INTRODUCTION: A HISTORICAL PERSPECTIVE ON THE IMPORTANCE OF STABLE MONEY

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Whether a writer or a speaker undertakes to unfold principles, to set them in a novel and more striking light, or to recommend their application, he should know what has been already undertaken, what has been accomplished, and what remains for discovery and elucidation.

—J. R. McCulloch, *The Literature of Political Economy*

The Fed's erratic behavior and the lack of any constitutional constraint on its monopoly power over high-powered money (circulating currency plus bank reserves) has led to great uncertainty about the future course of monetary policy. Such uncertainty makes it more difficult to plan future production and investment, which in turn stifles productive activity.

The growing discontent with the Fed's performance and the desire for real monetary reform provided the basis for the Cato Institute's conference on "The Search for Stable Money," which was held in Washington, D.C. on January 21–22, 1983. Leading experts on monetary theory and policy gathered to examine the Fed's behavior, the adverse effects of erratic money, and the importance of monetary reform for achieving the monetary stability that is necessary for the smooth operation of markets and prices.

Reform proposals ranged from subjecting the Fed to a strict monetary rule to abolishing the Fed and instituting either a 100 percent gold standard or free banking with competing private currencies. In general, participants agreed on the need for a constitutionalist approach

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to monetary reform versus the Fed's present discretionary policy. Thus, the papers contained in this volume provide a useful update of *In Search Of A Monetary Constitution*, edited by Leland B. Yeager (1962). We hope the present collection of papers will encourage further research into the causes and consequences of erratic money, and help focus attention on the types of monetary institutions that are consistent with a free society. This introduction provides a brief historical perspective for the importance of stable money and the proposals for monetary reform that are considered in this volume.

The importance of stable money (and, hence, a stable value of the monetary unit) was widely recognized in the 18th and 19th centuries. David Hume, in particular, emphasized as early as 1752 that variations in the quantity of (metallic) money do not immediately or uniformly affect prices. Typically, input prices lag product prices, causing fluctuations in the rate of profit. These changes in the *structure* of prices, of course, affect real economic behavior during the transition to the new equilibrium price level. As Hume said:

> [A]lterations in the quantity of money, either on the one side or the other, are not immediately attended with proportionate alterations in the price[s] of commodities. There is always an interval before matters [can] be adjusted to their new situation; and this interval is as pernicious to industry, when gold and silver are diminishing, as it is advantageous, when these metals are [i]ncreasing. The workman has not the same employment from the manufacturer and merchant; though he pays the same price for everything in the market. The farmer cannot dispose of his corn and cattle; though he must pay the same rent to his landlord. The poverty, and beggary, and sloth, which must ensue, are easily foreseen. ("Of Money," *Political Discourses*, in Rotwein 1972, p. 40)

Hume's disequilibrium analysis was carried on in 19th century America by a number of writers, including Erick Bollmann, Condy Raguet, Eleazar Lord, William M. Gouge, Charles Francis Adams, George Tucker, and Amasa Walker. Bollmann presented an especially lucid statement of the importance of stable money by explaining the effect of monetary disturbances on economic calculation, incentives, and economic organization:

> It is of the utmost importance that extraordinary and general changes of prices, such as arise, not from occasional and natural variations in demand and supply, with regard to one or another commodity, but from a sudden and considerable diminution or increase of circulating medium, *should be as much as possible avoided*. . . . This should be attended to; not only from principles of justice, but also from motives of convenience and policy; *because such revolutions in nominal value baffle all rational calculations,*

> *impair security, destroy industry, and thus undermine the very foundation of national power and wealth.* (1811, p. 255; emphasis added)

The tradition of what Clark Warburton (1950, p. 163) labeled the "theory of monetary disequilibrium" was so widely accepted by the early part of the 20th century that it was part and parcel of elementary economics textbooks.[1] These included texts by Francis A. Walker (*Money in Relation to Trade and Industry*, 1883), Frank A. Fetter (*The Principles of Economics*, 1904), Joseph French Johnson (*Money and Currency in Relation to Industry, Prices, and the Rate of Interest*, 1905), Irving Fisher (*Elementary Principles of Economics*, 1912), Herbert J. Davenport (*Economics of Enterprise*, 1913), Wesley Clair Mitchell (*Business Cycles*, 1913), and Harry Gunnison Brown (*Economic Science and the Common Welfare*, 1923). All of these works accepted the importance of stable money, and discussed the cumulative effects monetary disequilibrium can have on economic activity because of various rigidities and information costs.

F. A. Walker, for example, stated that:

> [A] progressive increase of the volume of money . . . raises prices, but not equally and at once in all directions. . . . It proceeds not only from one class of commodities to another, as Hume observed, but also, as Professor Cairnes has shown in his *Essays on the Gold Question*, from country to country, with appreciable intervals, which permit of important economical efforts being produced meanwhile. Those effects are various, but that which we are here particularly concerned is the influence upon profits. (1883, pp. 87–88)

One of the most complete and clearest analyses of monetary disequilibrium—and of the interconnection between monetary and value theory—was presented by Joseph French Johnson, a Professor of Political Economy at New York University. Johnson emphasized the

[1]According to Warburton: "The historical fact is that the classical theory of equilibrium was accompanied in its development by a concomitant theory of disequilibrium, applying to the circumstances under which the monetary condition for the maintenance of equilibrium is not met in the real world. . . . It was so widely understood that it is proper to say that it was not only a logical corollary of the classical theory of equilibrium but also as integral a part of the body of economic thought developed in the nineteenth century and first quarter of the twentieth" (1966, p. 27).

Warburton notes that monetary disequilibrium theory has two parts: "One part is a simple application to money of the pervading economic principle of supply and demand. . . . The second and much the larger part . . . is a description of the *process* by which the value of money becomes adjusted to changes in its quantity (relative to productive capacity), and of the disturbances to business and employment and the injustices in the distribution of the national income and product which result from the character of this process" (1950, p. 164; emphasis added).

long lags that can occur during the transition period, and the misdirection of resources that can be expected:

> [C]onsiderable time must elapse before a new level of prices, putting commodities into the same exchange relations which they held under the old, is established. During this transitional period there exists what may be called a maladjustment of prices to values, the exchange relations of commodities being disturbed by conditions not primarily affecting their demand or supply. . . . [S]ometimes the maladjustment is so great as to exert a powerful influence upon all industry, diverting capital into channels into which it would not otherwise flow, and bringing unexpected, if not undeserved, gains or losses to many *entrepreneurs*. (1905, pp. 130–31)

Although Johnson did not deny the adverse effects of unstable money on the creditor-debtor relationship, he did not think that such price-level effects were all-important. To his mind: "The worst effects of a change in the value of the standard are in the field of production. A depreciating standard tends to an overstimulated production and may lead to an unwise use of labor and capital. An appreciating standard, on the other hand, tends to discourage the production of wealth and so to bring hardship upon all" (1905, p. 171).

It is important to emphasize that Johnson recognized "that utility is at the foundation of value," but that "the only concept with which men are familiar, the one about which all of their thinking centers, is the concept of price. Men do not exchange goods for goods but for money" (1905, p. 162). Moreover, Johnson noted that:

> The level of prices . . . is itself of no importance; it does not matter whether prices are high or low, if there is perfect adjustment between prices and the supply of money. Whether the value of the dollar shall be much or little, whether prices, in other words, shall be high or low, is of no more consequence than the question whether the mile shall contain ten thousand or five thousand yards. But *changes* in the value of a dollar, that is, changes in the level of prices [occasioned by erratic money], are of the utmost importance, for they are always attended by an irregular readjustment of prices. (1905, pp. 162–63)[2]

At this point mention should be made of Ludwig von Mises' original contribution to the integration of monetary and value theory in *The Theory of Money and Credit* (first published in 1912, and translated into English in 1934). Mises emphasized the non-neutrality of

[2]Johnson observed that: "The disturbing effects of a change in the value of the standard are due to four circumstances,—(1) the use of credit, (2) the fact that production involves a period of time, (3) the fact that prices do not change uniformly, and (4) the psychology of confidence and depression" (1905, p. 163).

money, i.e., the distorting effects of changes in the quantity of money on the structure of prices and production. He was especially interested in the maladjustment between voluntary saving and investment—or between consumers' goods and producers' goods—that occurs when monetary disturbances cause the rate of interest to diverge from its natural or equilibrium level. His pioneering work in the theory of monetary disequilibrium followed in the tradition of Richard Cantillon, Henry Thornton, Carl Menger, and Knut Wicksell.

The essential element of monetary disequilibrium theory—"that major business fluctuations (inflations and depressions) have their originating cause in disturbances in the monetary system" (Warburton 1981, p. 285)—largely disappeared from the economics literature during the advance of Keynesian macroeconomic theory in the 1930s.[3] Except for the work of Warburton (1966), Hayek (1933, 1935, 1939),[4] Marget (1938, 1942), and a handful of other economists who were familiar with the older traditions, money lost most of its importance and simply became another good.

[3]Warburton offered the following explanation for the disappearance of monetary disequilibrium theory: "It appears to have been undue attention to Ricardo's cryptic remark that changes in the quantity of money affect only prices, and neglect of Marshall's comment on Ricardo's carelessness with respect to time, that have led present day economists to forget that their predecessors of the nineteenth century had a theory of disequilibrium as well as a theory of equilibrium" (1950, pp. 163–64).

[4]Hayek was one of the most persistent critics of Keynesian economics. Throughout the 1930s he constantly attacked the lack of attention paid by Keynesians (and others) to the effect that changes in money have on relative prices and production. He elaborated on the work of Wicksell and von Mises, and was highly critical of the emphasis placed by many monetary theorists on the long-run proportionality between money and prices. One of his main points in *Prices and Production* was that "almost any change in the amount of money, whether it does influence the price level or not, must *always* influence relative prices. And, . . . must necessarily also influence production" (1935, p. 28). Hayek hoped to see a new stage of development in monetary theory, namely, "a theory of the influence of money on the different ratios of exchange between goods of all kinds" (1935, p. 29).

It is important to note that Hayek was less concerned in the 1930s with a money that was stable in value than with a Wicksellian neutral money, i.e., a money that does not affect relative prices and misdirect production. (Cf. Hayek 1979, p. 17, where he states that "*The primary aim* [of monetary policy] *must again become the stability of the value of money.*") Although Hayek realized that a fully neutral money is not realizable in practice, he thought such a concept could provide a useful policy guide. Neutral money would require: a constant "total money stream," perfect price flexibility, and "correct anticipation of future price movements" (1935, p. 131).

The policy recommendation that emerged from Hayek's analysis was that "the supply of money should be invariable" (1935, p. 108; for exceptions to this rule, see pp. 109–128). In this regard, it is interesting to note that currently several prominent monetarists favor freezing the monetary base, while Hayek is advocating the denationalization of money.

Writing in the mid-1940s, Warburton noted:

> To me the Keynesian ways of thinking—particularly the American versions and adaptations—seem quixotic. . . . [T]hat analysis seems to me to by-pass the central economic problem of recent years. The theoretical developments since the publication of Lord Keynes's *General Theory*, in my view, have shifted attention away from the policies which produced the great depression and other cases of large departure from full employment [namely, monetary disturbances], and have laboriously diverted the energies of economists into fruitless directions. (1966, p. 257)

In 1950, Warburton predicted the demise of the Keynesian paradigm:

> As to the discard of earlier theoretical frameworks we can, I think, forecast the elimination from economic thinking, with respect to the origin of lapses from full employment and the conditions of recovery, of the current emphasis on governmental deficits and surpluses, the numerous structures described as "models," and a large part of Keynesian economics. These types of theory will be discarded because it will be found on close observation that the presence or absence of the factors emphasized by them is not closely integrated with the presence or absence of business depression or price inflation, or with the beginnings of upswings and downswings. (1966, pp. 34–35)

The "Keynesian diversion" (to borrow Yeager's term, 1973) was not effectively countered until the appearance of Milton Friedman's and Anna Schwartz's *A Monetary History of the United States* (1963). That work more than any other turned the tide against the notion that "money does not matter." The resurgence of interest in monetary theory and the integration of monetary and value theory since the Friedman-Schwartz work is testimony to its great impact on the economics profession. That impact, of course, has also left its mark on monetary policy. Yet, we are still far short of attaining stable money. On the other hand, there is growing consensus that "Money is too important to be left to the central bankers."[5]

Although few doubt today that "money matters," there is still disagreement on the exact transmission process whereby monetary disturbances affect real economic variables during readjustment to the new quantity of money. But whether we choose to focus on the effects of monetary disturbances on the structure of production, on expectations, or on portfolio adjustment is secondary to the fact that it is becoming more and more evident that the Fed's erratic monetary

[5]Friedman (1968, p. 173), paraphrasing Poincaré.

policy disrupts rational economic calculation, hampers efficient trade, and retards economic growth.

It is also being recognized more widely that the transition process can be lengthy. As Milton Friedman stated in his Nobel address:

> [U]nanticipated changes in aggregate nominal demand and in inflation will cause systematic errors of perception on the part of employers and employees alike that will initially lead unemployment to deviate in the opposite direction from its natural rate. *In this respect, money is not neutral.* . . . [S]uch deviations are transitory, *though it may take a long chronological time* before they are reversed and finally eliminated as anticipations adjust. (1977, pp. 469–70; emphasis added)

Friedman goes on to warn of the dangers of erratic money: "The growing volatility of inflation and the growing departure of relative prices from the values that market forces alone would set combine to render the economic system less efficient, to introduce frictions in all markets, and, very likely, to raise the recorded rate of unemployment" (1977, p. 470).[6] His conclusion:

> [T]he present system cannot last. It will either degenerate into hyperinflation and radical change, or institutions will adjust to a situation of chronic inflation, or governments will adopt policies that will produce a low rate of inflation and less government intervention into the fixing of prices. (1977, p. 470)

This conclusion paves the way for the in-depth analyses of alternative monetary arrangements that follow.

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[6]Cf. Hayek, "Unemployment: Inevitable Consequence of Inflation," in (1979, pp. 39–45).

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EDITOR'S NOTE

This issue is being dedicated to Professor Fritz Machlup whose sudden death one week after his conference address saddened all who knew him, either as a personal friend or through his outstanding and voluminous work. We were honored to have Professor Machlup at the conference, and we can readily agree with his former student and colleague Jacob S. Dreyer—editor of *Breadth and Depth in Economics* (Lexington Books, 1978)—that Machlup was characterized by: "rock-solid personal integrity, unconditional intellectual honesty, and genuinely superhuman capacity for work" (p. vii). Above all, he was a great teacher who, as Dreyer says, took it as "an article of faith" that "my first duty is to my students" (p. viii). Machlup combined his zest for teaching with his love of knowledge to become an extraordinarily productive scholar. Professor Machlup's vivaciousness, his humane character, his scholarship, and his love of freedom will not be forgotten.

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Fritz Machlup
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