's Wall Street "investigations," along with his indictment of investment banker Michael Milken contributed greatly to the S&L crisis and helped prolong the recession of 1991.

REFERENCES

Anderson, William L. and Candice E. Jackson. 2005. "It's the Economy, Stupid: Rudy Giuliani and the Wall Street Prosecutions, and the Recession of 1990–91," *Journal of Libertarian Studies*, Vol. 19, No. 4, 19–36.

Business Week. 1981. "An itchy Congress moves on bank reform," Unsigned column, 24.

Coggins, Bruce. 1998. *Does Financial Deregulation Work?* London: Edward Elgar Publishing.

Democratic National Committee Platform, 2008.

Farnsworth, Clyde. 1988. "Promise of Deregulation Proved Tough to Keep," The New York Times, B10.

Fischel, Daniel R. 1995. *Payback: The Conspiracy to Destroy Michael Milken and His Financial Revolution.* New York: HarperBusiness.

Groseclose, Elgin. 1981. "Time to Abolish the Fed?" The *Freeman*, Vol. 31, No. 8, 451–455.

Kern, William. 2008. "America's Financial Crisis: It's Time to De-Deregulate," The Moderate Voice, http://themoderatevoice.com/18776/americas-financial-crisis-its-time-for-de-deregulation/

Krugman, Paul. 2009. "Reagan Did It," *The New York Times,* June 1, A10.

Krugman, Paul. 2009. "All the President's Zombies," *The New York Times,* August 23, A19.

Krugman, Paul. 2009. "Making Banking Boring," *The New York Times,* April 10, A23.

Krugman, Paul. 2008. "Partying Like It's 1929," *The New York Times,* March 21.

Kuttner, Robert. 2007. "What's Behind the Subprime Mess? *The American Prospect,* online edition, August 29, http://www.prospect.org/cs/articles?article=whats_behind_the_subprime_disaster

Kuttner, Robert. 2007. "The Dangers of Deregulation," *The Boston Globe,* March 17, http://www.boston.com/news/globe/editorial_opinion/oped/articles/2007/03/17/the_dangers_of_deregulation

McCoy, Patricia A. 2007. "The Moral Hazard Implications of Deposit Insurance: Theory and Evidence," Unpublished paper.

Statistical Abstracts of the United States, 1984–85.

Timberlake, Richard. 1985. "Legislative Construction of the Monetary Control Act of 1985," *AEA Papers and Proceedings,* 97–102.

THE LONG-TERM IMPLICATIONS OF THE 2008 BAILOUT FOR THE AMERICAN MODEL OF CAPITALISM

MICHAEL DORSCH*

JEL CLASSIFICATION: D72, D73, P16

ABSTRACT:

This paper considers the future of free market capitalism in the wake of the American boom-bust-bailout experience. The political economy of financial sector influence in the United States is examined within the context of the banking bailout of 2008. I argue that the banking bailout, enabled by a corrupted political system, will have implications for (i) the future growth of the U.S. economy and for (ii) the philosophical foundations of free-market capitalism. Taken together, these implications may catalyze a re-evaluation of the optimality of the American model of free-market democratic capitalism, both in the United States and abroad.

* Department of Economics, The American University of Paris: 31 avenue Bosquet, Paris, France, mdorsch@aup.fr.
This paper is based on work that was presented at the Prague Conference on Political Economy in March 2010. I thank Farhad Nomani and Richard Beardsworth for discussions that motivated and improved this work.

"Capitalism without failure is like religion without sin. It doesn't work. Bankruptcies and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior."
Allan Meltzer, 1998.

1 INTRODUCTION

The tax-financed bailout of America's major commercial banks by the federal government in 2008, I argue, was a disastrous policy in terms of the perception of American free-market capitalism around the world. Why the policy (Troubled Asset Recovery Program, or TARP) that undermines free-market capitalism on the world stage was enacted, and what are its historical implications, will be debated by economists and historians for many years to come. It is possible that the TARP bill's passage will come to mark the beginning of the end of a period when democratic free-market capitalism was viewed to be the dominant model for long-run economic growth. I argue that the TARP bill's passage through the U.S. Congress was influenced by special interest political considerations, and was not the democratic outcome of a well-functioning representative body.[1]

It has long been recognized that powerful special interest groups can influence the machinery of representative law-making to deliver policies that benefit disproportionately the influential special interest group. Indeed, there is an entire branch of economic theory that is dedicated to the analysis of such possibilities, Public Choice, which analyzes the interactions of special interest groups and politicians that lead to the implementation of public policies. Within the field of Public Choice, there has been much analysis of the (non-electoral) channels through which interest groups can exert influence over the decision-making of politicians, in general.[2] In this paper, I am particularly interested in the role of the financial industry special interest group in the passage of the TARP bill. Previous work by economists has documented that the 2008 federal bailout of the largest commercial banks in the United States was legislation passed by a Congress under the influence of large doses of campaign contributions from the financial sector.[3]

In what follows, I give a general introduction to Public Choice theory and special interest politics, before moving on to discuss, more specifically, the influence of the banking special

---

1 I will use the terms financial sector bailout, banking bailout, and TARP bill to all refer to the Troubled Asset Recovery Program, passed in October 2008.

2 See the book Special Interest Politics [Grossman and Helpman (2001)] for a broad theoretical overview of how special interest groups influence politicians. For reviews of the empirical literature on buying influence over politicians through campaign contributions, see reviews by Ansolabehere, de Figueidero and Snyder (2003) and Stratmann (2005).

3 Johnson (2009) gives a particularly gripping account of the financial sector's influence over economic policy in the United States. Dorsch (2010) provides a detailed statistical analysis of this phenomenon in Congressional voting over the TARP bill. Mian, Sufi, and Trebbi (2010) also look at the role of lobbying by the financial sector in getting preferential legislation in Congress, leading up to and after the financial crisis.

interest in securing a tax-financed bailout for the biggest banks in the United States in 2008. After describing the politics of the banking bailout, I discuss its implications for (i) the American financial sector, in the context of the overall welfare of American society, (ii) the growth of the American economy, and (iii) the image of American capitalism in the future. I argue that the bailout episode, enabled by a political institution driven by special interests, has rattled the philosophical foundation of American free-market capitalism. The paper concludes with very general policy recommendations to mitigate the damage done to the American model of democratic free-market capitalism as a template for the industrialized world.

2 PUBLIC CHOICE THEORY AND SPECIAL INTEREST POLITICS

Public Choice theory originated at the University of Virginia in the 1950's. It was *The Calculus of Consent* [Buchanan and Tullock (1962)] that awakened academic economists to the possibility that government is composed of individuals, who may act in their rational self-interest and may not be the enlightened souls that political philosophers would like to believe them to be. Economists had always held that individuals act selfishly within the context of markets, so why should individuals behave any differently when working at a government bureau rather than at a business firm? In other words, why should individuals act to maximize their individual welfare in market transactions, but act to maximize the welfare of society at large in political interactions? This was the challenge that Buchanan and Tullock (1962) put forth and it revolutionized the way that economists thought about the machinery of representative politics.[4]

Special interest groups are defined as minority groups in the population who attempt to influence politicians to pass legislation that benefits their minority group disproportionately. Usually, special interest legislation is not only contrary to the preferred policy of the majority of the population, but also has associated economic costs for the majority. In general, special interest groups engage in lobbying activity or make monetary payments to politicians to influence politicians to support (block) legislation that benefits (harms) the minority special interest group.[5] Such preferential access to political influence goes against the fundamental principle of democracy, which is to aggregate the policy preferences of the majority into legislation that reflects the majority opinion, rather than the opinion of (often, very small) minorities.

Of course, politicians *do* have to stand for re-election, so it is not accurate to suppose that all politicians are all the time serving the interests of the special interest groups that fi-

4 See Besley (2007) for a general introduction into the "new political economy," in which Public Choice theory plays a prominent role.

5 Most work has focused on registered campaign contributions, which are legal monetary payments to politicians that do not have explicit *quid-pro-quo* contracts. Less studied in the literature are illegal, unreported monetary payments or in-kind transfers. The difference between campaign contributions and bribery is largely legalistic. As an economic transaction, they should be equivalent. See Welch (1974) for more on this distinction.

nance their campaigns. Politicians, like any economic actor, face trade-offs when they make decisions. For every vote a politician makes to support a minority special interest group, there are potential electoral consequences. The calculus of the utility-maximizing politician, therefore, involves trading off monetary payments from special interest groups against the possibility that voting to support special interest legislation will enrage their constituents to the point of voting the politician out of office. This is how democratic elections work in the direction of keeping politicians *accountable* to the interests of their constituents.[6] If politicians must stand for re-election periodically then they cannot stray too far from the policies that please a majority of their constituency, assuming that their constituents have some means of monitoring their behavior.[7]

3 FINANCIAL SECTOR INFLUENCE IN AMERICAN CONGRESSIONAL POLITICS

In October 2008, the United State Congress passed the TARP bill, which unconditionally bailed out the biggest (in terms of market share) banks in the United States. The budgeted cost of the TARP bill was $700 billion and required a 25 percent increase in the federal budget for fiscal year 2008 and a 7 per cent increase in the total debt position of the United States. The initial TARP proposal by then Treasury Secretary Paulson was a remarkably vague document of two pages that stipulated virtually no oversight on how the secretary would be able to distribute the $700 billion that he requested from the Congress.[8] The House of Representatives voted down the initial TARP proposal, at which point Treasury Secretary Paulson drafted a longer (though equally vague) TARP bill that passed through the Senate and then the House several days later, on October 3, 2008.[9]

---

6 For more on the role of elections in keeping politicians accountable, in general, see the seminal work of Barro (1973) and subsequently Ferejohn (1986). Besley (2006) summarizes and synthesizes the work that has built upon the original "political agency" problem provided by Barro (1973). Dorsch (2010) extends the theory and applies it to the financial bailout.

7 The role of the media as a monitor in political accountability is fundamental. There have been several studies that conclude that political corruption is mitigated by a strong media presence. See, for example, Besley and Burgess (2002), Islam (2008), and Petrova (2008).

8 It bears noting that Treasury Secretary Paulson‘s previous position as C.E.O. of Goldman Sachs, a firm that was ultimately one of the biggest beneficiaries of the financial sector bailout. The so-called "revolving door" between Wall Street and Washington is another way that Wall Street firms exert control over policy makers. Quite literally, many top policy makers used to work for the Wall Street firms that policies affect. Many times, it‘s the other way around, with policy-makers going to work in highly paid positions or as consultants in the firms that benefited from the special interest legislations the policy-maker helped pass. The revolving door phenomenon is not the focus of this paper, but readers should be aware that it is an equally troublesome problem in American politics.

9 See Congleton (2009) for a thorough summary of the financial crisis and the policy responses of the Federal Reserve System and the U.S. Congress.

The TARP legislation was deeply unpopular. In the days following its passage, there were protests outside of the Capitol building, as well as outside of the New York banks that were the primary beneficiaries of the legislation. Many economists at the time insisted (and still insist) that the TARP bill was necessary to prevent the meltdown of the American financial sector, and even global finance at large, though this is not a uniformly accepted proposition. Most every economist would acknowledge that without assistance to the major American banks there would have been a period of severe volatility in financial markets. But, to suggest that financial Armageddon would have ensued in the absence of the bill's passage is becoming less and less axiomatic.[10] It was fairly obvious from the outset that the TARP bill would benefit the bailed out banks at the expense of the tax-paying public, and this in itself was a major source of the bill's unpopularity. The bailout redistributed income from the tax-paying public "up the distribution" to the executives of the major Wall Street banks that were bailed out. Furthermore, the terms of the bailout were largely arbitrary and Treasury Secretary Paulson, predictably, gave preference to the firm of which he was recently C.E.O., Goldman Sachs. Finally, the bill added significantly to the debt position of the United States, a fact that Americans have only recently begun to acknowledge. It does not seem controversial to state that the TARP bill has been one of the most unpopular public policies in modern American history.

This, of course, begs the question of why, if the bill was so unpopular and not absolutely necessary, did it pass through the Congress in October 2008.[11] The previous section hinted at the answer, which is that legislators were under the control of the financial sector special interest during the 110th Congressional cycle. The House of Representatives, as a whole, received $47,609,033 in campaign contributions from the financial sector between 2006 and 2008. The Senate, as a whole, received $83,609,094 in financial sector contributions between 2002 and 2008. While these sums of money are large indeed, they pale in comparison to what the financial sector received in return, at the expense of the tax-paying public, in an unconditional financial sector bailout of $700 billion. The proposition put forward, then, is that Congressmen in the United States voted for the unpopular TARP bill because they were, on average, under the monetary influence of the financial sector special interest. Table 1 provides some data to support this claim.

---

10 There were several mainstream economists who were vocal in opposition from the outset. Notably, Miron (2009) argues that a normal bankruptcy procedure for the major banks would have been preferred to a bail-out. Congleton (2009) and Taylor (2009) argue that the TARP legislation may have exacerbated the "credit crunch" problem that it was intended to solve. Several prominent economists spoke out against the worth of the TARP legislation at the 2010 annual meeting of the American Economics Association, including former chief economist of the IMF Simon Johnson and Nobel laureate Joseph Stiglitz. Johnson, and Kwak (2010) is extremely critical of the government's response to the financial crisis.

11 There is a larger question here that is not well addressed in the political economy literature. In general terms, why do politicians pursue unpopular policies?

TABLE 1. SUMMARY STATISTICS OF CAMPAIGN CONTRIBUTIONS TO LEGISLATORS, BY SUB-SAMPLE, IN THE HOUSE OF REPRESENTATIVES AND IN THE SENATE.

		House Yes	House No	Senate Yes	Senate No
	Number	261	173	71	25
Total Finance:					
	Mean	**124,447*** **	**87,550*** **	**958,262*** **	**622,900*** **
	std. err.	10,617	7,943	117,865	94,108
	p-value	0.003			0.014
Commercial Banks:					
	Mean	**28,434*** **	**22,475*** **	173,822	153,825
	std. err.	2,363	1,560	18,558	26,943
	p-value	0.018		0.272	
Securities and Investments:					
	Mean	**58,996*** **	**33,751*** **	**530,965*** **	**291,767*** **
	std. err.	6,399	4,343	81,024	47,344
	p-value	0.001		0.006	

Notes: Calculations by the author, based on data from the Center for Responsive Politics. Bold face indicates that the mean from the *Yes* sub-sample is greater than the mean from the *No* sub-sample at least the 10% significance level in a one-sided test that corrects for unequal sub-sample variances. *, **, and *** indicate significance at the 10, 5, and 1 percent levels, respectively.

Table 1 presents summary statistics of campaign contributions received by United States Congressmen, broken into sub-samples according to whether or not they supported the bailout. Table 1 reports the average contributions from the total financial sector, from the commercial banking sub-sector, and from the securities and investments sub-sector for the House representatives who voted *Yes* in the first column and *No* in the second column. The reported *p*-values in the table refer to a one-sided difference of means test, where the alternative hypothesis is that the mean contribution to the *Yes* group up is greater than the mean contribution to the *No* group. We reject the null hypothesis of equal mean contributions received by House representatives who voted in different ways for all measures of financial sector contributions. In other words, House representatives who voted to support the bill had received greater campaign contributions than representatives who voted against the bill, on average. Table 1 also reports the summary statistics for Senators in columns three and four.[12] Mean contributions from the financial sector are uniformly higher for Sena-

[12] The contributions received by the three main presidential candidates (Senators Obama, McCain, and Clinton) were obvious outliers and were omitted from the data set. All three of them voted to support the bailout, so the differences between the Yes and No groups in the Senate would have been even greater if they were included in the statistics presented in Table 1.

tors who supported the bailout, though not with statistical significance for the commercial banking sub-category of campaign contributions. In other words, as in the House of Representatives, Senators who voted to support the bailout took more in campaign contributions than those who did not support the bailout, on average. See Dorsch (2010) and Mian *et al.* (2010) for more detailed statistical analyses of this proposition.[13]

4 IMPLICATIONS FOR THE FINANCIAL SECTOR

The logic of bailing out the largest financial institutions posits that these institutions were simply "too big to fail". If they went down, it would cause chaos in the market for credit that is required for a modern economy to function, the argument goes.[14] Regardless if one buys into the necessity of preventing the failure of "too big to fail" financial institutions, the bailout has installed a perverse economic incentive for the financial institutions that are left standing (or left propped up, perhaps is a better term). Bailing out the Wall Street banks has put in place a severe "moral hazard" problem.

In general, moral hazard occurs when a party insulated from a risk has an incentive to behave differently than it would behave if it were fully exposed to the risk. In this case, the government insulated the big banks from the risk of going out of business if their imprudent positions went sour. Will bankers behave differently now that there is precedent that the government won't let them fail? The answer is almost certainly yes. Banks make higher potential returns on riskier ventures and they will be more likely to chase higher returns by engaging in riskier lending if they know that the government will be there to bail them out if the loans go bad. In a world with bailouts, the big banks have an incentive to seek out the bets with the largest potential upside, which will always be the riskiest, without considering the downside risk. The government has established an incentive for the "too big to fail" institutions to engage in *more* risk-taking than before the crisis, a perverse outcome of the bailout policy, since it was excessive risk-taking by big banks that caused the financial crisis in the first place.

Furthermore, the bailout money went disproportionately to the biggest banks. Hundreds of smaller, regional banks have gone under since the TARP bill gave the big banks a com-

---

13 To really support claims of Congressional corruption, however, one must control for other factors that influence the voting behavior of legislators. Dorsch (2010) shows that legislators were more likely to support the TARP bill when the importance of the financial sector for employment in their district was greater, campaign contributions from special interest groups from outside of the financial sector were smaller, and their tenure in Congress was longer, among other factors. After controlling for political and ideological differences between congressmen, Dorsch (2010) shows that a one standard deviation increase in the campaign contributions received from the financial sector increased the probability that a Democratic (Republican) representative supports the bailout by 10.7 (3.9) percentage points.

14 It does not appear that the bailout did indeed prevent chaos in credit markets during the end of 2008, however. Miron (2009) and Taylor (2009) have both written that, in fact, the bailout may have exacerbated the tight credit conditions that the bailout aimed to ease.

petitive edge in credit markets. There has been a dramatic consolidation of market power in the commercial banking sector since the government picked its winners. On his blog The *Baseline Scenario*, MIT economist Simon Johnson reported that in the beginning of February 2010, the top four banks have 1/2 of the market for mortgages and 2/3 of the market for credit cards. If these banks were considered "too big to fail" before, they are even bigger now. In the minds of executives at the big banks, the government is more likely to bail them out again should their bets go bad again. The moral hazard problem has thus been amplified and encourages banks to acquire larger and riskier lending portfolios. By addressing the financial crisis with a policy to bailout the biggest banks, it is my view that the government has planted the seeds for a future financial crisis that will be even costlier for American taxpayers than the $700 billion spent on the 2008 bailout.15

5 IMPLICATIONS FOR AMERICAN DEMOCRATIC FREE-MARKET CAPITALISM

The most dramatic long-run impact of the financial crisis may be the tarnished perceptions of the model of American democratic capitalism, both in the United States and abroad, for two main reasons. On the one hand, the United States will likely grow at a new, lower long-run growth rate going forward, which will lead to criticism of the American model, especially in comparison to the explosive growth rates of more undemocratic, centrally-controlled economies, such as China.[16] Secondly, the philosophical foundations of free-market capitalism have been undermined by the bailout incident. It will be harder for Americans and the rest of the world to continue to buy into the rhetoric of free-market capitalism when the federal government of the United States is active in shielding some of its largest corporations from adverse market outcomes. The rhetoric appears hollow.[17] I will consider the two implications in turn.

5.1 GROWTH IMPLICATIONS

The growth implications of the TARP bill to bailout the banks can be broken into three categories: (i) the fiscal cost of the bailout policy itself, (ii) the mis-allocation of financial

---

[15] Boone and Johnson (2010) have coined the term "doomsday cycle" to describe the dynamics of boom-bust-bailout that governments seem to be encouraging.

[16] While this is likely to be the perception, it is a false comparison. China's growth is largely driven by the "catch-up" phenomenon, which was also experienced by the "Asian miracle" economies in the second half of the twentieth century (South Korea, Japan and Taiwan, for example). See the exogenous growth literature beginning with Solow (1956) and summarized nicely by Lucas (2002). Briefly, there is a tendency for less developed economies to grow at "miracle" rates as they "catch-up" to the most advanced economies, regardless of the institutional characteristics of the political economy.

[17] Similarly, Wolf (2005) discusses the world's growing disillusion with the gap between American rhetoric on free trade and its actual policies.

capital and factors of production, in general, towards failing firms, and (iii) the costs associated with the likely populist backlash.

The loans associated with the TARP bill have been largely paid back, but the government, and the tax-payers that finance it, are still on the hook for $117 billion. As indicated in the previous section, future bailouts may likely be far more expensive. Large scale bailouts of this kind are extremely expensive, especially if they are recurring.[18] The money has been largely debt-financed, which will have the eventual effect of pushing up interest rates and income tax rates. Government debt expansions increase demand in credit markets (and thus the price of credit) in the near term, and must eventually be paid back when the debt matures (requiring increased income tax rates) in the longer term. Both higher interest rates and higher income tax rates are widely acknowledged by economists to be a drag on growth. Of course, there was an opportunity cost associated with the public funds directed towards the banks. Rather than bailing out Wall Street bankers the public funds *could have* been spent on public investment projects in areas such as education, infrastructure, or research and development that would have made the U.S. economy *more productive* in the future. Any forgone growth due to these missed opportunities to make productive public investments must be counted as an implication of the bailout policy.

Secondly, the federal government gave $700 billion in sweetheart loans to *failing companies* in the commercial banking and automotive sectors. It does not require a doctorate in economics to see that this was a mis-allocation of financial capital. Furthermore, by keeping these failing companies in business, the government has kept other scarce factors of production from being re-allocated to more productive enterprises. While bankruptcy of some large commercial banks and/or automotive firms would have caused short-term volatility in the relevant factor markets, the re-allocation of factors into more competitive and viable firms would have benefited the economy in the long-run. The mis-allocation of resources into failing industries that may require future public assistance can cause long periods of economic stagnation, if the experience of Japan in the 1990's is any guide. More generally, a political culture driven by special interest groups may bias the economy towards systematic mis-allocations of resources. Socially wasteful expenditures by special interest groups often lead to policy outcomes that protect inefficient and declining industries, rather than promoting innovative and entrepreneurial industries. I will return to this point in the next subsection.

Finally, it is possible that the injustice of the bailout incident will lead to a populist backlash against the elites in America that could result in a new paradigm of income redistribution via income taxation. While well-intentioned and targeted initially against the financial sector, it will be difficult in the long run to prevent a greater degree of income redistribution from affecting high income earners *in general*. A new focus on income redistribution from the high income earners in general will discourage the most productive

---

18 As a point of reference, consider Japan, which bailed out its banks for nearly an entire decade during the 1990's at a huge cost to the economy in general. The 1990's are often referred to as the "lost decade" for Japan, largely due to the ineptitude of the government in shutting down insolvent banks.

members of society to exert effort, innovate, and engage in entrepreneurial activity, which will put a drag on economic dynamism and therefore growth. The end of "American Exceptionalism" could begin with populist reactions to the government's bailout of the banks.[19] As the American economy grows at a new, lower long-run rate due to these three factors, the attractiveness of the American model will be diminished around the world.

5.2 PHILOSOPHICAL IMPLICATIONS

Following the IMF bailouts of East Asia and Mexico during the late 1990's, the lament of economist Allan Meltzer [Meltzer (1998)] became an instantly classic quotation among economists. "Capitalism without failure is like religion without sin. It doesn't work. Bankruptcies and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior." In religion, it is the punishment from sin in some hypothetical afterlife that incentivizes individuals to engage in virtuous lifestyles. Without a conception of sin, religion loses its primary means of dictating behavioral outcomes. In capitalism, the reward for productivity and efficiency is profit. Those business entities that operate efficiently earn profits, while those that cannot compete in the marketplace fail. Just as religion cannot drive individuals towards a virtuous and civil social outcome in the absence of sin, capitalism cannot achieve an economically efficient social outcome when firms are protected from economic failure. When inefficient firms are shielded from failure by forces outside of the marketplace, such as the government, the incentive structures facing managers are necessarily distorted. Indeed, a bailout culture can even invert the incentive structure, with those firms that are the largest relative failures receiving the biggest bailout windfalls.

This is suggestive of the absurdity of the "too big to fail" logic: it applies equally to all institutions above a certain (vaguely defined) size threshold. The competence of the institution's management or the soundness of its business strategy do not affect whether or not the institution is "too big to fail." The result is that firms that really should fail are bailed out; excessive risk-taking is rewarded, and therefore, there are incentives for *more* of it in the economy.[20] By preventing the failure of "too big to fail" institutions, market forces that eliminate inefficient enterprises and promote successful ones were superseded.

Indeed, it is *failure* that is at the heart of macroeconomic development according to the Austrian economist Joseph Schumpeter. In his book *Capitalism, Socialism and Democracy*

---

19 The United States economy has been often lauded because of its perceived meritocratic nature. Indeed, the U.S. has been described as "exceptional" because U.S. citizens have been more willing to accept high degrees of income inequality in society because they believe that social mobility is possible in such a meritocratic society. See Benabou and Ok (2001), Alesina and Glaeser (2004), and Dorsch (2010a), for example. The bailout incident damages this perception, as it demonstrates that downward social mobility may be sticky for well-connected individuals or firms.

20 The managers of the large commercial banks that got bailed out by the government were all allowed to keep their jobs. If the government had forced the managers out of their privileged positions, managerial moral hazard incentives in the future would have been reduced, though not eliminated.

[Schumpeter (1942)], he famously used the term "creative destruction" to describe the dynamics of long-term economic growth. Declining industries, or inefficient firms, are destroyed in a free market when more innovative industries, or more efficient firms, emerge to replace them. Innovative firms drive complacent firms out of competitive markets, and resources are re-allocated out of the declining firms and into the innovative firms that emerge. Free-market capitalism is an engine of economic growth, Schumpeter argued, due to this destructive process of economic dynamism. If the big banks were allowed to fail, more prudent and efficient banks would have emerged to fill the void in the U.S. market for banking services, despite the short-term volatility that would have occurred in financial markets. The bailout incident is troubling because the government stood in the way of this kind of Schumpeterian "creative destruction".

At this point, it is worth a pause to recognize that it was a political system heavily influenced by special interest groups that enabled such a breakdown of the fundamental free-market principle that efficiency is rewarded with profit and inefficiency is punished with economic failure. The political economist Mancur Olson posits that the influence of entrenched special interest groups on political systems in rich nations leads to their ultimate decline. In his book *The Rise and Decline of Nations* [Olson (1982)], he identifies the propensity of old-guard industries or labor groups to use their political influence to prevent their fall into obsolescence, which at the same time prevents the advancement of the economy as a whole.[21] The political blockage of economic failure threatens the very nature of American capitalism, which has been successful due to fostering innovation and entrepreneurialism. Olson (1982) documents how in modern history, great nations have risen due to economic dynamism and have declined when special interests use their political influence to strangle the innovative forces of free-market competition.

To sum up, there are implications of the financial bailout both for the future growth of the United States economy and for the coherence of the philosophical foundations of free market capitalism in America. The desirability of the American system of free-market capitalism within a democratically-governed society will be questioned as a model system due to these implications, both in the United States and abroad.

6 CONCLUSION

In conclusion, there is an irony here that is worth mentioning. The big banks would not have been allowed to grow so large were it not for their pressure on Congress in the late 1990's to repeal the 1933 Glass-Steagall Act.[22] The result was massive deregulation in the

---

21 Parente and Prescott (2000) present a similar theory to explain why there are such disparities between rich and poor countries. Essentially, established industries or factor owners in poor countries block technology adoption that could lead to growth but would threaten the dominance of the established methods of production.

22 See Stratmann (2002) for evidence of special interest influence over this vote.

financial services industry which allowed commercial banks to engage in operations that had been restricted to investment banks since the 1930's. The deregulation resulted in dramatic consolidation between financial institutions and increasingly risky and exotic trading strategies being pursued at banks that held commercial deposits. Lobbyist pressure from the financial sector on Congress was intensified leading up to the crisis, preventing regulations in the U.S. mortgage market.[23] The irony is that the principal drivers of the American model of neo-liberal capitalism since the 1980's, namely big finance, may go down in history as the same entities that led to the model's extinction by choking on the degree of their own risk-taking, the right to which they fought so hard to obtain.

It was a government captured by the financial sector that both allowed the financial institutions to become a systemic risk to the economy and then bailed them out when the risk was realized. As a first step, the big banks *must be broken up* and a firm size limit for banks, assets relative to GDP, must be established so that the government can never be held hostage again.[24] Of course, there is a trade-off to financial regulation of this kind. If one believes that putting size limits on financial institutions reduces their potential to provide efficient banking services, then the trade-off involved in regulation is lost efficiency in the banking industry versus the future possibility of a (bigger) financial crisis and bailout scenario. If large financial institutions and other industries get bailed out again following their own incompetent behaviors, the perception of the United States as a free-market economy will have been shattered. The (possible) lost efficiency seems the lesser cost. Paradoxically, regulation of the market for financial services seems necessary to ensure the survival of free-market economics in the United States.[25]

In my view, breaking up large banks is a necessary, but not a sufficient condition for the future vitality of American democratic capitalism. American democratic capitalism can only thrive if the government gets out of the business of shielding powerful industries or firms from failure. Only then can capitalism function true to its philosophical foundations within a democratically governed society. Ultimately, elected policy-makers must get out of the grip of the special interests. At the end of the day, the financial crisis and the bailout policy response were failures of a captured government on a massive scale. There is evidence to support the notion that this failure of government was brought on by the nature of campaign finance in the United States, which allows for powerful (i.e., rich) special interest groups to influence legislators to pass laws that do not serve the general interest. Campaign finance reform, which realigns the policy preferences of the public with the policy agenda of their representatives, must be of paramount importance moving forward if American democratic capitalism is to continue to be a viable model for the industrialized world.

23 See Igan, Mishra, and Tressel (2009) for evidence.

24 See Johnson and Kwak (2010) for more on this policy recommendation.

25 The financial regulation that President Obama signed into law in July 2010 stopped well short of breaking up the 6 megabanks that pose the greatest risk to the American and world economy. It is insufficient to prevent another boom-bust-bailout cycle, in my opinion.

REFERENCES

Alesina, Alberto and Edward Glaeser (2004) *Fighting poverty in the United States and Europe,* Oxford University Press: Oxford, UK.

Ansolabehere, Stephen, John de Figueidero and James Snyder (2003) Why is there so little money in U.S. politics?, *The Journal of Economic Perspectives* 17: 105–130.

Barro, Robert (1973) The control of politicians: An economic model, *Public Choice* 14: 19–42.

Bénabou, Roland and Efe Ok (2001) Social mobility and the demand for redistribution: The POUM hypothesis, *Quarterly Journal of Economics* 116: 447–487.

Besley, Timothy (2006) *Principled agents? The political economy of good government,* Oxford University Press: Oxford, UK.

Besley, Timothy (2007) The new political economy, *The Economic Journal* 117: 540–557.

Besley, Timothy and Robin Burgess (2002) The political economy of government responsiveness: Theory and evidence from India, *The Quarterly Journal of Economics* 117: 1415–1451.

Boone, Peter and Simon Johnson (2010) The doomsday cycle, *CentrePiece* 13: 2–6.

Buchanan, James and Gordon Tullock (1962) *The calculus of consent: Logical foundations of constitutional democracy*, University of Michigan Press: Ann Arbor, MI.

Congleton, Roger (2009) On the political economy of the financial crisis and bailout of 2008–2009, *Public Choice* 140: 287–317.

Dorsch, Michael (2010) Bailouts for sale? The political economy of the TARP bill, *American University of Paris working paper.*

Dorsch, Michael (2010a) Social mobility and the demand for public consumption expenditures, *Public Choice* 142(1): 24–42.

Ferejohn, John (1986) Incumbent performance and electoral control, *Public Choice* 50: 5–25.

Grossman, Gene and Elhanan Helpman (2001) *Special interest politics*, MIT Press: Cambridge, MA.

Igan, Deniz, Prachi Mishra and Thierry Tressel (2009) A fistful of dollars: Lobbbying and the financial crisis, *IMF working paper.*

Islam, Roumeen (2008) *Information and public choice,* The World Bank: Washington, D.C.

Johnson, Simon (2009) The quiet coup, *The Atlantic,* May.

Johnson, Simon and James Kwak (2010) *13 bankers: The Wall Street takeover and the next financial meltdown*, Pantheon Books: New York, NY.

Lucas, Robert (2002) *Lectures on economic growth*, Harvard University Press: Cambridge, MA.

Meltzer, Allan (1998) Asian problems and the IMF, *Cato Journal* 17(3): 267–274.

Mian, Atif, Amir Sufi and Francesco Trebbi (2010) The political economy of the U.S. mortgage default crisis, *American Economic Review* (forthcoming).

Miron, Jeffrey (2009) Bailout or bankruptcy?, *Cato Journal* 29(1): 1–17.

Olson, Mancur (1982) *The rise and decline of nations: Economic growth, stagflation, and social rigidities*, Yale University: New Haven, CT.

Parente, Stephen and Edward Prescott (2000) *Barriers to riches*, MIT Press: Cambridge, MA.

Petrova, Maria (2008) Inequality and media capture, *Journal of Public Economics* 92: 183–212.

Schumpeter, Joseph (1942) *Capitalism, socialism and democracy,* Harper & Brothers: New York, NY.

Solow, Robert (1956) A contribution to the theory of economic growth, *Quarterly Journal of Economics* 70: 65–94.

Stratmann, Thomas (2002) Can special interests buy Congressional votes? Evidence from financial services legislation, *Journal of Law and Economics* 45: 345–373.

Stratmann, Thomas (2005) Some talk: Money in politics. A (partial) review of the literature, *Public Choice* 124: 135–156.

Taylor, John (2009) The financial crisis and the policy responses: An empirical analysis of what went wrong, *NBER working paper 14631.*

Welch, William (1974) The economics of campaign funds, *Public Choice*, 20: 83–97.

Wolf, Martin (2005) *Why globalization works*, Yale University Press: New Haven, CT.

THE ENDOGENOUS STABILITY OF FREE BANKING. CRISIS AS AN EXOGENOUS PHENOMENON

NICOLAS CACHANOSKY*

JEL CLASSIFICATION: E02, E59

ABSTRACT

This article studies the main aspects of free banking to put forward the argument that such a system is endogenously stable and that financial crisis is an exogenous phenomenon. In support of this conclusion, it analyzes the cases of bank runs, concerted expansion and how free banking would affect business cycles according to different schools of thought. The article concludes that money can efficiently be a market phenomenon outside the state.

* Nicolas Cachanosky, Department of Economics, Suffolk University, Boston, ncachanosky@suffolk.edu

It is an extraordinary truth that competing currencies have until quite recently never been seriously examined. There is no answer in the available literature to the question why a government monopoly of the provision of money is universally regarded as indispensable [...]. Nor can we find an answer to the question of what would happen if that monopoly were abolished and the provision of money were thrown open to the competition of private concerns supplying different currencies.

Friedrich A. von Hayek (1976 [2007]; pp. 26-27)

1 INTRODUCTION: WHERE DID THE FREE BANKING DEBATE GO?

Until Hayek's *Denationalisation of Money* (1976), there was little discussion on free banking in contemporary economics. This, however, was not always the case. We can find some implicit exposition, for example, in Adam Smith's *Wealth of Nations* (Book II Chapter II) and in Mises' *The Theory of Money and Credit* (1912), as well as the old debate in the nineteenth century between the Currency School, Banking School and the Free Banking School.

When Hayek debated with Keynes during the 1930s the free banking alternative was not raised as the debate took place in the context of the Great Depression and was not grounded on purely theoretical considerations. It is not that in his arguments Hayek accepted the need for a monetary authority, as he acknowledged that that was the context of the debate.

When Hayek later moved to the University of Chicago in 1950, he shifted his subject of study to institutional and epistemological problems, and Milton Friedman filled his place as a protagonist in the business cycle debate.[1] This, however, was more than just a change of names; it also implied a methodological move. Friedman employed the Keynesian tools to build his counter-arguments. This was the meaning of Friedman's statement that "[i]n one sense, we are all Keynesians now; in another, nobody is any longer a Keynesian."[2]

One of the outcomes of this development was the casting aside of the free banking alternative. The need for a monetary authority was no longer questioned; the discussion turned on what central banks should do rather than whether they should be there in the first place.[3] Hayek and Friedman agreed that the crisis was not a market phenomenon, but while, for Hayek, the cause was an over-expansion of the money supply through the financial market

---

1 This does not mean that Hayek did not get involved in the subject at all. His articles on monetary policy were reprinted in his *Studies in Philosophy, Politics and Economics* (1967) and in *New Studies in Philosophy, Politics and the History of Ideas* (1978).

2 Quoted by Mark Skousen in Skousen, M. (1998). Milton Friedman, Ex-Keynesian. *The Freeman,* 48 (7). For the mis-quotation of Friedman's expression, see *We Are All Keynesians Now* in TIME (December 31, 1965) and Friedman's response letter in TIME (February 4, 1966).

3 For an evolution of Friedman's standing regarding the role of a central bank against free banking, see Selgin (2008).

by the Fed, for Friedman the cause was the opposite, a failure to expand the money supply when it was most needed.[4]

There are, nevertheless, some studies related to free banking, especially those by Vera C. Smith (1936) and Murray N. Rothbard (1964). It was Hayek's *Denationalisation of Money* (1976), however, that revived the interest in free banking, even though he proposes currency competition rather than free banking as it was understood by Mises.[5] Some contemporary studies related to the subject are those of Leland B. Yeager (1997), Lawrence H. White (1984) (1989) (1999), Larry Sechrest (1993) and George A. Selgin (1988) (1996) (2008).

If the problem of how money and banking affect business cycles is important, as is the question of what monetary policy a central bank should follow to avoid them, a comparative analysis including free banking becomes relevant. It is incomplete to ground the debate of economic policy between rules or discretionality; the problem is not a dichotomy, but a trichotomy: rules, discretionality or market competition.

Economists usually agree that monopolies are inefficient. However, such agreement does not seem to exist on the subtle topic of money supply, where the situation is not just that of a monopoly, but of a governmental monopoly, which, of course, opens the door to the traditional problems of incentives in government as analyzed by Public Choice. Why do economics warn not to control prices but willingly play with interest rates, even while acknowledging the latter to be a much more complex phenomenon? Why is money the exception where government can, and should be, the monopolist issuer? This seems to be an unquestioned fact, but one of the arguments for this is that freedom in money supply will be unstable.

This short essay seeks to put forward the argument that this is not true and explain why free banking is an endogenously stable system and why, in such a case, financial market crises are exogenous. If free banking is stable and provides an efficient monetary and banking system, then the case of free banking deserves serious scrutiny.

2 THE ENDOGENOUS STABILITY OF FREE BANKING GENERAL ASPECTS OF THE FREE BANKING PROCESS

The main characteristic of free banking is the absence of a monetary authority, such as central banks, as well as any regulation interfering with the market of money and bank-

4 This is also the reason why Austrians studied the twenties and Monetarism in the thirties to explain the Great Depression.

5 Hayek assumes a scenario in which banks issue fiat money, while free banking (a la Mises) assumes a scenario where gold is the currency and banks issue money substitutes. This difference is also due to the different historical contexts of their writings. The main difference of Rothbard's work rests in his defense of an enforced 100-percent reserve rule. It should also be mentioned that in his Ideal Money (2002), John Nash notices that his article has very similar ideas to those of Hayek, although he reached his conclusions independently.

ing. Free banking does not carry a different meaning. Strictly speaking, a market cannot be considered free of intervention if there is no free competition in money and banking as well.

It might be useful to introduce Mises' terminology on money (1912, Chapter 3 and Appendix B). Money, in the narrow sense, can be a commodity (i.e., gold or silver), credit money and fiat money; and money in the broad sense includes money substitutes (like fiduciary media and money certificates) in addition to money in the narrow sense.

In such a system, both commodity money and money substitutes are endogenous to the market; money supply is no longer an exogenous variable, but an endogenous self-regulated phenomenon. While money in the narrow sense is a market phenomenon originated, as explained by Carl Menger (1892) and Mises' Regression Theorem, money substitutes are offered by banks *ex-post* the appearance of money in the narrow sense. There are no legal restrictions, however, for banks to offer money in the narrow sense, like fiat money, despite how difficult such a task could be. Money substitutes, of course, require the previous existence of money in the narrow sense. There are, as it were, two levels: the economy with money in the narrow sense (outside money) and banks with money-substitutes (inside money) (White, 1989, pp. 48–69). It is not necessary for all commodity money to be distributed among all banks; part of it could be held by individuals or firms outside the banks. Neither is it necessary that there be only one commodity money; there can be more than one, as was the case with gold and silver.

This situation does not mean that banks will be able to issue all the money substitutes they want or that they will chronically do so until repeated financial crises arise. Each bank has a very strict limit to its issuance imposed by the market itself. If any issuer, for example, Bank A, over-expands its fiduciary media, the receiver of such notes will be in a position to over-bid market goods as it has more notes that have not yet lost purchasing power. As this excess of fiduciary media enters the market, part of it reaches individuals who are not clients of this issuer bank but of a competitor, for example, Banks B or C. When these individuals go to Bank B or Bank C to deposit these notes, these banks will send the issued notes to Bank A (probably through a clearinghouse which reduces transaction costs to the system as a whole) in exchange for its reserves (i.e., gold). Thus, any bank that over-expands its fiduciary media will begin to lose its reserves to its competitors. This adverse clearing is the market signal that there is an excess of issued money-substitutes. Furthermore, as Hayek (1976 [2007], pp. 41–43) mentioned, Gresham's Law, which states that the bad currency displaces the good one, does not apply because there is no fixed exchange rate between competing notes in free banking by definition; it is the good currency that replaces the bad one. Without fixed rates, Gresham Law says that the good currency replaces the bad one.

Thus, in a free banking scenario, it becomes clearer that banks' clients are not those asking for credit, but those relying on them for saving. Banks can only expand their fiduciary media to the extent that the specific demand for their currency has increased and as long as more money in the narrow sense is deposited in them. It is easy for any bank to find debtors by lowering interest rates; this, however, results in a loss of reserves for the bank if it is not facing an increase in demand. If Bank A decides to lower its interest rates, agents in debt with Banks B and C will take A's debt to cancel their debts with Banks B and C, resulting in a drain of reserves from Bank A to Banks B and C. To gain market confidence, on the other hand, is something more difficult and delicate. It does not matter if the marginal cost of printing money-substitutes is virtually zero; this production cost does not consider the loss of reserves. This last indicator is much more relevant to the issuer-bank than is the marginal cost of printing notes.

Issuer banks need their currency to be commonly accepted in the market so that it can circulate and there is no need to change it for money in the narrow sense or for a competitor's notes. On the other hand, they also need their currency to be a reliable medium of saving that will not lose purchasing power over time. Thus, only those banks that excel in managing their currency and in gaining the market's confidence will be able to expand their money circulation as their specific demand increases from market growth as well as from new clients.

Note that the issue involves not only how much money-substitute there should be in circulation, but also where changes in the money supply should take place geographically. As Hayek (1967 [2007], pp. 270–279) pointed out, to expand money in the wrong places through fiscal policies causes not only economic but also demographic disequilibria and consequences. What should have been a step-by-step market and demographic evolution becomes an accumulation of errors to be solved all at once. Even though this problem could be avoided by open market operations by the central bank, the lack of a market for money and banking may distort its adjustment as there is no place for competition signals to appear. Nonetheless, the problem becomes more serious if the central bank becomes – formally or informally – a lender to the government to finance fiscal deficit and spending.

Under such a scenario, there is also independence between economic and political borders. As there are no institutional benefits for any currency, each issuer is unaffected by the political borders and governments. It is no longer the government making monetary policy; the evolution of the money supply responds to market demands.

Regarding the shortage of money supply, a particular difference deserves to be mentioned. An excess supply results in reserve losses. The cost of such a mistake is easily seen, and if the action is not corrected, the bank will eventually lose all of its reserves. However, an increase in demand may remain continuously unnoticed. An increase in demand in the place where the banks are already operating may be easily spotted, but opportunities in other regions must be discovered or even anticipated. The Kirznerian entrepreneurial alertness to discover market opportunities is not infallible and cannot guarantee that such opportunities will be successfully noticed. Thus, some market error of shortage in money supply may remain undiscovered indefinitely.

This is no less true, however, for a central bank; in its presence, money in the narrow sense tends to be accumulated in it rather than diversified in different commercial banks. The adverse clearing system is altered, becoming sticky in comparison to free banking with competing issuer banks. Monopolistic central banks rely only on international clearing, which might be less regular and imply higher values of reserve movements than a more vivid clearing adjustment in free banking. Consequently, central banks may suffer higher volatility in the reserves' movements than issuer banks in free banking. In addition, the central banks have less information available from the market because the banking market is constrained. Free banking is, of course, not perfect, but its stability is much more efficient than that achievable by a monopolistic central bank. There is no reason to think that a central bank will be more efficient or have better information and analysis than free banking to discover excesses of money demand, but on the contrary, central banks do not have as strict a limit as that imposed in free banking to over-expand the money supply thanks to legal tender laws and their monopolistic power in their region. Central banks are a governmental monopoly subject also to political incentives rather than following only those of economic efficiency. In free banking, there is no place for chronically devaluating currencies, as is so common for central banks.

3 PRICES AND MONETARY DISEQUILIBRIUM

The fact that markets are not in equilibrium, but in a process of discovering disequilibria, is equally relevant in the money market. Money supply and relative prices are not in equilibrium at any given point in time, and money supply and demand are not equal, just as they are not in any other market.

The fact that any quantity of money *can* be optimal does not mean that any quantity of money supply *is* optimal in any given specific circumstances. Any quantity of money supply is optimal once the market is in equilibrium; that is, once the market has made all of the necessary adjustments to make that quantity optimal. Thus, being in disequilibrium does not mean that any change in the quantity of money is anti-equilibrating; on the contrary, money changes can be part of the adjustment process.

As changes in money supply and demand affect relative prices in different times and to different extents, changes in either of those will always affect relative prices. In free banking, however, as the money supply can change only in the quantity and specific places in which its demand has increased, changes in relative prices are diminished, albeit not eliminated. Issuer banks do not inject money in random places, but through the specific economic agents demanding their money-substitutes. The fact that money supply and demand may not be equal in any given time and space is the other side of the fact that prices of goods and services are not in equilibrium. Market prices are not prices in equilibrium, but prices in disequilibrium. Free banking helps to minimize the effect on relative prices due to changes in money supply and demand.

Note that in free banking, money supply (in the broad sense) evolves *pari passu* with money demand. There is room for neither monetary inflation nor monetary deflation as a chronic policy. A drop in prices will happen through an increase in productivity, not through price level adjustment, because money supply does not follow money demand. Monetary deflation is as bad for relative prices as monetary inflation is. Free banking minimizes these effects on both sides.

4 BANK RUNS

One of the main reasons why free banking is alleged to be inherently unstable is bank runs. It should first be mentioned that studies of historical cases with similar scenarios to that of free banking have been found to be nothing but stable (White, 1984). One of the most interesting cases is that of Scotland; it is notable that in Scotland currency still circulates from their free banking epoch issued by the Bank of Scotland, the Royal Bank of Scotland and Clydesdale Bank, despite not getting the benefits of legal tender laws. History shows that it was not the instability of free banking that gave rise to central banks and monetary authorities, but governmental fiscal needs (Smith, 1936).

We can divide bank runs into two types, "micro" and "macro." The first are runs against a specific bank, say Bank A, not the system as a whole. Runs against specific banks are due to their inefficiency in managing their reserves or to losing reserves through risky investments. In such a case, while Bank A loses reserves, the system as a whole does not if the runners do not take their savings out of the banking system but deposit them in a competitor, say Bank B. If the clients of Bank A still want to be in the banking system, as they did when they entered the market in the first place, then they will take their savings to Bank B, which will ask for Bank A's reserves rather than running away from the system. If the initial assumption is that the individual wants to be in the banking system, then a change of behavior toward the system as a whole rather than toward a specific bank should be addressed rather than implicitly assumed. If not, the run to the system remains unexplained. The market is not in a crisis, but changing its structure in a similar way as when a competitor buys out an incompetent bank. Of course, a bank that cannot fulfill all of its claims will be in bankruptcy, as would any firm that cannot fulfill its debts. In a free banking system there is no place to devaluate the issued IOUs to avoid bankruptcy as history shows central banks did more than once.

A "macro" or systemic run is not against particular banks, but to the system as a whole; it is not a bank that raises doubt, but the system. Individuals do not want to be in the system anymore regardless of the availability of other banking alternatives. This suggests a problem exogenous to the system as such, important enough to affect the money market and making all individuals, not only a few, run away from the market. Why, in a competitive market with so many clear problems, can no single bank correct its performance and attract the runaways? Why does no new competitor appear and capture the drain of reserves? If the problem is so widespread, then the bankers should be aware of it as well. It is as unrealistic to assume super-intelligence on the part of banking entrepreneurs as it is to assume super-incompetence by assuming that they are the only ones who do not know what to do. Something exogenous is not allowing the banks to correct their behavior or allowing new competitors to behave differently than existing banks; and that is why the market assumes that the problem will not be solved by anyone.

If there is a change in preferences such that individuals prefer to use commodity money rather than banks' money certificates for their exchanges or new regulations come into force, then the motive of the run on the banking system is exogenous to the system as such. Any bank may suffer a run and go into bankruptcy, but the system as a whole does not experience an endogenous crisis any more than any real market industry does. Using White's (2008, p. 2) analogy, the fact that any bank cannot fulfill all of its claims at the same time is not an explanation of bank runs, just as a constant like gravity would not explain all planes falling to the ground at the same time; the explanation needs to be exogenous.

This scenario of bank runs is commonly presented through game theory with an unstable Nash Equilibrium, where a run by one individual could lead to a generalized run on the system. This is why a last resort borrower -like a central bank- is needed (Diamond & Dybvig, 1983).

However, as White points out, this kind of game is not a fair representation of a free banking scenario, and it would be unsuitable to project this conclusion to a free banking situation; a "bank that modifies a relatively fragile contract to make it less fragile has a strong survival argument. It would be remarkable indeed if a truly fragile banking contract had survived the centuries of Darwinian banking competition before the first government deposit insurance scheme was devised." (White, 1999, pp. 128–129).

In the presence of a monopolistic issuer, the issuer bank and the system become one; it is precisely the presence of the monopolistic issuer that raises the need for a borrower of last resort. Commercial banks are branches of the central bank's currency that compete between themselves, but not as independent currency issuers. As reserves are in the central bank rather than in commercial banks, a run on any bank easily becomes a run on the system. Furthermore, as long as there are legal tender laws that promote an excess of demand for the central bank's currency, the ratios of reserves will be situated below their optimal levels, making a run even more likely. It is not that these games are flawed in their formal construction, but that they do not represent a free banking scenario, and it is inconvenient to project their conclusions to such a situation.

It is important to discern what triggered the run in the first place. Banks cannot fulfill all of their claims any more than an insurance company can fulfill all of its contingencies at once or an industry reimburse all of its debts at once; but none of them suffers a run against them originated in an unstable Nash Equilibrium because someone "suddenly" realizes that if all clients call for their claims together, he may not recover his deposit.

A more suitable free banking game should include the possibility for any bank to change its policy and gain competitors' reserves through adverse clearing; or even for new banks (players) to enter the market (game) when a run starts. Additionally, it might also be composed by a set of $i = 1$ to n parallel games, where the run in any game i would result in an increase in reserves in other games through new incoming players or the appearance of new parallel games. While any given game may become unstable, the system as a whole would not.

It should also be mentioned that the issued IOUs might have an option clause, as in the Scottish case, where the banks keep the right to redeem the commodity with a delay (compensated by a rate premium). This gives not only more security to the bank, but also confidence to the clients as they know the bank will have time to acquire the needed commodity money if needed without facing a run. It is worth pointing out that in the Scottish case, although the bank notes have an option clause of up to six months, the notes were accepted at par in the market given the stability and trustworthiness of the issuers, who very rarely called the option. Because issuer banks that accept rival notes at par can increase their own market shares, there is an incentive not to discount money substitutes if they are trustworthy enough (White, 1984, p. 229), making a money-substitute as good as commodity money.

Because in free banking commodity money exists outside the banks, a bank's bankruptcy does not jeopardize the situation of the commodity money. This is clearly not the situation of monopolistic central banks issuing inconvertible, i.e., fiat, money. While in free banking commodity money is an outside phenomenon and reserves are diversified through different banks in the market, the presence of central banks concentrates reserves and risk in one place.

5 CONCERTED EXPANSION

Concerted expansion, as in collusion, is another common worry concerning free banking. In relative terms, it should be proven that if colluded expansion is feasible, it is so in a higher degree than that of central banks. This comparison is not always made, as the possibility of colluded expansion is a common concern about free banking stability rather than as a comparative analysis with a monopolistic issuer.

This situation is commonly presented as a prisoner's dilemma, as, for example, Huerta de Soto (1998 [2006], pp. 667–675) does, to show that there are incentives for the banks to collude, expand fiduciary media and seize higher profits than they would if they did not expand. This game, according to Huerta de Soto, demonstrates three main ideas: 1) that there are incentives to over expand, with all of its economic consequences; 2) that the situation is unstable and a crisis may happen at any moment when one of the colluders decides to get out of the deal; and 3) that because of this, there are strong incentives to have a central bank playing the role of the lender of last resort.

Although this two-bank game is constructed with the idea of a free banking scenario rather than with the presence of a central bank, it has some similar limitations to the game previously mentioned. In particular, this kind of game, like any prisoner's dilemma, assumes the context and players to be constant; that is, there is no room for new players to enter the banking market when the two actual players collude and increase earnings. The prisoner's dilemma case, as interesting and appropriate for its case as it might be, is not suitable to model banking behavior in free banking. Such incrementing of earnings should attract new competitors, a phenomenon that is not captured in this kind of game but is a fundamental aspect of the real market. Banking collusion cannot last in a competitive market without governmental protection, which is absent by definition in free banking.

However, beyond these limits in these kinds of games and unprotected collusions in general, there are other reasons more specific to the case of why a concerted expansion is unlikely to happen, albeit not impossible; or at least is likely to happen with a narrower limit than a central bank has.

Mises (1949 [1996], p. 441) mentions that solvency considerations will constrain issuer banks to collude with less efficient competitors, and it happens to be that more solvent banks are the ones expanding less. A financial institution like a bank, Mises argues, has a very difficult and long-term task to build up its goodwill, but it can lose it and fall into bankruptcy rather quickly. Money expansion threatens that goodwill and invites more serious competitors to gain market shares. Collusion is unlikely to happen if both banks do not hold exactly the same goodwill. The more efficient bank may prefer to wait for the less efficient one to keep losing reserves and then seize its market. Such a decision will depend on time preferences (rapid increase with lower goodwill and shared market or slow increase with better goodwill and more market) and on each bank's expectations of its competitor's future behavior. In light of this goodwill concern and the adverse clearing, Mises (1949 [1996], p. 443) concludes:

> *Free banking is the only method available for the prevention of the dangers inherent in credit expansion. It would, it is true, not hinder a slow credit expansion, kept within very narrow limits, on the part of cautious banks which provide the public with all information required about their financial status. But under free banking it would have been impossible for credit expansion with all its inevitable consequences to have developed into a regular – one is tempted to say normal – feature of the economic system. Only free banking would have rendered the market economy secure against crises and depressions.*

Another important aspect was pointed out by Selgin (1988, pp. 80–82): even if banks collude to expand fiduciary media, they cannot control the specific dynamic of their issuance once they enter into the market. This concerted expansion, while possibly keeping the expected value reserves constant, will increase its variance, which, as a risk measure, will require the banks to increase their reserves holdings.[6] Unless the new fiduciary media leaves each bank and reaches all competitors at the same time and in the same amount, a variance increase is to be expected; Selgin (1988, p. 82) concludes:

> *Thus, given the quantity of reserve media, the demand for and turnover of inside money, and the desire of banks to protect themselves against all but a very small risk of default at the clearinghouse at any clearing session, there will be a unique equilibrium supply of inside money at any moment. It follows that spontaneous in-concert expansion will be self-correcting even without any "internal drain" of commodity money from bank reserves.*

The assumption that new competitors will not enter the market is contradictory to the free banking rules. Any game or model with this constraint is missing a fundamental aspect of free banking and fails to accurately describe its process. It would be a better representation of duopolies or monopolistic competition than of free banking.

On the other hand, the implicit assumptions that all banks hold the exact same goodwill and that all new fiduciary media behave in such a specific way that reserves' variance remains constant are a better description of a fictional world than of the real market process being analyzed. The problem with these assumptions is not only that they are very unlikely, but that they also lead to the wrong conclusions.

Thus, in free banking it is quite improbable for concerted expansion to succeed in a significant way without new competitors entering the market or the banks being constrained because they start to face higher risk indicators through reserves variance. Under free banking, the limits of credit expansion are narrower than are those of central banks.

6 FREE-BANKING, BUSINESS CYCLE AND FINANCIAL CRISIS IN SCHOOLS OF THOUGHT

There are three main theories that try to explain the business cycle, namely the Monetarist, the Austrian and the Keynesian. Despite their differences, money plays an important role in all three. It is unnecessary here to go into the details of each one of them as they are already well known and widely treated in the literature; it is sufficient to briefly explain how a free banking scenario interacts with the problem of the business cycle under each one of them.

---

[6] Selgin also mentions that the increase of reserve variance may be less in proportional terms than the money expansion; this would allow for a slow increase in money supply through concerted action, but slower than assumed without taking into consideration the changes in reserve variance.
It is also worth mentioning that Huerta de Soto's game does not address Selgin's argument of a change in the (expected) variance of reserves, which is ten years prior to Huerta de Soto's book.

The Monetarist identification of the crisis, with the Great Depression case as a basis, contends that a crisis happens when the money supply falls short relative to money demand. The Fed, it is said, did not expand money by a sufficient amount, and the outcome was a financial crisis spreading through the banking system; that is, the crisis was the result of an error in monetary policy. Whether the error was a purely entrepreneurial error, was due to a different theoretical opinion or happened because of political pressures is indistinct. The point is that a competitor with better judgment could not compensate for the Fed's error. In a free banking scenario, if a bank falls short in its money supply, another banker takes its place with better entrepreneurial alertness. Whilst it is not theoretically impossible for all banks to make this mistake together and precipitate a crisis, it is certainly much more unlikely than only a governmental monopoly falling victim to such a mistake is.

The well-known Friedman's rule to expand money supply according to the historical performance of GDP growth rate is founded on the idea of equating money supply changes (by the central bank) with money demand changes (GDP). If, instead of a monetary authority, there were a free banking market, this idea underlying the rule would be self-controlled by the market itself; it is the absence of a market that generates the need for a rule. The rule will be the spontaneous result of the market and not the monetary policy decision of the monetary authority. There are, of course, differences in the mechanism. Friedman (1968, p. 16) suggests expanding the monetary base and leaving the banks free to manage their fractional reserves, so there is no total control of the money supply in a broad sense. Commercial banks will have to adjust their multipliers given the changes in demand and monetary base they face. The monetary base should follow a rate of change correlated with the rate of change of GDP. It should be mentioned that contractions are not the only problem for all instances; inflation is clearly considered a problem as well. Friedman's rule, then, by setting a cap on monetary expansion would also avoid problems derived from inflation.

Austrians, on the contrary, see the problem arising earlier than does Monetarism. It is not the drop in money supply that causes a crisis, but errors accumulated in the capital structure because of an artificially lowered interest rate that will eventually need to be corrected altogether. At that point, a large number of firms will become unable to repay their debts to the banks, causing the drop in money supply. What is commonly called the crisis is identified as the correction phase. The Mises-Hayek business cycle theory starts with a continuous shock of monetary expansion entering the market through banks pushing the market interest rates below the Wicksellian natural rate. However, there needs to be an important monetary expansion for enough time in order for a crisis to happen as described in the Austrian Theory of the Business Cycle. A one-time shock or one of a small magnitude will not be sufficient. Any given bank can commit an error and over-expand its money supply, but this cannot become a recurrent error because a bank that fails to correct its policy will be set aside from the market through adverse clearing. A monopolistic central bank favored with legal tender laws is in a different situation and can put into motion important increases in money supply for enough time to affect the temporal structure of capital, as the Austrian Business Cycle Theory requires.

From an Austrian point of view, free banking also eliminates the possibility of a crisis as explained in the Mises-Hayek business cycle theory. This does not imply that a crisis cannot occur for different reasons, but it cannot take place because of a distorted interest rate for a long period.

A Keynesian position, however, describes a different situation. A crisis is triggered by a drop in aggregated consumption, and hence the solution is to increase it through go vernment spending. The Keynesian approach gives less weight to the role played by changes in money supply, but sees them as a tool to increase government spending to get out of the crisis. As free banking cannot do this, it is not as affable to Keynesianism as is the case with the Austrians or could be with Monetarism.

Of the three approaches, Austrians seem to be the most interested in the case of free banking. However, this does not mean that Austrians were only concerned with theoretical problems and did not offer practical solutions to specific monetary problems. There were practical recommendations from Austrians just as there were from Monetarist and Keynesian points of view. During the Great Depression, Hayek (1931 [1967], pp. 123–124) used the $MV=PQ$ equation to suggest keeping MV stable as a general policy of a central bank. Note that this does not aim at stabilizing P, nor at stabilizing or increasing M, but at keeping MV stable. This can happen with an increasing Q and a decreasing P.[7] Hayek's later *Denationalisation of Money* also suggests how to move from a situation with central banks to currency competition.

In 1952, Mises wrote his *Monetary Reconstruction,* which appeared as a fourth part in his 1953 edition of *The Theory of Money and Credit*. There, he put forward his monetary policy recommendation of converting central banks into currency boards through a marginal 100-percent requirement for issuer banks against gold; leaving commercial banks with the freedom to manage their reserves as they consider best. Mises took some inspiration for the idea from the Gold Standard rule and Peel's Act; his intention was, as Friedman's, to constrain central banks' ability to over-expand the money supply.

7 INFORMATION AND KNOWLEDGE IN BANKING

A final aspect that deserves a few comments is the differentiation between information and knowledge. While information refers to data, knowledge refers to interpretation; information is a quantitative concept, whereas knowledge is a qualitative one.

This can be illustrated with a simple example. If we take three economists, a Monetarist, an Austrian and a Keynesian, and give to all of them the same complete information regarding the Great Depression or the recent Sub-Prime Crisis, they will give us in return three different explanations. Information does not speak for itself; it needs to be understood. The

7 For more on this productivity rule see Selgin (1997).

same will happen if we ask them to forecast the result of a stimulus plan in the middle of a crisis. Their differences are not because of diverse information, but because of different knowledge. Therefore, while information is quantitative and objective, knowledge is qualitative and subjective. Information can be complete or incomplete, but knowledge can be neither complete nor incomplete; it just is.

This distinction is important for two reasons. First, the presence of complete information does not suffice to guarantee an equilibrium as there can still be important differences in how that information is understood by the economic agents. In addition, because information and knowledge are of different natures (quantitative and qualitative), they cannot be mixed together; complete information cannot mean equal knowledge. To set aside the aspect of knowledge is, as Hayek (1948, p. 91) suggested, a kind of assumption that sets aside the specific problem that economics has to solve.

The second aspect is related to centralization and decentralization in the market. Entrepreneurial activity uses information to discover market opportunities and anticipate market movements, but this anticipation implies subjective considerations. It depends on each entrepreneur's understanding of the market, which is mixed with his/her assumptions and instincts. Preferences are not the only subjective aspect of economic agents; knowledge and expectations are subjective as well. The aggregated information a central bank can use cannot contemplate the circumstances of particular time and places, as each bank in free banking would be able to do for its own place and circumstances.

A monopolistic issuer, even if we grant that it could solve the problem of lack of information, would not be able to solve the problem of an incorrect understanding of the market. If he makes a mistake, there is no competitor with a better understanding that could take his place. In free banking, as in any other market, the banks with better performance will be those with better knowledge of the money market. To support the presence of central banks presumes the availability of knowledge that they do not, and cannot, have.

A central monetary authority, regardless of how much information it has, does not resolve the problem of different knowledge. If it were the case that a central bank can have more and better information, why not transform the central bank into an information center to provide data to different issuer banks? Free banking is superior to a monopolist issuer not only because it is more efficient through competitive forces, but because there is also knowledge competition in gathering incomplete and diffuse information, an important aspect that is usually passed over.

8 CONCLUSIONS

We have seen that the free banking case has been set aside in the monetary discussion in economics. It is understandable that, from a pragmatic point of view, central banks are the reality with which economic policy must work, but this does not apply to the discussion in pure theoretical terms. Economics as a science should aim not only to work with present institutions, but also to study better alternatives and make them viable from a political point of view. It is vain to expect politicians to open their minds on monetary policy if economic theory does not do so first.

The free banking scenario is not only more flexible to respond to the spontaneous and unpredictable evolution of an unhampered market, but it has historically shown itself to be stable and efficient. Contrary to some opinions (Hülsmann, 2003, p. 416), free banking is not a "hypothetical history," but a very real one. Although none of the historical cases involved pure free-banking, many of them shed light on how the system works (like the Scottish case) and how intervention negatively affects the system (like the Suffolk case). The fears of bank runs and concerted expansion seem to be overstated by historical and theoretical studies. For this same reason, business cycles originating in money markets tend to be constrained as free banking sets limits to the issuance of fiduciary media and money-substitutes, a fundamental requisite that is not so strictly followed by central banks.

It should be pointed out that even if crises became rare under free banking, market fluctuations due to changes, for example, in technology or preferences would still take place. These fluctuations are part of the natural changes of the market, whereas crises are exogenously caused.

It is true that currency competition, as suggested by Hayek, is somehow present among central banks, but the situation suffers from important imperfections. Below each central bank, there is no market freedom and no central bank can open a branch within another's region. The situation among central banks is more similar to monopolistic competition than to Hayek's free competition currency. There are still regional monopolies through legal tender laws.

There is nothing to indicate that the existing distribution of monopolistic issuers is the best arrangement of issuer banks. The numbers of banks and currencies co-existing in a single region are parameters to be defined endogenously by the market. The fact that free banking means free competition in issuing money does not imply that the outcome will be a large number of currencies; the limit, as small or large as it may be, would be imposed by the market itself by choosing with which and how many currencies to work. Free banking minimizes transaction costs by adopting the optimal quantity of currencies.

Money, like religion, should be independent of the state; money cannot only exist outside the state, it can also do a better job than is being done by central banks. As Mises (1912 [1981], p. 482) suggested, "[f]ree banking would have spared the world many crises and catastrophes."

REFERENCES

Cachanosky, J. C. (2002). Crisis Económicas: Crisis y Consecuencias. *Libertas* (36).

Diamond, D. W., & Dybvig, P. H. (1983). Bank Runs, Deposit Insurance, and Liquidity. *The Journal of Political Economy*, 91 (3), 401–419.

Friedman, M. (1966, February 4). Friedman & Keynes. *TIME*, 87 (5), http://www.time.com/time/ /magazine/article/0,9171,898916-2,00.html.

Friedman, M. (1976). Inflation and Unemployment. *Nobel Memorial Lecture*.

Friedman, M. (1968). The Role of Monetary Policy. *The American Economic Review*, 58 (1), 1–17.

Friedman, M., & Schwartz, A. J. (1963). Money and Business Cycles. *The Review of Economics and Statistics*, 45 (1), 32–64.

Garrison, R. W. (2001). *Tiempo y Dinero. La Macroeconomía de la Estructura del Capital* (2005 ed.). Madrid: Unión Editorial.

Hayek, F. A. (1976). *Denationalisation of Money* (2007 ed.). London: The Institute of Economic Affairs.

Hayek, F. A. (1948). *Individualism and Economic Order.* South Bend: Gateway Editions.

Hayek, F. A. (1984). *Money, Capital & Fluctuations. Early Essays.* (R. McCloughry, Ed.) Chicago: The University of Chicago Press.

Hayek, F. A. (1978). New Studies in Philosophy, Politics, Economics and the History of Ideas. Chicago: The University of Chicago Press.

Hayek, F. A. (1931). *Prices and Production* (1967 ed.). New York: Augustus M. Kelly.

Hayek, F. A. (1967). *Studies in Philosophy, Politics and Economics* (1978 ed.). London and Henley: Routledge & Kegan Paul.

Huerta de Soto, J. (1998). *Money, Bank Credit, and Economic Cycles* (2006 ed.). Auburn: Ludwig von Mises Institute.

Hülsmann, J. G. (2003). Has Fractional-Reserve Banking Really Passed the Market Test? *The Independent Review*, VII (3), 399–422.

Kirzner, I. M. (1973). *Competition & Entrepreneurship.* Chicago: The University of Chicago Press.

Menger, C. (1892). The Origins of Money. *Economic Journal*, 2, 239–255.

Nash, J. F. (2002). Ideal Money. *Sothern Economic Journal*, 69 (1), 4–11.

Rothbard, M. N. (1994). *The Case Against the Fed.* Auburn: The Ludwig von Mises Institute.

Rothbard, M. N. (1983). *The Mystery of Banking.* Richardson & Snyder.

Rothbard, M. N. (1964). *What Has Government Done to Our Money?* (1979 ed.). Novate: Libertarian Publishers.

Sechrest, L. J. (1993). *Free Banking* (2008 ed.). Auburn: Ludwig von Mises Institute.

Selgin, G.A. (1996). *Bank Deregulation and Monetary Order*. London: Routledge.

Selgin, G. A. (2008). *Good Money.* University of Chicago Press and The Independent Institute.

Selgin, G. A. (2008). Milton Friedman and the Case against Curreny Monopoly. *Cato Journal*, 28 (2), 287–301.

Selgin, G. A. (1988). *The Theory of Free Banking.* New Jersey: Rowman & Littlefield.

Selgin, G. A., & White, L. H. (1996). In Defence of Fiduciary Media–or, We are Not Devo(lutionists), We are Misesians! *The Review of Austrian Economics*, 83–107.

Skousen, M. (1998). Milton Friedman, Ex-Keynesian. *The Freeman*, 48 (7).

Smith, V. C. (1936). *The Rationale of Central Banking and the Free Banking Alternative* (1990 ed.). Indianapolis: Liberty Press.

TIME. (1965, December 31). We Are All Keynesians Now. *TIME*, 86 (27), http://www.time.com/ /time/magazine/article/0,9171,842353-10,00.html.

von Mises, L. (1949). *Human Action. A Treatise on Economics* (1996 ed.). New York: The Foundation for Economic Education.

von Mises, L. (1912). *The Theory of Money and Credit* (1981 ed.). (H. E. Batson, Trans.) Indianapolis: Liberty Fund.

White, L. H. (2003). Accounting for Fractional-Reserve Banknotes and Deposits – or, What's Twenty Quid to the Bloody Midland Bank? *The Independent Review*, VII (3), 423–441.

White, L. H. (1989). *Competition and Currency. Essays on Free Banking and Money.* New York and London: New York University Press.

White, L. H. (1984). *Free Banking in England* (1995 ed.). London: The Institute of Economic Affairs.

White, L. H. (2008). How Did We Get into This Financial Mess. *CATO Institute Briefing Papers* (110).

White, L. H. (1999). *The Theory of Monetary Institutions*. Oxford: Basil Blackwell.

Yeager, L. B. (1997). *The Fluttering Veil. Essays on Monetary Disequilibrium*. Indianapolis: Liberty Fund.

BOOK REVIEW

THE AUSTRIAN SCHOOL: *MARKET ORDER AND ENTREPRENEURIAL CREATIVITY.* BY JESÚS HUERTA DE SOTO 2008. CHELTENHAM, UK: EDWARD ELGAR

Jesús Huerta de Soto's *The Austrian School: Market Order and Entrepreneurial Creativity* provides for the first time ideas previously unavailable to the English reader. As a brief overview of the key points differentiating the Austrian from Neoclassical schools of thought, the book will be of most use to students grasping this novel approach for the first time. Spanish students have been enriched through this introductory text to the Austrian school for over eight years already. This marks the first time that the many of Huerta de Soto's more micro-oriented ideas have seen the light of English-day. Besides its clarity and conciseness of explication, the book may prove to be of interest to established scholars, already well-versed in the finer points of the Austrian school.

One of the most valuable contributions lies in the explanation of the entrepreneur, an approach with combines many facets of previous Austrian concepts into an integrated whole. The stress of the *Huertian* entrepreneur falls not on being alert to the discovery of new profit opportunities (á la Kirzner), nor looking to the future to create a yet uncertain market (á la Mises), but in a process which perceives, produces, changes, and disseminates dispersed knowledge throughout the market to facilitate co-ordination. The stress laid on tacit knowledge as the focal point of this process becomes evident as entrepreneurship is the *only* role through which this coordinating factor may become widely known. These ideas first appeared in his 1992 Spanish-language book *Socialismo, Calculo Económico y Función Empresarial,* but will be welcomed by both Austrian, as well as more mainstream economists focused on entrepreneurship.[1]

[1] An English translation of this book is forthcoming, however, under the name Socialism, Economic Calculation, and Entrepreneurship, and will be of interest to those delving deeper into the related issues than the present book may afford.

Only two minor problems may be raised with the current book, which in no way detract from its success in delivering other topics. First is Huerta de Soto's persistence in (correctly) explaining the link between the early Spanish Catholic scholastics, and the true revival of these ideas through Menger and his Austrian descendants. A common thread seems to be alluded to that present day Austrian economics begin life as a field steeped in religion. The secular underpinnings of Menger, despite having read these early Catholic scholars, should not be forgotten, nor should the wholly *wertfrei* message that resulted from it. Subsidiary to this stress on Spanish scholars is the denial of British influences on Menger's thoughts. Adam Ferguson, for instance, had delivered the foundation for the theory of spontaneous order almost 75 years prior to Menger's elaboration, a point largely overlooked.

These small quibbles may prove to be moot, and are largely over-shadowed by other ancillary contributions which may be overlooked by the ease with which they are integrated into the greater text. Mises' own stress on the importance of knowledge of multiple languages is practiced by Huerta de Soto more than any other living Austrian economist, with many fruitful results. Explaining the original roots of such words as "entrepreneurship" (stemming from the Latin – *prehendo-endi-ensum* – to discover, see, perceive, receive, realize or capture) provides many insightful hints as to what these concepts were originally meant to designate. Huerta de Soto's personal research agenda also becomes evident. Viewing the last great intellectual achievement as being now completed in theory and practice (the impossibility of Socialism), the greatest attention should be heeded to the field of money and banking – a subject still in its infancy and ripe to be developed further after his own previous *Money, Bank Credit and Economic Cycles*. A bibliography is provided which outlines which works are deemed most pertinent to the school – a resource of utmost use to young scholars trying to expand their minds.

In the final pages, several claims against the current Austrian school are refuted. Foremost among these is the assertion that "Austrians are dogmatic." In fact, the converse is shown to be true, with the mainstream economists relentlessly holding onto flawed concepts and proving to be dogmatic in their own approach. *The Austrian School: Market Order and Entrepreneurial Creativity* proves Huerta de Soto to be not only a clear and persuasive proponent of this field of study, but also keen to blend ideas from diverse and seemingly unrelated fields. Indeed, over these 129 pages, dogmatic is something Huerta de Soto proves to be anything but.

David Howden
Department of Business and Social Sciences
Saint Louis University-Madrid Campus, Madrid, Spain
dhowden@slu.edu

LIST OF ARTICLES