Ch. 6 - Bagehot’s Open Money Supply Theory Approach: Conclusions

Bagehot’s work „Lombard Street“ (1873) is about the function of money, not about the “lender-of-last-resort” function. Thus reinterpreted, it can give a fundamental contribution to the renewal of monetary theory and of the macroeconomic knowledge behind that theory.

The key to Bagehot’s arguing lies in the concept of “open money supply”. An accurate exploration around this concept became for us an invitation to start conceiving an alternative approach to monetary theory, which we believe has the potential to rediscuss the state of the art with regard to the quantity theory of money.

Our work begins with the discussion of a case- -study (Ch. 1), an interpretation of the policy strategy of the Federal Reserve System in 1924-1931, the years around the „big crash“ of 1929. This study, which began as an autonomous research, led us to discover the presence of a hurdle inside the central bank’s statute of the time, which severely limited the Fed’s discretionary power upon money supply. This rule, abolished by law only at the beginning of 1932, actually impeded the Fed to support the commercial banking system with liquidity, when this support was urgently needed. We understand the Fed Statute of the time as an important cause explaining the destruction of the financial system occurred during the crash of 1929 and in the years afterwards.

By analysing this evidence with reference to Bagehot’s work, a crucial question was highlighted, of relevance for both practice and theory, a much differing interpretation of Lombard Street from the usual description of the „lender-of-last-resort” function. What became suddenly clear was that a central bank’s money supply should never be curbed by law (even if mainstream theory of money might suggest such a rule).

Economic history clearly reveals that money-supply curbing, first formally stated through the Peel Act in England (1844), never was traduced into practice by any successful central bank, i.e. it was always lifted during stress periods, thus never becoming effective. This is true, unless we take the unfortunate example of the 20's USA, which provides our paper with a most unfortunate case against the fixed money supply assumption and with almost a paradigmatic example pro open money supply.

The mainstream tradition of monetary theory, descending from the „currency school" or „quantity theory of money", places the fixed money supply as the cornerstone of its building; this explains the difficulty to objectively and seriously consider the alternative hypothesis of an open money supply.

A cleft was offered by the ever existing gap between the theory of money and the practice of central banking.This gap exists even if far from being formally recognised, in fact, the practice has been formally forced into a mainstream theory explanation. Otherwise, the tradition of practice starting exactly with those experimentations by the early Bank of England, which Bagehot describes, has been implicitly assimilated by successful Western central banks and actually seems to guide central bank behaviour. But this behaviour is not openly justified and reflected so that its underlying rationale is not directly available to less experienced central bankers - in transition countries and elsewhere -, even though it is implicitly understood as the "art of central banking". The present difficulty in the work of practice-decoding is still the same as has ever been the challenge to translate "Lombard Street" into the terms of economic theory.

Even if the correct principles can indirectly escape and circumvent theory and be implemented by successful Western central banks, they cannot influence the action of other countries, lacking experience and tradition, and thus constrained to a formal and unsuccessful monetary theory as their only guide. Bridging the gap between the textbook as well as the sophisticated versions of the theory of money on the one hand side and successful central banking on the other, thus becomes necessary, in order to fill a more dangerous gap, the one between Western successful and the remaining unsuccessful central banks, a gap actually menacing not only distant countries but the general international stability of markets.

Open money supply is the strong suggestion offered by Bagehot, it is the core argument and the main resource presented in our paper.

1.
The work by Bagehot and a careful decoding of its "practical" nature in terms of theory reveal the arguments towards an alternative approach to monetary theory.

A fundamental step towards this path is to recognise the existence of a solution of continuity between:

- pre-monetary systems based on goods and coins, which we can call "currency"-systems, and
- "monetary" systems, basing on fiat money issued by a central bank as the pivot market actor.

The currently accepted monetary theory, with its doctrines derived from the currency school, and with a certain influence of banking-school scholars, portrays an economic reality which we unmistakably consider as pre-monetary. Its approach well fits into a world, which doesn't represent our present one and thus can hardly represent our future.

Bagehot wrote in 1873[164]: "[...] probably up to 1830 in England, or thereabouts, the main profit of banks was derived from the circulation, and for many years after that the deposits were treated as very minor matters, and the whole of so-called banking discussion turned on questions of circulation. We are still living in the *débris* of that controversy, for, as I have so often said, people can hardly think of the structure of Lombard Street, except with reference to the paper currency and to the Act of 1844, which regulates it now." The discussion does not look that different today.

What directly inspires a monetary theory for our time, is Bagehot's concern with an advanced monetary system featuring fiat money, identifying trust as the macroeconomic condition for money and the existence of a monetary system, and consequently offering adequate advice to policy with money market management principles.

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[164] LS, p.85

2.
Along the path of open money supply, we discover that the unique liquidity degree money presents is the outcome of an equally unique money market procedure, the provision of an uncapped money supply of legal tender.

This procedure has thus identified the condition of existence of the money market, because it defines the market features securing stability. Since instability disrupts the system to the extent of ruining it, stability and existence have been treated as one concept, and shown to be the (right and only) goal of monetary policy.

Under these premises, we revise and replace the traditional money function definition – in Ch. 3. The key elements Bagehot provides lie in the "extra" or "extraordinary" need for cash, generated because of the immanent endogenous instability of money demand in a monetary system.

The extraordinary need for money testifies the ultimate and not predictable need for a "means of payment", and this is the unique function money fulfills inside the system. Many short-term assets are used in quiet times for functions related to payments, witnessing the wide economisation of money characterising modern monetary economies. However, the true nature and peculiar rarity of central bank money becomes nonetheless evident in a state of distress, when people ask for the most and only secure form of liquidity. Extraordinary money demand shows the immanence of instability in finance, therefore it signals the way to the most relevant money function and toward market management in a properly defined monetary economy.

The unique need for money in a monetary economy explains the role of central bank money as the sole means of payment in the system, whose eventual unreliability (through incorrect money market management) by destroying monetary (credit, trust) connections lets the whole system's building fall down.

3.
Lombard Street is considered as the work of a man of practice in the academic world, and it actually strongly links to history and to its author's professional experience. Nonetheless, when expressed

in terms of theory – Ch. 4. -, this work reveals the first solution to the Say's Law critique, which can be considered fully monetary.

The Say's Law critique holds a special status in economic theory, since it was the starting issue raised by Keynes in his "General Theory", and a basis for the "revolution", or innovation in economic thinking many contemporary economists have been looking for since then. According to Bagehot's logic, it is only by stabilising money through an adequate open money supply policy that the investment and savings variables can meet dynamically and exponentially, whereas they would be reduced and disconnected through fixed money supply implementation.

Our discussion around a Bagehotian critique of Say's Law suggests that open money supply represents the dynamic solution to investment and savings convergence in modern monetary capitalism. Chapter 4. adds a structural, macroeconomic answer adequate to the revised definition of the money function, and explains money as the leverage of growth and development.

4.

Bagehot is fundamental to understand that credit (trust), the main feature of money systems, is a power which may grow, but cannot be constructed. Those who live under a great and firm system of credit must consider that if they break up that one they will never see another, for it will take years upon years to make a successor to it.

Any law somehow fixing the quantity of money supply, easily destroys trust and credit; monetary economies collapse when thus restricted. The extreme consequence of the destruction of credit lets money disappear and reduces the economy "within twenty-four hours to a state of barter"[165]. This is precisely the result we show in the model, which we derive from our interpretation of Bagehot's, in Ch. 5.

Our model presents a simplified scheme exemplifying the singular, demand-pushed scarcity of money, and thus the priority to be given to stability. The stability of the general price level, which is the declared goal for the orthodoxy, becomes only secondary when

[165] LS, p. 200.

confronted with the need to defend the very existence and availability of money. Bagehot recognises money as the actual basic reference for economic production in a monetary system.

Open money supply explains the significance of the money function and the role of monetary policy in achieving the goal of stability. Open money supply does not only trace the path to economic growth and accumulation in monetary systems, but it is also their only possible macroeconomic mechanism to ensure the consistent utilisation and allocation of resources.

Our work is of minor relevance for the practice of central banking than for theory, since the practice of (successful) central banks already implements Bagehot's money market management, while monetary theory needs to overhaul its fixed money supply approach. We end up evaluating the fundamental importance of trust, which increases with the growth and sophistication of the monetary system.

5.

There has been an underlying belief in the thought of my teacher Prof. Hajo Riese, as I learned to know it. Opposite to the well-known principle of neo-classics: "we need a micro-economic theory founding macro-economics", Riese has been looking for a macro-economic theory founding the micro-principles instead.

Viewing at the monetary issue more generally, Bagehot's work is precisely about giving new foundations to macro-economics.

What we learn, is that money is pure trust. It is the main connection element between the immaterial and the material, the individual and the collective elements ruling economics. Trust is the immaterial bonding material, i.e. abstract market entities with concrete behaviours and mechanisms. Money management is the management of trust, every element of money management is about implementing and strengthening trust principles. Moreover, beyond[166] the criteria of individual profit maximisation, a central bank has to act for the advantage of the whole.

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[166] Even against, if necessary.

Bagehot’s merit is to understand the need for trust as the connection energy of markets, and to implicitly open the horizon beyond conceiving individual profit-maximisation as the goal and measure of economic activity.

The unknown side of his macroeconomics lies perhaps in this unexplored horizon beyond individual utility and in explicitly putting the central bank - as a market partner! - in a key position responsible for the utility of the whole, in a new linkage of self-interest with the interests of the system’s survival. It is not altogether clear how this reconstructed theory works in detail, and which behaviour of the different actors it requires in terms of micro-economics. So we keep interested in a further development of this issue, starting from Bagehot’s contribution, towards a deeper knowledge of macro-economic foundations and individual economic behaviour.