Four Lectures on the History of Monetary Theory

by

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Lecture 3

Money in an open economy

“The subjects of coin, of paper credit, of the balance of commerce, and of exchanges […are] intimately connected with each other.” Henry Thornton.

Completing the picture of monetary equilibria

- Megnad Desai (see lecture 1) showed that one can only properly speak of exogenous money supply in a closed economy system
  - In an open economy the connections between the national money supply and the rest of the world may work out slowly but are certainly there
  - To put it otherwise, central banks may have the illusion that they can create money exogenously but in time the pigeons of their mistakes come home to roost from abroad
  - Especially for a small open country's money supply is not exogenous, the *monetarist* Karl Brunner said. 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
  - Even for a large country money supply is not purely endogenous. It is only that the decisions of a predominant central bank will feed into the world equilibrium path and back

Jacob Viner, the master

- Jacob Viner's immense erudition and unerring economics tells us the history of the connection between money and foreign trade
  - *Studies in the History of International Trade* (1937) is, in its chapters 3 to 7, a history of money in a world economy
  - There is no separating the theory of money from the theory of international trade
- Mercantilists not only want to defend groups of national producers from foreign competition but traditionally fear the country would never have enough money if exchanges were not controlled
  - Though 'the big problem of small change' must be solved
- This for me is the point of the 'specie flow mechanism' combined with 'Gresham's Law': Mercantilist monetary theory is theoretically and empirically wrong

The quantity of money and the value of money

- **Azpilcueta** again, in 1556

“when there is a general lack of money, it is not that the ducat is worth more reals … it is that all money is worth more, because more saleable things can be found at so much per money, than before.”

  - Nothing of that in Bodin’s *Response à Malestroict* (1568)

The Quantity Theory and the exchanges

- **Tomas de Mercado** (1525?-1575) *Tratos y contratos*, 3rd edn. 1571

A Dominican friar who was asked for a report on the ethics of trade by the merchants of Seville. He died on his way back to the Indies

“There are two points in this chapter to discover and clarify: the first is that modern exchanges are based on the current estimation of money.... Never do exchanges carry such great interests as the remittances that are made to places, where it is evident that money is much appreciated… The second is that from Seville to Medina and Lisbon, and any other place, what makes the market fall or rise is the abundance or dearth of silver, if there is much, the exchanges are low, and it is clear that the abundance or lack leads to it being esteemed in much or in little.. (cap. vi, 465)

Self-regulating specie flow

- Mercantilists worried about a net loss of precious metals
  - Geronymo de Uztáriz in a book (1724) quoted in the *WoN*, for the harmful effect of Spanish sales tax taxes (the *Alcabala).* Uztáriz was moved by the wish to see the foreign trade of Spain better arranged; as his translator John Kippax put it: “to import only from countries that take the growth and produce of Spain in return, instead of encouraging those who must be paid for their manufactures entirely in bullion, and who thus, in time, extract the very vitals of the kingdom.”
  - Hence, directing foreign trade o controlling gold and silver exports
- The answer: the self-regulating specie flow
- David Hume (1752)
  - In his *Political discourses* started with the hypothesis that “four-fifths of all the money in Great Britain was annihilated overnight”. British prices and wages would fall, foreign competition would be overwhelmed, and the difference in exports would be paid in money until the “level of money” would be restored to its former equilibrium
  - The correcting role of exchange rates, interest rates and (implicitly) incomes
  - No need for Government to worry or to intervene

The equilibrating mechanisms of the BoP

- Relative price changes
  - This is the first mechanism for Hume and the only one for Ricardo (*The High Price of Bullion,* 1810): the effect of the law of one price after transportation costs
- Goods and service flows
  - Imports are purchased with exports: JS Mill, if read carefully, sees that almost no need for prices changes
- Income movements
  - Though not mentioned by Hume, changes in money income consequent on price changes also help re-establish equilibrium
- Terms of trade
  - Already in Hume. Terms of Trade changes move the final equilibrium. Discussed between Ohlin and Keynes on German reparations
- Compensating movements of interest rates
  - The market rates of interest (and the discount rate) would influence and quicken the flow of specie
- Movements in exchange rates
  - The Bullion Committee convened because of depreciation of BoE notes

The classical gold standard in an open economy

- The price of the currencies linked to the gold standard is kept within the gold points set by the import and export of gold
- The central price is £3/17s/10.5d since Newton fixed it
- The discount rate of the BoE used to forestall external drains
  - If the gold reserve of the BoE falls to 'dangerously' low levels the bank rate is increased to attract foreign gold
  - And to 'cool' the economy
- When the internal demand for gold or liquidity increases due to a financial crisis, the discount rate should be lowered

The Banking School

- The Banking School: Thomas Tooke (1774-1858) and John Fullarton (1780?-1849)
- They underlined the invention of bank notes and bank deposits, which changed the transmission mechanisms outlined by the Currency School
  - For them, convertibility was guarantee enough against over-issue
  - And over-issued notes would be naturally restricted by ‘reflux’ to the bank
- Distinguished between external and internal drains of BoE gold reserves
  - Internal drains due to fall of confidence in the national economy called for BoE increasing liquidity and reducing the discount rate
  - External drains should be corrected by hikes in the Bank Rate
- Bagehot (preceded by Henry Thornton) wanted the BoE to act as a Lender of Last Resort
- Despite the return to Ricardo of the Robert Peel 1844 Bank Act slowly the Banking School view made its mark

The Latin Monetary Union.

- The Latin Monetary Union, created by France in 1865, in agreement with the Governments Belgium, Switzerland, and Italy, in effect lasted only until 1873 (formally until 1927)
- Really a bi-metallic coinage union: the gold and silver coins of the member freely acceptable in the others
- Italy first, the Vatican later, financed their budget deficits with the issue of silver coins of lower fineness that were exchanged for good coins at the Bank of France
  - The conquest of the Vatican by the Kingdom of Italy and the rout of the II Empire at the hands of the Germans put an effective end to this anti-gold standard experiment
  - Despite the precipitous fall in the price of silver after 1875

Fiat money in an open economy

- The monetary measures during WWI brought to a head the *theoretical* changes of the 2nd half of the 19th c. (as Laidler shows)
- **JM Keynes** showed his undoubted mastery in monetary questions with his *Tract on Monetary Reform* (1923)
- The real start of the theory of fiat money management
  - Keynes distinguished between two kinds of monetary regimes for the Bank of England, then still out of the gold standard
    a. With a flexible exchange rate of sterling with the dollar
    b. With a fixed exchange rate £/$
  - The object of a flexible rate would be to put the management of the British price level in the hands of the Bank of England
  - A fixed rate would put the money management in the hands of the Fed
- He preferred (a) flexibility, since “in the long run we are all dead”

Keynes at Bretton Woods.

- Curiously, a modified pegged exchange rate plan
- "Bancor", one of many attempt of Keynes's at creating an international currency with the aim of:
  a. Obtaining the stability of the gold standard without its rigidity
  b. Fixing the exchanges of the main currencies but allowing exceptional rearrangements
  c. Penalising countries with excessive and prolonged BoP surpluses as well as deficits
  d. Avoid exchange control limits of international trade

  o Debtor countries: depreciation of currency, paying interest on bancor negative balances, forced gold sales, capital export restrictions

  o Creditor countries: currency appreciation, fines on excess balances

- Proposal failed against Harry Dexter White's opposition as US representative

Friedman on flexible exchange rates.

- “The Case for Flexible Exchange Rates”, written in 1950, and published in 1953 (M. Friedman, *Essays in Positive Economics* (Chicago: University of Chicago Press, 1953), pp. 157-203
- Friedman’s proposal had two dimensions:
  - Flexible exchange rates would automatically preserve BoP equilibrium
    - Would allow a country’s economic autonomy
  - Coupled with a rule for the proper conduct of monetary policy
    - Would avoid inflation and volatility
    - The rule he finally proposed was the growth of MS at the secular rate real growth of the economy

Milton Friedman’s license plate

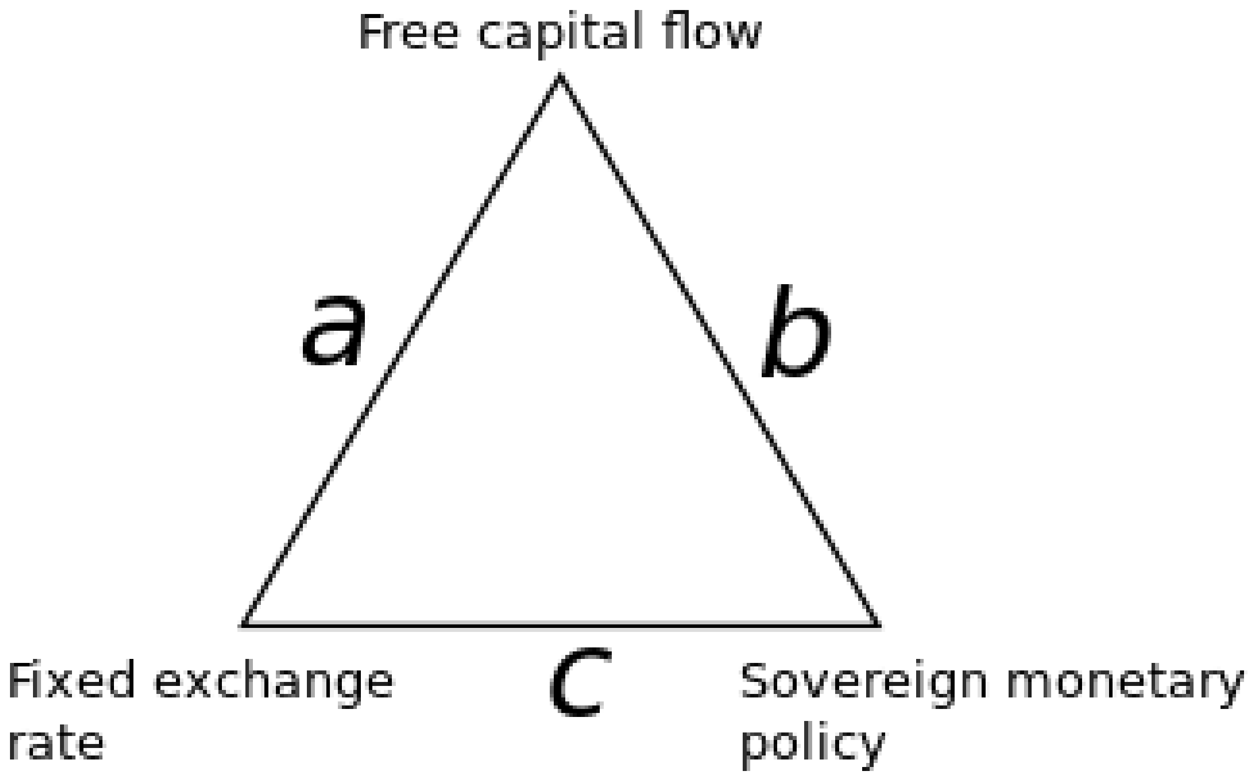
The Balance of Payments, an accounting instrument

- BoP is of little value in itself
- Nations don’t trade, individuals and firms do
- Should be used as a symptom of different developments of the real economy
- Excessive MS results in BoP’s deficits: Harry Johnson monetary approach
- Budget deficits (esp. visible in Δ foreign debt) reflect $S<C+I$.
- Budget deficits are usually financed by excess MS originated in Δ public debt
- The balance is not important: it’s the growth of total trade that matters for growth
    - We should add up exports and imports to come to a conclusion

Harry Johnson and Bob Mundell’s monetary approach to the Balance of Payments

- If the supply of money falls short of the demand for money, the country will have a BoP surplus, and vice versa
- With a flexible exchange rate, the depreciation of the exchange in the case of a deficit will ‘absorb’ excessive MS by making money worth less
- In the case of the devaluation of a pegged currency, the Government must refrain from returning to monetary ease and should correct Budget deficits
  - Devaluations must be reinforced by what the IMF use to call “accompanying measures
- These are short-term measures, when ait is the increase in total trade should be aimed at

The Mundell-Fleming impossibility triangle.



The World's bankers (Triffin's Dilemma?)

- Benefits of running a world reserve currency
  - Being the world's bankers allows the country to settle in a deficit current and capital account situation, as General de Gaulle complained
    - The US supply dollars as the reserve currency to other nations by having a BoP deficit. So the US are in the privileged situation of consuming excess foreign goods and services by paying with greenbacks
  - The US also supply capital by foreign investment in other countries
- The costs of running a world reserve currency
  - "The reserve currency is a global public good, provided by a single country, the US on the basis of domestic needs"
  - Pres. Johnson financing the Viet Nam War and the War on Poverty with public debt; Volker's fight against inflation under Pres. Reagan
  - Danger of dollar accumulation and lending abroad

- See BIS Working Papers No 684 by Bordo and McCauley (December 2017)