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The birth and rebirth of monetarism: David Ramsay Steele

Although glimmerings of Monetarism appeared in the Ancient World, medieval Scholastic writers have some claim to be the original Monetarists. With them it was a commonplace that princes, having gained a monopoly of coinage, might be tempted to debase the coins (for instance, secretly mixing lead with purportedly silver coins), thus enriching themselves, because at first the debased coins would buy goods at the old prices. Since more coins would be issued in order to take advantage of the debasement, prices of goods other than money would be bid up. In the sixteenth century prices rose dramatically in Europe. Malestroict argued that this was due to debasement. Bodin, in his famous *Response* (1568) to Malestroict, contended that other factors were involved, especially the influx of new gold and silver from America.

But maybe it would be more apt to say that Richard Cantillon and David Hume were the first Monetarists, particularly as they were reacting against the "Keynesian" inflationist ideas of John Law who advocated (1705) a managed currency, and a continuos increase in the money supply to promote prosperity.

Law did not dream of denying that inflating the currency would cause prices to rise. He simply thought that a little inflation would he a tonic for trade.

Cantillon and Hume

"Everybody", affirmed Cantillon (about 1722), "agrees that the abundance of money or its increase in exchange raises the price of everything". This had been accepted by Davanzati, Petty, Locke and numerous others, but Cantillon broke new ground: he tried to trace, in imagination, the path by which new money would spread throughout the market, in what order it would raise different prices, and what effects it would have, at successive stages of its dissemination, upon employment in different industries. Although he supplied alternative analyses according to the various possible sources of the new money, his underlying premise was that people who became richer by receiving the newly-introduced money at an early stage would increase their consumption spending, thus bidding up the prices of the goods they purchased, and enriching the suppliers of these goods, who would in turn increase their consumption. Cantillon explained that inflation would not be neutral in its effects on prices. "Market prices will rise more for certain things than for others, however abundant the money may be."

Hume (1752) emphasised that the total amount of money in society was of no consequence, but changes in that total were important. In less detail than Cantillion, Hume outlined how the first spenders of new money had the advantage of prices adjusted to the old money supply. They were therefore encouraged to greater industry. As the money rippled outwards, prices rose and the initial gain was lost. The demand for money is as important as its supply. Hume pointed out that "If the coin be locked up in chests, it is the same thing with regard to prices, as if it were annihilated." Like all Monetarists, Hume understood that if the first recipients of the new money were simply to increase their cash balances, and spend no more than previously, there would be no rise in prices. But he could see no reason why they would behave in this peculiar fashion, and no sensible reason has ever been offered by anyone.

Arguing that the rate of interest was ultimately not affected by the total quantity of money, Hume imagined that "by some miracle, every man in Great Britain should have five pounds slipped into his pocket in one night". Prices would rise and society would be no better off, as the available goods apart from money had not increased. Unlike Cantillon, Hume seemed to think that all prices would rise in proportion to the increase in money, whether it entered by gradual dissemination from a few first recipients, or by an overnight miracle. This is not correct even in the latter case, unless by another miracle, everyone was informed of what had happened, so that all sellers increased their prices by the right amount as soon as they opened their shops next morning, and also unless the miraculous additions were not equal but proportionate to cash holdings.

All the classical economists were Monetarists. Smith took for granted the views of his friend Hume, and didn't add much to monetary theory. Thornton (1802) made the greatest contribution. He investigated the motives for holding money, the interaction between money supply and interest rates (and the natural and market rates of interest) and the tendency towards parity in the purchasing powers of different regional monies at their exchange rate. He noted that monetary expansion would provide new jobs for the idle, but would also draw workers away from useful employment's to new jobs which would last only as long as the expansion. He observed that an increase in the money supply would increase output for a time by lowering the real wages of some workers, but that the increase in output would not be sufficient to prevent a rise in prices - though at the start of an inflation, price increases would be less than proportionate to monetary expansion.

Ricardo added little to monetary theory, but he was a militant Monetarist propagandist whose pamphleteering on this question did much to entrench sound money in Britain and thus install a potential for wealth creation which has still not been entirely destroyed by the Keynesians.

Two schools of thought

Discussions of money in the early nineteenth century became completely dominated by the controversy between two schools of thought, the "Currency" and "Banking" schools. The Banking School correctly saw that checking deposits were analogous to banknotes, and part of the money supply. On all other major issues, the Currency School was correct and the Banking School mistaken. The Banking School thought that an increase in paper money would have no adverse effects so long as convertibility to gold was maintained. They held the idea of "reflux", that loans made by the banks would soon return as deposits. The Currency School saw that notes issued in this way would lower interest rates temporarily, creating an unsustainable boom based on mal-investment, as well as raising prices generally.

This, together with Cantillon's work which was unknown to the Currency School, was the basis of the Austrian Theory of the Trade Cycle, later developed by Mises and Hayek. If the new money enters in the form of loans to businessmen, it lowers interest rates and thus stimulates investment in "higher order goods" (capital goods most removed from final consumption), simultaneously curtailing investment in "lower order goods". In other words credit expansion fools entrepreneurs into acting as if there had been a general, voluntary increase in saving. When it is revealed that this hasn't occurred, the painful but curative process of depression sets in. Inflation is a tonic, but it can have an almighty hangover.

The Currency School triumphed in Peel's Bank Act of 1844, which assured long-term price stability but at the cost of numerous short-lived commercial panics. These occurred because of the failure to appreciate the importance of money-substitutes and the consequent notion that a rigid rule was the best way to keep a check on inflation. The alternative of a free market in money and banking, ending the privileged position of the Bank of England, was never considered.

Marx the monetarist

Both Currency and Banking Schools were Monetarist: they both accepted that excessive issue of inconvertible paper money would drive up prices. Karl Marx was a devout adherent of the Banking School - a soft Monetarist perhaps, but a Monetarist nonetheless. Many of our present-day Marxists have dug up texts from Marx asserting that the quantity of money is irrelevant to its value. However, these texts refer to gold, or to paper money convertible on demand into gold. Marx explicitly pointed out that the exchange-value of inconvertible paper money would be regulated entirely by its quantity. Marx held that the price of gold, like all commodity prices, was governed by the labour-time required to produce it. This theory obviously could not be applied to inconvertible paper money. The division of monetary theory in this way is unsatisfactory, and helps to expose the fallacy of the labour theory of value. But it was what Marx held.

All major Marxist writers, insofar as they have paid any attention to the determination of the purchasing power of money, have been Monetarists. The same goes for all Marxist-Leninist regimes, including Russia and China. China's Monetarism is not an innovation of the recent liberalization: they were just as Monetarist under the Gang of Four. Prior to the Communist Party takeover, there was runaway inflation in China, which has left an indelible mark. (See the Peking pamphlet *Why China Has No Inflation*), Where Communist Party regimes abandoned Monetarism for Keynesian policies, as in Yugoslavia, they have suffered from Western- style rising prices.

Leon Trotsky was not only a Monetarist, but a "hard" Monetarist and gold bug, who thought that commercial calculation would be devastated unless gold was employed as money. He called for the Soviet Union to go onto a gold standard, and predicted dire consequences if it did not. (Although a gold standard does guarantee that the money supply cannot be increased beyond a point, it is purely the regulation of the quantity which matters, and gold is not essential for that).

Throughout history, politicians have wanted to inflate the currency, in order to be able to spend more without having to raise taxes. They have been joined by superficial pamphleteers who have seen that inflation gives an immediate boost to trade, but have lacked sufficient powers of concentration to think through the further consequences. Serious economists since Cantillon have always seen it as their duty to oppose the easy road of inflation which leads to disaster. For about thirty years this resolve lapsed, because of the Keynesian aberration, which is now concluded. Keynes' General Theory is a muddle, and its interpretation is controversial. One element in its analysis is that if there is large-scale unemployment, and if money wages cannot fall so as to employ the unemployed, an injection of new money will set the unemployed to work. The resulting price rises (and fall in real wages) will be lessened by the increase in output and therefore in demand for money. This is correct, though how it could have any applicability to post-war Britain, in which unemployment was lower than Keynes ever thought possible, is a mystery. In any case, the same outcome, minus the undesirable side-effects, could be reached by finding out what prevents money wages from falling and removing it. Probably Keynes himself remained a Monetarist, but his influence was partly responsible for the growth of macroeconomics, founded on fictititious mathematical relationships between statistical aggregates. The professional manipulators of macroeconomic models had no interest in economic theory. Hayek distinguishes two senses of Monetarism: (1) the view that "a general rise of prices such as we in the Western world have experienced in recent years is wholly due to, and made possible by, an excessive increase of the quantity of money, and that, therefore, governmental monetary policy is wholly responsisble for it", and (2) what he calls "a somewhat mechanical form of the quantity theory of the value of money", associated with Cassel and Fisher, and now revived by Milton Friedman. Hayek holds (1) to be "Incontrovertible", but rejects (2). (1) is broader and includes (2). Throughout this article, I use the word "Monetarism" in sense (1).

Monetarism is again becoming what it ought to be: a truism. There are two main grounds for holding Monetarism to be as certain as any human knowledge can be. First, reflection on what must happen if the stock of any good available for sale is increased if other things are held equal, the price of that good must fall. To "sell" something for money is equally to "buy" money with that something. Just as the price of strawberries will be lower if there is a good strawberry harvest, so the price of money will be lower if the amount of money "for sale" is expanded. A lower price of money means higher prices for (virtually) all other goods.

Second, there is a historical experience. No major expansion of the money supply in excess of production has ever occured without a subsequent rise in prices; And no persistent, general rise in prices has occured without a prior increase in the quantity of money in relation to other goods. This proves nothing, but it is a powerful hint.