

## Ch. 4 - The Money Theory of Open Supply

Our aim is to understand whether the open money supply hypothesis can be developed into a comprehensive organic theory approach. To reach this goal, we connect the collected elements into a coherent net of meanings.

The new definition of monetary economy, which we advanced in the previous chapters, will play the priority role as a reference.

### 1. From pre-monetary to monetary theory: monetary economy redefined (2.)

1.

The function of money in a monetary economy is not to be found in the exchange of goods. The use of less liquid assets, such as deposits and other assets created by commercial banking in their activity as savings collectors, is more than enough in order to do the exchange.

The money quality is liquidity. Liquidity creates acceptance, the liquidity quality is always relative, in the case of money it is expressed at the maximum degree. This extra-degree of liquidity is first due to the State guaranty - a country's money generally coincides with the country's legal tender - and second to the market liquidity condition, established by the emission rules.

The need money serves, the function of money, works as the basis to all the other less liquid assets, money is the macro-element of connection in the system. This means that money contains both the acceptance and credibility, and the fidelity (stability and accessibility) elements, which make it become the strongest symbol in the system, the only one requested during the emergency. The same emergency is a symbol, it is the opposite of trust, and it is on this occasion that the priority, the function and the features represented by money are unmistakably signalled, thus explaining the reason why Bagehot's work has been focussing on it. Panic immediately indicates which asset serves as money, - and that it is disappearing.

2.

The money function as a medium of exchange for the goods-market relates to the barter system. The money-good, the 'numéraire', characterises a barter economy, where the direct barter of a good with another good is replaced by a more abstract double relation facilitating the exchange: first the exchange of a good with a third having the "same value", then the exchange of this "same value" with a second good<sup>114</sup>.

A monetary economy must be defined instead through the features of credit. Bagehot's monetary economy is a growing pyramid of credit founded on an infinitesimal money (reserve) basis as a sign for efficiency in the use of resources, and of the presence of strong stability principles.

3.

Based on the new understanding of the features showed by a monetary economy, fiat-money, the money created by the central bank as a form of credit to commercial banks, appears in all its efficiency. A central bank is a bank, even if a special one, and money is a paper money, it is credit itself. Paper money can thus "stretch" (open money supply) in order to serve the needs of credit, and its elasticity is adjusted by its price (interest rate).

In the relationship between banks and the public, following the needs of business and safety, other assets of minor liquidity are created, which are not money-forms. Away from the neo-classic "M0...Mn"-concept, tending to subsume every possible object into the chain of liquidity towards the money-form. These assets can be efficiently used for the exchange, and the other ex-money-functions: reserve, speculation, etc.

Bagehot teaches that money true identity and function reveal during the emergency, i.e. when money is (extraordinarily-)demanded. During the emergency money cannot be substituted with any other asset, no credit card, no cheque. Even the national currency can be accepted only if it is really money: if it is not, the economy will request an international key-currency instead, even by recurring to black markets creation.

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<sup>114</sup> C.Gnesutta, *Moneta*, in "Economia e Storia", vol.1, p. 451.

4.

A monetary economy cannot thus be anymore defined through Clower's formulation<sup>115</sup> "money buys goods, goods buy money, but goods don't buy goods on any organised market". Instead, by translating Bagehot, we define as monetary an economy where money can be replaced on every organised market by assets created on the credit market, since the convertibility (more or less on demand) of these assets into legal tender is guaranteed by money market management.

5.

The object of our analysis is the means of payment. Bagehot defines money/the means of payment as that credit asset - definitely characterised as fiat-money, the credit paper emitted by the central bank for the sake of support for commercial banks - which is requested and accepted during the emergency of panic.

This argument helps distinguishing between the precautionary/reserve function and the means of payment function, whereas the first is a static, stock-function, and the second is a dynamic, flow-function. When referred to the central bank subject, this distinction entirely abolishes the thesis - incorrectly defended by the same Bagehot - about the exigency for a continuous adjustment of central bank reserves to face credit market liquidity needs. It fully focusses instead on the adequacy of the principles governing the emission of money, i.e. on the significance of open money supply.

## **2. Towards open money supply theory**

1.

The elements we could collect by analysing Bagehot are precious pieces we put together to understand the general contribution this author brings to monetary theory, a fundamental contribution to the establishment of a new theory.

His concept of credit stabilisation as the unique goal for monetary policy radically differs from the ultimate goal shared by the whole orthodoxy comprising Keynes, i.e. the goal of stability in the price of goods, and it already reveals the deep separation in approach.

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<sup>115</sup> In "La teoria monetaria", 1969, Angeli, Milano.

The orthodox position derives from a strong and unavoidable – either as a positive or as a negative model<sup>116</sup> – reference to General Equilibrium as the frame, within which mainstream economic thought has been developed.

The difference in policy goals reveals the underlying difference in the potential structure of theory.

Bagehot leaves directly no theory; but a great work in economic policy, building on precise indications of a practical nature, which we interpret as follows:

1. Money is credit;
2. it is emitted on the money market;
  - the money market has to be discretionarily governed (no automatism), through money market management;
  - money market management's goal is the stability of credit, i.e. of the basic economic relationships;
  - this credit stability goal can only be met throughout open money supply and interest rate adjustments, in line with the dynamic of money demand expressed by the system.

Bagehot<sup>117</sup> preferred calling his essay “Lombard Street” instead of “Money Market” to signal his wish to deal with concrete realities. He found the courage to call the Peel Act “only a subordinate matter in the Money Market”, while the economists' majority cannot even today leave it to fight or to endorse it. The strength of his approach allows Bagehot to avoid the economic theory debate of his time, basically the same debate we still meet today, in order to directly face the new reality and its extreme delicacy, in order to discuss new, baldly needed requirements for its management.

Therefore, even if his approach to capitalism is as controversial as in the best “heretic” tradition of Malthus and Keynes, General Equilibrium is not a reference for him, neither as a model nor as a counter-model – as it is in Keynes' work. Bagehot avoids every belief in laissez-faire, or in automatism governing the market, his capitalism explicitly requires the human hand's guide. And most important, he conceives money and credit as fertile forces for growth and development.

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<sup>116</sup> Riese, H., 1987.

<sup>117</sup> LS, Introductory.

What Keynes had to fight from the inside, i.e. the General Equilibrium reference, has been ignored by Bagehot as non-pertinent to money and money market matters. We can thus find in Bagehot a coherent and systematic approach to the money market needs and functions, beyond the concerns of theoretical relevance, succeeding in representing money directly.

Although Bagehot's open money supply concept already can awake a new attention towards the nature of money, this input is far from being thoroughly examined and systemised in the light of economic-theory methodology. On this path, interesting results can be obtained via the confrontation and conjunction to the counter-laissez-faire line, and to the work of Keynes in particular.

By connecting Bagehot with Keynes, we face the Say's Law critique, a milestone in the criticism of mainstream economics. Along this path, Bagehot enables us to centre farther (than Keynes) the role of money and monetary policy in a monetary economy.

2.

Keynes' "General Theory" starts with the recognition of the hiatus between Investment and Savings, and of the dangers coming from it to development and growth. Keynes' critique of Say's Law also deeply revised the role of the interest rate (the price of money), criticising the constant connection between the two variables, which the whole orthodox theory still believes in.

The role played by money, the attachment to it shown by the savers' classes represented for Keynes a most tangible obstacle between Investment and Savings equivalence. For the first time in the history of economic thought money was not a "veil" anymore, as it always was in the classical tradition. Money suddenly acquired the enormous weight of being the element impeding the equilibrium between Investment and Savings. As a result, the economic system could no longer automatically be called a full-employment one.

By assigning to money the role of being the "maximum hurdle" in the system, Keynes otherwise forced his solution again into a non-monetary path. Indeed, Keynes ends arguing in favour of State interventions (public expenses, debt) equilibrating and sustaining the

market, in the effort of building national income and of avoiding the tendency towards the unemployment of resources.

3.

Bagehot's interpretation of the role of money meets the function of money with a significance in our opinion superior to Keynes' work, since the detention of money acquires a positive meaning, already implicit in the function of means of payment. Instead of being the hurdle to full-employment, money represents for Bagehot the value all the economy turns around, able – if well managed - to protect and secure business for the sake of its widest development.

Money is not a veil, and not always the obstacle in the wheels of the Say's Law mechanism. Even if also for Bagehot there is no automatism able to connect Investment to Savings in a monetary economy, but the power of the adequate money market management he describes, i.e. the stability of credit, enhances the economy to growing levels of wealth. In spite of its fragility, money reveals through the right management a positive force, which gives form to the complex system of relationships a monetary economy consists of.

By specifically connecting some of Bagehot's suggestions for this aim, we can evidence the parallelisms and differences with the Keynesian path. Say's Law does not apply, investors and savers do not automatically meet. It is a good-working money market, which stabilises credit, which in turn brings Investment and Savings together. The monetary economy displays thus all its potential.

4.

Investment and Savings meet as credit market variables, i.e. inside the credit market. A well-managed commercial banking system, a well managed money system, as the experience of the English market already showed at Bagehot's time, leads Investment and Savings to converge inside the credit market, the best representation of the economy's flourishing and resources' optimisation.

5.

In Bagehot's formulation<sup>118</sup> of the adequate money market management the interest rate doesn't rule the fundamental mechanism connecting Investment and Savings, as also in Keynes critique to orthodoxy. Bagehot's specific contribution is that open money supply does.

Bagehot clearly explains that the adjustment of the (central bank) interest rate plays an important but also secondary role, not the determining role in the market policy for stabilisation.

6.

In a monetary economy resources are not fixed, as the orthodoxy defines them by axiom. Since they are expressed in terms of money<sup>119</sup>, they are variable and potentially increasing (decreasing).

Inside a monetary economy, wealth is produced via the credit market.

7.

The right management of the credit system does not depend on the credit system itself, but on the money market, i.e. on the institution ruling the money market and the emission of money. In our historical experience this institution can be efficiently expressed by the central bank<sup>120</sup>.

The money market rules the credit market since it a) emits money b) at credit (fiat-money) c) for the sake of commercial banks' stability<sup>121</sup>.

The system's stability passes through money (its management).

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<sup>118</sup> "Lombard Street", Ch.VII.

<sup>119</sup> Ref. Berliner Schule or "Berlin School of Monetary Keynesianism", H. Riese and others.

<sup>120</sup> See par. 1.3 in Ch.3, this paper. Also ref. Bagehot (ed.1969), A Practical Plan for Assimilating the English and American Money as a Step towards a Universal Money, Greenwood Press Publ., New York.

<sup>121</sup> Bagehot never argues along the line of and Investors' and a Savers' class, as Keynes does. His macro-relationships are focussed on the central bank and commercial banks link.

8.

Money acts through its function of means of payment in credit contracts, it does not only serve the exchange of goods in spot markets. Its function truly and actively arises in the case of emergency, exemplified by "extraordinary demand", since money is the basic value enabling the existence of every other value. Only money can gain general and complete acceptance as a means of payment, and this is functional to the evolution of the monetary economy.

Emergency is not the panic, panic arises only when the emergency is not satisfied. The emergency is actually signalled by the same extraordinary increase in money demand, since extraordinary demand always represents a drop in trust.

9.

Money demand which is not met by an adequate rise in supply lets the system collapse. Its dissatisfaction generates a status analogous to the "liquidity trap" as Keynes defines it, but under completely different conditions. Not the inability to engender investment inside a state of recession is the problem, but the very opposite is at the origins of its outburst: Market demand for liquidity cannot be met because of the cap on supply dictated by the quantity theory (and policy) of money. The unsatisfied demand lets people cling to all the legal tender it can hold or find or obtain. Commercial banks break under the weight of money demand, which dries up deposits and makes the whole credit pyramid irremediably fall, a situation which cannot be easily reversed.

10.

The emergency-rise of money demand lets the credit market break, by separating the system's ability to give credit (its ability to sustain Investments) from its ability to collect deposits (to attract Savings).

Money demand instability, given the money function in a monetary economy, plays a crucial role in the Bagehotian system of thought. Translated into terms of theory, a negative monetary influence breaking every possibility of Investment and Savings meeting has to be counterbalanced with (money market) management.



11.

In a condition of panic with a large money demand increase, the management of interest rates, both on the credit and on the money market, has no effect. Interest rate management alone has no force to oppose the power of a rising money demand.

The only valid solution to money demand instability is open money supply.

12.

No reserve stock in the central bank's vaults can calm money demand instability. Its force, if not equilibrated through money market management, and primarily open money supply, destroys the whole credit pyramid. Thus eventually and potentially forcing to change every value into money, consequently reducing the (value of) wealth of a nation to that amount which in a collapsing market can still be translated into money.

Money values equilibrate only through the stabilisation of money demand. Money demand instability destroys values along the market dynamic of destabilisation. Market stabilisation instead contributes to the generation and increase of (monetary) resources.

Open money supply shows and demonstrates thus the dynamic solution to the convergence of Investment and Savings, along the path of central bank's support to the creation and expansion of the commercial credit system.

Fixed money supply closes the development path of a monetary economy by leading it into restriction and collapse. Eventually returning to barter, since the destruction of credit leads in its extreme consequence to a situation in which money becomes a means of exchange again, as in non-monetary economies.

Open money supply, as the main element of money market management, traces the path to the widest utilisation of resources. It contributes to the generation and sustenance of resources by drawing them into the monetary sphere.

According to this logic, the linkage between Investment and Savings is dynamic and exponential, it recedes though fixed money supply letting the two variables separate, while it advances through open money supply policy approaching the two variables towards an eventual coincidence.

The role of monetary policy reveals with Bagehot its widest significance in the history of economic thought, and a new path for macroeconomic theory development is also shown.