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Monetary stability and the rule of law

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ABSTRACT

This paper investigates the relationship between the functioning of money and the rule of law. We explore the claim that monetary stability is a necessary condition for the rule of law to operate and that periods of rapid inflation and deflation stemming from monetary instability erode and undermine the rule of law. We support our argument with panel data evidence and four detailed case studies from the Roman empire, the Weimar Republic, the Great Depression and the Great Recession. Our conclusions examine what monetary institutions are most conducive to maintaining monetary stability and the rule of law.

1. Introduction

The macroeconomic consequences of monetary instability are well understood by economists. However, monetary instability can have additional, harder to detect, effects on the institutions of a market economy. This paper investigates the relationship between monetary instability and the rule of law.

For instance, the aversion that central bankers, policymakers and the public have to high inflation indicates that there is a tacit understanding that periods of high and unstable inflation can inflict serious damage on a society. But this tacit knowledge is not reflected in either theory or in textbooks; the costs of inflation emphasized in the standard macroeconomic literature (menu costs, shoe leathers, fiscal drag, etc.) do not fully capture the reasons why high inflation is feared.[1] This gap between the theory and practice suggests that it is important to explore the connections between monetary stability and a country's political and legal institutions, and specifically, its adherence to the rule of law.

The ways in which macroeconomic and monetary instability can undermine the rule of law have been not been extensively studied despite the fact that episodes of monetary instability have often been associated with a breakdown of the rule of law.[2] One reason for the neglect that this topic has received is that it is difficult to do empirical work in this area due to obvious endogeneity concerns. We use panel data to show that there is indeed a negative relationship between measured inflation and rule of law. But this analysis is far from conclusive due to concerns of omitted variable bias and reverse causality. To address these limitations, we utilize an analytical narrative approach that allows us to identify potential mechanisms and channels through which monetary instability can affect the rule of law. These mechanisms are: (i) the effect that monetary instability has on the structure of relative prices and hence on the informational properties of the price system; (ii) the effect of monetary instability on the distribution of income; and (iii) on

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[1] Ball and Romer observe '[a]lthough inflation is widely viewed as a major economic problem, economists have yet to give a clear account of why it is costly' (Ball and Romer, 2003, p. 177).

[2] Prominent examples include Revolutionary France, the Confederacy, Germany and Zimbabwe in 2008. Other examples of hyper-inflation occurred in Hungary after 1945 and in some Post-Soviet economies after 1991. See Burdekin and Langdana (1993) for an account of the Confederate inflation.

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the economic and political institutions of a society, in particular, the rule of law.

We draw on evidence from four case studies: Ancient Rome, Weimar Germany, the United States in the 1930s, and the aftermath of the Great Recession in order to substantiate our claims. Our conclusions examine what monetary institutions are most conducive to maintaining monetary stability and the rule of law. Our findings provide further evidence in support of a rule-based monetary policy and provide additional reasons to consider reforms to existing central bank practice.

This paper is organized as follows. Section 2 proposes four mechanisms that link monetary instability to the quality of institutions, in general, and the rule of law, specifically. Section 3 presents cross-country data consistent with the thesis that monetary instability is associated with less adherence to the rule of law. Section 4 develops our historical case studies. The first explores debasement and inflation in the Roman empire, and assesses the role played by monetary instability in the transition from the comparatively liberal early empire to the more autocratic later empire. The second case study we employ is Weimar Germany; we examine how monetary instability destabilized a nascent liberal democracy and made the institutional transition to autocracy more likely. Finally, we look at the United States to see how rapid and unexpected deflation brought about the crisis of the Great Depression, and how this crisis was used to justify various policies that were in violation of the liberal rule of law and would otherwise never have been considered. Our final case study examines reevaluates modern inflation targeting regimes in light of the recent Great Recession to assess the properties that a desirable monetary system should possess. Section 6 concludes.

2. Rule of law and monetary stability

Legal scholars such as Dicey (1908), Fuller (1969) and others suggest that the rule of law requires (1) a concept of legal equality, that is, that all individuals are equally subject to the law; (2) rules that are public, consistent, not retroactive, and stable over time; and (3) rules that are general and apply uniformly to a large group of individuals.[3]

In addition to this thin definition of the rule of law, social scientists also employ thicker definitions of the rule of law to refer to a nexus of desirable institutions such as the existence of procedures that help protect human rights and institutional arrangements that are conducive to the development of a market economy (see, for example, Locke, 1967; Hayek, 1960; Weingast, 1997; Haggard et al., 2007). We refer to this broader definition as the liberal rule of law. Individuals are subject only to rules of behavior that are general, widely accepted, and well known; this enables individuals to plan their lives around them. Moreover, these rules of behavior are stable; they cannot be arbitrarily changed by the legislature and have, instead, to be anchored in an explicit or tacit constitution. Thus the rule of law provides a check on the power of government and guarantees each individual their own private sphere of non-interference.[4]

Monetary stability or equilibrium refers to a situation where changes in the supply of money are approximately equal to changes in the demand for money. More specifically, in equilibrium producers and workers should not have to make large or costly changes to prices or wages in order to equilibrate the real and nominal money stocks. A situation of monetary instability could involve a short term, but very large one time adjustment to equilibrate money supply and money demand, or one in which the price level becomes less predictable due to an increase in the variance of inflation. Under this definition, moderate increases in the price level may be consistent with monetary equilibrium so long as that inflation is anticipated and stable. Individuals can hedge against inflation if they have some confidence about the future path of prices. High and unstable levels of inflation, on the other hand, do disturb the real economy. Sudden and unanticipated deflation likewise can generate unemployed resources, financial crises, and cause a sudden collapse in aggregate demand.[5]

Monetary instability has a first order effect on the ability of the market to coordinate individual plans. We state this as follows:

Mechanism 1. *Sustained monetary instability corrodes the ability of the price system to allocate resources.*

In a market economy, producers respond to prices which convey information about the state of demand and the relative scarcity or abundance of inputs into production. Prices communicate, and allow individuals to act upon, knowledge that would otherwise be unavailable.[6]

Inflation, particularly unanticipated inflation, injects noise into this process because prices adjust at different rates. Some prices are able to respond to inflation quicker and more flexibly than others. As a result, after a period of inflation the price system become less accurate and less informative. Producers are less able to tell which prices are rising because of an increase in inflation, and which are rising because of a change in economic fundamentals. Consequently, the relative structure of prices, which conveys the relative scarcity or abundance of resources, is distorted. The increased epistemic burden inflation imposes on economic actors reduces the ability of the market to coordinate individual plans. Thus the effect of inflation is not merely redistributive; it is not a zero-sum but a negative-sum process.[7]

Deflation is benign if it is driven by increased productivity and consistent with monetary equilibrium (Selgin, 1995). However, deflation that is the result of monetary disequilibrium, either because of a contraction in the money supply or a failure to accommodate an increase in the demand for money, will have deleterious effects. In an environment in which wages are sticky downwards or workers have an aversion to nominal wage cuts, deflation causes resources to be unemployed. In the absence of sophisticated

[3] According to Dicey the rule of law has three meanings: (1) 'the absolute supremacy or predominance of regular law as opposed to the influence of arbitrary power, and excludes the existence of arbitrariness, of prerogative, or even of wide discretionary authority on the part of the government'; (2) 'equality before the law, or the equal subjection of all classes to the ordinary law of the land'; and (3) a formula for expressing the fact that the law of the constitution, the rules which in foreign countries naturally form part of a constitutional code, are not the sources but the consequence of the right of individuals, as defined and enforced by the Courts' (Dicey, 1908, pp. 198–199). Raz (2009) argues for a still thinner and solely procedural based definition of rule of law under which a 'non-democratic legal system, based on the denial of human rights, on extensive poverty, on racial segregation, sexual inequalities, and religious persecution may, in principle, conform to the requirements of the rule of law better than any of the legal systems of the more enlightened Western democracies' (Raz, 2009, p. 211). However, this definition of the rule of law, though logically coherent, is of little value for applied research in the social sciences.

[4] This statement is most clearly stated in Hayek (1960). It can be traced back to Cicero, St. Augustine, and Thomas Aquinas (see Waldron, 2008, p. 13). Note, this definition of the liberal rule of law presupposes a market economy (it is incompatible with non-market forms of economic organizations such as slavery, feudalism, or a command economy). For an analysis of the microfoundations of the rule of law see Hadfield and Weingast (2012). Gowder (2013) provides an analysis that seeks to bridge the different definitions of the rule of law.

[5] See, for instance, the discussion in Yeager (1997).

[6] This insight was best expressed by Hayek (1945).

[7] However, it is important to note that in the presence of macroeconomic rigidities, second-best theorizing suggests that some inflation may make the price system work better see (Akerlof et al., 1996). The empirical issue is then at what level of inflation do the costs of inflation exceed the benefits.