Four Lectures on the History of Monetary Theory

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Lecture 1

The institution of money

Why these lectures

- *The institution of money is not at the centre of the research programmes of mainstream macroeconomics. In most models proposed by the profession money is inserted as an afterthought – if at all.*
- *This is in sharp contrast with the importance generally given to financial and monetary institutions when analysing the political economy of crashes and their aftermath, such as that of the Great Recession.*
- *The history of monetary theory can help remedy this contradiction.*

Perennial problems

- The value of money
- Inflation and deflation
- Interest and usury
- Money and the trade cycle
- Money and international trade
- Monetary management and political power

An evolutionary story

- My story is: the slow displacement of a self-managing monetary and financial order (the gold exchange standard), by a ‘rationally’ managed fiat money system (on the basis of the quantity theory). Whether that will in turn be displaced by system of private money competition is anybody’s guess
- The Gold Standard had the advantage of being automatic, if some rules were obeyed but … *The Wizard of Oz:* “We didn’t know it could be done”
  - No sterilisation of gold inflows
  - Preventive Central Bank action with the discount rate
  - Lender of Last Resort
- Quantity Theory management by an oligopoly of Central Banks
  - Rules rather than discretion?
  - Central Bank independence of politics
  - Public Choice problems
- Monetary competition
  - By function rather than wholesale

Lecture I

The Institution of Money

Nations stumble upon establishments,
which are indeed the result of human action,
but not the execution of any human design.

Adam Ferguson,
An Essay on the History of Civil Society (1767)

What is money? Wrong question

- ‘What is money?’ is a misleading question, as ‘what is’ questions usually are: they degenerate into verbal disputes (“What do you mean by…?). Definitions usually hide theories.
- The concepts of metallic money and fiduciary money, two rival theories about the economic power of the state
  - o Two political theories in search of a pedigree
- The source of monetary value?
  - o The intrinsic value of the coin (gold or silver weight)?: metallism
    - o Even when value is by weight it becomes by tale when the king stamps it with a guarantee
    - o The sovereignty of the state (money, a creation of the state): chartalismThe value of money is what money can buy
- To keep its value one year with another there must be some rule that limits its quantity

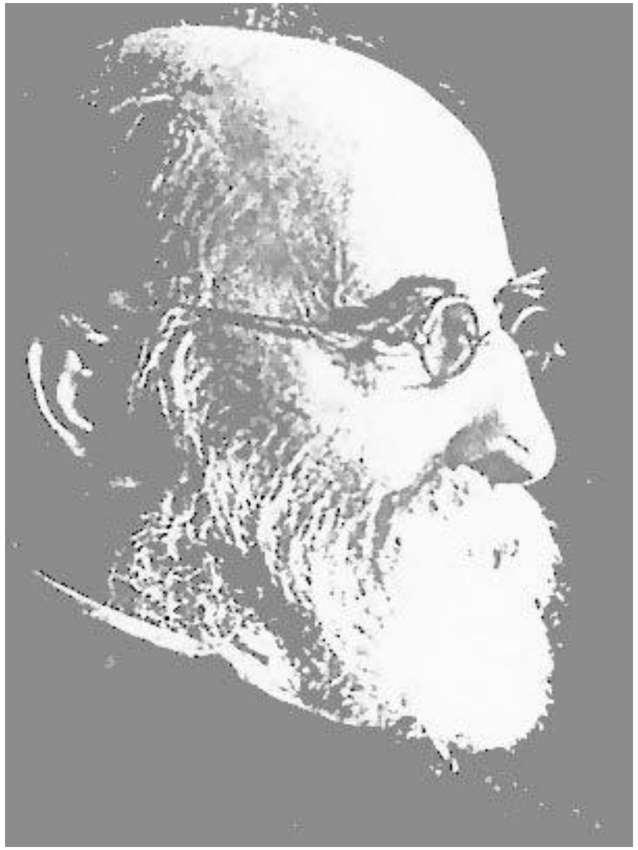
The origin of money

- Two theories about the origin of money
  - The reduction of the transaction costs of barter. Spontaneously born of merchant practice to replace barter
    - Money a creature of the market
    - Later nationalised
  - The settling of debts: anthropological research denies the widespread use of barter in pre-historic times. Money was used for the noting and settling of debt, with no connection with immediate purchases and sales, or the present performance of labour services.
    - Money a creature of the state
    - Progressively, the coin’s value becomes independent of its content

Hypothesis (1) The individualistic origin of money

- Carl Menger (1840-1921): rational reconstruction of the birth of money
  "On the Origin of Money" *EJ* 1892
  - Based on methodological individualism
  - Money, a social institution in no need of a holistic explanation
    - Methodological individualism applicable to other social institutions such as language or law
  - The pragmatic origin of money
  - The transaction costs of barter minimised by the initiative of commercial entrepreneurs
    - A given merchandise is accumulated by an entrepreneur because of its observed saleability
    - The expectation that people will prefer that relatively saleable commodity will allow the entrepreneur to get a lower price for what he or she buys and a higher price for what he sells.
    - The state has no essential role to perform, except the guarantee of the metal content of coins

Friedrich Knapp and Carl Menger



In the spirit of Menger: Hayek

- Present-day national currencies are the result of the nationalisation of merchant currencies
  - Herodotus: Kings of Lydia (7^{th} c. BC) discovered the advantage of coining to overvalue monetary metals
- Even state currencies underwent political manipulation
  - Zollverein currency, mainly from 1836; Peel's Act of 1844; National Bank Act in USA 1863; creation of the peseta and Bank of Spain issue monopoly 1874
- Private moneys could again become possible
  - Friedrich von Hayek (1899-1992): *The Denationalization of Money* (1976); *The Argument Refined* (1978)
  - A business plan for launching private currencies!

Hypothesis (2): Chartalist or statist origin of money

- Georg Friedrich Knapp (1842-1926): the value of money created by the state

  The State Theory of Money (1905, a shortened English edn. in 1924.)

  Preface to 1st German edn.

  - "That the money of a State is not what is of compulsory general acceptance, but what is accepted at the public pay offices; and that the standard is not chosen for any properties of the metals, but for the deliberate purpose of influencing exchanges with the commercially important neighbouring States."
  - "I hope for the approval and perhaps the help of those who take the monetary system (or, better, the whole system of payments) to be a branch of political science."
  - "If anyone says that my own aim has been to discover the soul of money, well, so be it."

  End of Table of Contents

  - "Alterations in price not alterations of the 'validity' of a piece. The State Theory of Money to be kept separate from economic reflections on Money."

In the spirit of Knapp: Abba Lerner

- Abba Lerner (1903-1982): “Money as a Creature of the State”, *AER* May 1947
  - Lerner’s definition of money alludes to ‘general acceptability’ but the source of acceptability is the state accepting it in payment of taxes
  - Mocks his teacher at LSE Theodore Gregory for traducing Knapp and for holding that “the value of money derives from the scarcity of gold and that this scarcity is impervious to declarations by government officials”.
  - For Lerner, when the gold standard was abandoned the idea that money derived its value from the backing of some real good could be seen as absurd.
  - The backing of the sovereign state, coupled with the acceptance of the state currency by the government in payment of taxes, ‘would do the trick’ of general acceptance.
  - The state should use its monetary power to fight depression by creating state money and avoid inflation by curtailing the power of trade unions!!

Misunderstandings

- Gold currencies were ***not backed*** by gold
  - In fact, sticking to the supply of gold was al rule governing MS: the flow of gold reserves ***controls*** the amount of paper money issued by the Central Bank
  - Even the value of a *fiat* money depends on an issuing rule, given MD (the Quantity Theory)
- The value of state money is not ultimately in the hands of the sovereign
  - The final decision is the proportion of liquid money that individuals and firms want to hold for contingencies: ‘**cash balances**’ Marshall and Walras call them
  - An excess supply of state money will lead people to get rid of that excess liquidity, push prices or the exchanges up, and reduce the value of money the state thought it was creating
- Money is a ‘network good’, so of that the **share of the market** enjoyed by a currency is crucial for its value in use
  - In an open economy MS may again not be in the hands of the sovereign
  - But US the banker for the world

Demand for money (I)

- I will analyse the evolution of the institution of money with the elementary tools of demand and supply
- The demand for money depends on the functions it has performed over the years
- Indispensable reading on the origin of monetary theory: Schumpeter (1954). Ch.2, parts 3 & 4 “The Scholastic Doctors”.
- Among a myriad of Scholastics interested in money and usury let me choose:

Demand for money (II)

- Friar Martin de Azpilcueta, Dr. Navarrus, listed the following uses of money in 1556:

"The first use, for which money was found was, as price to buy with it, and sell through it the things necessary for human life, and so that it should be a public measure of saleable goods, so to speak [...]. Then [...] began the art of exchange, which is the art of dealing in money.[...] The fourth is as measure of wealth [by] putting it on the bench or venue where it is dealt or exchanged. The fifth is to wear as medals and adornment of garment. The sixth is to gladden with its view. The seventh, to heal some illnesses. The seventh, to give it as security."(Ch. iii, 12)

  - At the time, an application of gold or mercury was used to cure syphilis
  - Much better than Bodin

Martín de Azpilcueta, Dr. Navarrus

The three functions of money

- The three functions of money (numéraire, transactions, asset) are by now a fundamental framework.
- Keynes (1936) changed them by imprecisely introducing expectations
  - o Transactions, precautionary, and speculative
- At present the classification is lamentably split in two with no encompassing theory (says Benjamin Friedman in *New Palgrave Dict.*)
  - o Money as a capital asset
  - o Money as medium of exchange.
- Benjamin Friedman wrong to give up the function of *numéraire*
  - In countries with high inflation day-to-day transactions may be in the devaluating national currency, important transactions valued in an international currency but effected in the local currency at the market exchange rate; wealth stored in the international currency

Money supply (I) the alteration of money

- Money supplier's profit
  - Seignorage and market share; depreciation and revaluation; change of alloy: gold and silver fineness, *vellón* (silver and copper)
- Undercover gain
  - Clipping and filing; melting; counterfeiting
- Bishop Nicole Oresme (1320?-1382): *Traictie de la première invention des monnoies* (1360, 1366)
  - The prince had the right to coin money but the moneys resulting belonged to the individual owners and he condemned the alteration of the fineness of the coin. Adviser and confessor of Charles V of France, he convinced the King not to follow the policy of his father John the Good, who had devalued eighty six times.
- The Jesuit priest Juan de Mariana (1536-1624) : *De monetae mutatione* (1609)
  - In *De rege et de regis institutione* accepted regicide as permissible if…
  - His *On money* was listed in the *Index librorum prohibitorum* and he himself was confined to a monastery for considering the debasement of coins and inflation as a tax not properly voted by the *Cortes*

Bishop Oresme and Jesuit Juan de Mariana

Money supply (II) Seignorage today

- Seignorage is the profit made by the mint or the issuer of currency if that currency is **imposed** as legal tender
- It was one of two charges demanded by the mint for coining gold or silver bars
- The other charge was *brassage* (from *bras*, arm) to cover the cost labour and machinery needed for coining.
- Seignorage is at bottom a tax and can sum to a considerable income for the mint and the state.
- Over time the amount thus collected will be a function of the difference between the face value of the coin or paper and the cost of producing it, on the one hand, and the purchasing power of the coin or paper, on the other
- So there will be an optimum amount of seignorage depending on the effect on prices of further minting or printing
- The importance of seignorage in the Eurozone

Money supply (III) Fractional reserve and bank money

$$M = (1 + cu) / (rr + er + cu)$$

- An essential part of the modern financial system, ever since the late Middle Ages, is the creation of money by Banks of Deposit
    - The famous study of Raymond de Roover, *The Rise and Decline of the Medici Bank, 1397-1494* (1963) shows how the Medici Bank first prospered by relending the deposits of its clients on a shrinking amount of cash held in guarantee. Then the family dangerously shifted its business to lending the money held in deposit to princes and churchmen. The political result was placing Marie de Medici as the virtual ruler of France and having four popes consecrated. But the Bank finally failed.
    - Jesús Huerta de Soto (1998) has generalised this and other rise and fall stories to condemn the re-loan of deposits on a dwindling cash guarantee
    - Should commercial Banks be restricted to being depositees of cash for a fee?

Financial services and broad money

- When we come to study the Quantity Theory we shall discuss which of the kind of liquid assets that can most readily be turned into purchasing power
- Before the wide use of paper money and deposit accounts for transactions, narrow money was the instrumental variable to use when calculating the effect of money on the real economy
- If the currency multiplier between base money and other near monetary assets is rigid, then the choice of form of money is (almost) indifferent
- Not so after economic evolution created sophisticated financial markets
- In that case a broad definition of money will be more operative
- JSM included the whole of credit on the liability side of monetary accounts. As for Prof. Congdon, he bases his monetary analysis on the total sum of the monetary assets M4.

Endogenous and exogenous money

- Governments and Central Banks like to think that they can create outside or fiat money exogenously
- Meghnad Desai and different kinds of monetary economies (the article of that name in *New Palgrave* is luminous)
  - In a commodity money system MS is not in the hands of the Authorities, except if excessive money creation takes some time in translating into a BoP deficit
  - With bank money in the system, financial intermediaries can multiply the base money lent them by central banks, within reason or resulting in credit booms and slumps
  - Both Keynes and Friedman built models of closed economies with outside fiat money
  - Modern financial instruments make these closed models increasingly unlikely

Money supply never really exogenous

- Governments act as if excessive money supply would never come home to roost
- Karl Brunner's entry in the *New Palgrave* summarises the large amount of work done by Brunner (1916-1989) and Alan Meltzer (1944-2011) over the years.
    - When I was a member of the European Shadow Market Committee Brunner corrected me for being content with assuming a model where demand only counted and MS was exogenous
    - There was no point in modelling a closed economy when the aim was to explain MS: In the end an injection of *fiat* money is offset by the loss of international foreign reserves.
        - ✓ A small open country's money supply is not exogenous. The foreign price level, the exchange rate, and the country's money supply and technology determine the country's stock of money and price level.
    - The aim of monetary policy should be, he said, the creation of institutions "lowering short run monetary and long run price-level uncertainty"

Can money be managed?
Should it be?