S.N.SEN Memorial Lecture , 2017

Monetary Theory Revisited

Ratan Khasnabis

37th Annual Conference of Bangiya Arthaniti Parishad
(Bengal Economic Association)
PRABHU JAGATBANDHU COLLEGE,ANDUL, HOWRAH
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I. Dr. S. N. Sen : My Teacher

Dr. Satyendra Nath Sen had been my teacher, a direct teacher in the Economics Department of Calcutta university when I was there a post graduate student. A Khaddar-clad gentleman with sharp eyes, he was then possibly in his late-fifties, serving as the Head of the Department with proper command over everything in Kantakal campus where Economics Department was located. By the time I entered Kantakal as a student, I was an intellectual rebel. It is still a puzzle to me, but I must admit, he used to appreciate me. In political belief or, to put it in proper way, in the realm of ideology, we were them in opposite poles. Sometimes, I had the opportunity to travel with him in his car from Kantakal to College Street campus, and during the entire period we used to debate – not on any issue of economic theory but on 'politics'. It was never a bitter exchange of malicious words, rather a game of wits in which he used to indulge me. I realized, in due course that he had a sense of appreciation for that young rebel. I must admit, I had received a lot of support from Dr. Sen. Some of them are so private that I cannot share these with others in a public domain. Without a subtle appreciation for that rebel, all these could never happen. Of course, he never received anything in exchange. I am sure, he never expected this either. As I grew older and found time to look back, I realized I should pay something as my homage to this extra-ordinary academician of a generation which had the conviction that the frontier of knowledge expands as the intellectual rebels are received with some indulgence in the seats of higher studies. When I received the invitation from Bengal Economic Association to deliver a lecture in memory of Dr. S. N. Sen, I realized, here is an opportunity to pay my homage to my Acharyadev Prof. Satyendra Nath Sen. I could not say no. On the contrary, I decided to grab this opportunity and prepare a lecture setting aside other commitments for the time being. My heart–felt thanks to Bengal Economic Association for offering this opportunity to me.

II. My Journey to the World of Monetary theory with Prof. Sen

In Kantakal, Professor Sen used to teach theory of money in our class. The central theme was the relation of money with macro variables in the real sector of the economy. The panorama was confined to so called 'mainstream economics' in which Marx, Ricardo or even Adam Smith had no place. Money, under this dispensation had been 'high powered money'. As medium of exchange paper money was fast replacing bullion or other 'costly' materials having some intrinsic value. Otherwise , worthless bits of paper whose cost of production had in no way been linked with the 'value' that it enjoys in the market had gradually occupying the drivers' seat in the money

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market. Prof. Sen had not seen the zenith of this development when money was, in fact, officially be linked with gold and the 'price' of this otherwise worthless piece of paper was being determined even in the international l market by just its 'demand' and 'supply'; the worthless piece of paper was even being replaced with 'plastic card' and paperless transactions. The central issue with respect to monetary theory that we were taught at that time had implicitly recognized this power of money and quite correctly shifted the pivot of the theory or theories of money towards 'relative price' of money vis-à-vis prices of other macro variables, without trying to link these prices with the supply of a precious metal which could provide a simple explanation of 'price inflation' or 'deflation' – as it has been the *raison detre* of such developments in the early monetary history of Europe. Development of modern Economic institutions of capitalism, particularly the institutions of commercial and investment banks along with fiscal and monetary power of the capitalist states, there had been a sea charge in the operation of 'money' as an instrument in setting the relative prices of commodities including labour or 'labour power' (as a productive factor). It was also a reality that the stability of capitalism as a system of production in largely signaled by the stability of the 'price' of money. Moreover, the history of modern capitalism also point out that the system does not overcome a 'crisis' by anything which is *sui generis* to the institutions of market; it needs an external intervention and monetary instruments play an important role in this regard (increasing government spending – 'fiscal measure' in common parlance – is also operated by applying monetary tools to create extra demand or for 'bailing out' the lending institutions, as it happened during 2008-Crisis in the USA).

The economists of early 20th century were recognizing this role of money as a macro variable and the issue of 'stability' of relative price of money was gradually becoming the central issue pertaining to 'monetary economics'. The relation between the real sector and monetary sector was being explored further. With Walrasian mind set, the theoretical problem of the stability of the price of money (relative price vis-à-vis real sector including labour), the problem was apparently trivial. With free play of market forces, under general equilibrium, there will not exist any 'excess demand' or 'excess supply', full employment of every factor would be attained. Money market would also attain equilibrium and by definition, the 'price' of money would be settled. The stability problem with respect to 'price' of money should not receive any more attention. The policy prescription that followed would be on allowing the *tatonnement* process to play its role for which all the institutional barriers to 'free market must be removed.

Under such dispensation, thematically money is neutral to other (real) sectors. If money supply increases in a free economy where Walrasian general equilibrium has been achieved, only the price 'level' will increase and effect would be inflationary, it will be deflating if the supply decreases. There will be equi-proportional effect on relative prices. Money is neutral to the

function of variables in the real sector of the economy. Needless to say, money is just the medium of exchange. The equilibrium level of quantity of money in the economy would be determined by the total volume of monetary transactions that takes place in a turnover period multiplied by the general price level. This will be mitigated by coins, notes , bank deposits in stock – the so called "higher powered money. The physical amount of thin stock, required for transactions would, of course be lower because the same 'coin', or 'note' is used for more than one transaction – a phenomenon in the exchange economy which is technically described as velocity of circulation. Irving Fisher, in his book 'Purchasing Power of Money' described this phenomenon by **MV=PT.** This in fact is the first as initial description of the Quantity Theory of Money which is still taught in the class room in a course for the beginners on Monetary Economics. Needless to say, essentially this is an identity; the both sides describe the same phenomenon. For Walrasian general equilibrium model in which life is very simple, perfect knowledge on commodity in the market plays its due role, and thus risk or uncertainty in ruled out in every market, money should necessarily play a single role – the role of serving as medium of exchange and Fisher's Quantity theory is sufficient to describe the price of money which has to be stable once the general equilibrium in attained.

Of course, life is more complex. There are barriers to free market and the Walrasian model describes a long run truth in the market economy which is logically unrefutable. But then, the long run truth is based on the understanding that all barriers, including institutional barriers to free market would be removed in the long run. This is easier said than done. There are other economic factors, not reflected in Walrasian structure that creates stumbling blocks to free market in the true sense of the term. Most of them are rooted in the institution of private property that denies free access to resources that determine the level of production (and distribution). The rules of exchange are determined accordingly. The question of 'price' and 'equilibrium' in the exchange economy comes next. The requirement of institutional reforms signaled from market can be met only within the rules of property that the capitalist market economy would allow. The Walrasian logic has to operate within this limit.

Without entering in property issue, i.e., without entering in the discussion on institutional barriers to free market, in other words, without entering in the debate on barriers to free market that need reform for seeking answer to the problem of stability of price of money, attempts have been make and still are being made for solving the problem of attaining a finite (definite) and positive price for money which with be stable under the existing institutional arrangement. This needs to find a rationale for treating money as neutral to real sector of the economy so that money might serve only the requirement of transaction in the exchange market. As the debate started, Fisher's Quantity Theory equation was suitably changed and the 'cash balance' approach

to Quantity Theory of Money evolved via Cambridge (new) quantity theory. One of the exponents of this new theory of A. C. Pigou on who tried to utilize this concept for finding a clue for addressing the issue of stability. This in effect gave rise to the theory of 'real balance effect' which would find the rationale for holding cash balance only for transaction purposes, i.e., to justify the neutrality of money – the dichotomy between the real sector and the monetary sector of the market economy.

The contemporary reality during 1920s was, however, opposite to what the theory of money at that time was suggesting. The proportion of cash balance of high powered money in total monetary transaction, 'k' in Cambridge equation of the quantity theory of money was then being used for 'speculative purposes' as s well, and its share in total cash balance was fast increasing. There was a boom in the stock market and the expectation of getting high return as premium of holding cash was fast increasing. Ultimately, there was a crash in the stock market, bearish behavior with cash balance ruled over bullish behavior, and the real sector almost collapsed in the USA. Stagnation and unemployment in the real sector followed and gradually the era of 'Great Depression" set in. All over the capitalist world, there was crisis – general crisis of the economy which the contemporary theory of money failed to explain. It was also proved that value of money was never neutral to real sector. On the contrary, the stability of the value of money is necessary for the stability of the capitalist system.

J. M. Keynes theorized this development by recognizing the role of 'speculative demand' in determining the proportion of cash balance. This logically led to questioning the theory of neutrality of money and the dichotomy between real sector and monetary sector. Assuming that money is non-neutral, he developed a new theory of unemployment and stagnation. He did not put a critique on the given institutional arrangements. His theory just admitted a living reality, namely, the existence of wage rigidity. Why it should be do, in other words, why the distribution of the share of output between capital and labour is determined in this way, why the price flexibility does not operate there – had not been his concern in his theoretical construct. One may infer that he was considering a 'short run' phenomenon e where the Walrasian *tatonnement* process was not working in the labour market. Or else, one may as will argue that he was tacitly admitting that wage rate has to be determined by the bargaining power of labour vis-à-vis capital, there is no question of having any so-called 'short run' or 'long run' difference in this phenomenon. The rationale of this distribution theory is based on the economic theory developed by Ricardo and Marx where 'value' is different from 'price' and the distribution issue is settled at the level of creation of economic value.

Be that as it may, armed with the additional tools derived out of the new approach to Cambridge e cash balance equation for demand for holding cash and rigidity of money wage,

Keynes put forward a new theory within the ambit of the received wisdom of the subject at that time, which could explain the 'great depression' in a different way. The rationale for increasing government spending through fiscal measures, the essence of Roosevelt's 'New Deal' could thus be rationalized in the realm of economic theory. Keynesian theory gradually becaume the basis of the 'Macro theory of mainstream economics; the demand side factors received the due attention.

When Dr. Sen was teaching us monetary theory the era of best days of Keynesian Economics was over. The supply-side economics was gradually gaining ground, because of rising inflation and unemployment after the golden age of capitalism was over in the capitalist world. A look back to 'real balance effect' was suggested and Patinkin's reconstruction of 'classical dichotomy' was being discussed in the ''new' monetary theory. Dr. Sen was teaching this is our class and the rebel in me reacted. In private talks, Sir appreciated this without accepting my submission that the question of stability of the 'price' of money depends on the stability of its governing factor (not just demand and supply of money) which are located at the value creation level-a original point recognized by Smith, Ricardo and Marx. Sraffa's reconstruction of Ricardo's Value theory was then being discussed in academic journals, but Sir simply ignored it as the 'brain child' of Cambridge Radicals who were placing them outside the 'main stream economics', as he thought. I must admit at the same time that Sir had a liberal mindset – he appreciated the audacity to think differently. As an epilogue to this journey, I should point out that the debate on 'speculative demand' for money took a new turn in the following days when the theory of rational expectation was being advocated. Patinkin's interpretation of 'real balance' lost its significance. Briefly speaking, the theory argues that even if money is held as store of value, rational expectation about the future does not adversely affect the stability of the demand for money over time. Since money is used for transaction, its demand should remain stable. There is no theoretical rationale in developing a critique of it; money would remain neutral to the real sector of the economy. Dr. Sen was then busy with the administrative works. It was a turbulent time. I did not have any opportunity to discuss with him on the new theory justifying the (new) classical view of quantity theory of money.

III. The journey that still remains

As Prabhat Patnaik in his book 'Value of Money' has rightly pointed out, the theory of Rational expectation in internally inconsistent. Why should someone store money if the expectation is rational? Money is held because there is an expected return for holding cash. This in turn is based on the understanding that in some real sector, the condition of perfect price flexibility is violated. But this contradicts the monetarist's basic point, namely, money is neutral to real sector of the economy. Prices must be expected to remain sticky, at least in some areas of the real

sector. Otherwise, what is the rationale for holding cash? The expected return on holding cash cannot but be zero under perfect price flexibility .The theory is internally inconsistent.

The value of money has to be decided outside the market system. This is the only way to assign stability to value of money. For Marx, it is the labour they of value. Value of money is the labour embeded in money which was labour cost of production of bullion at his time. Bullion was of high value not because it was scarce, but because the labour cost of procuring gold or siliver was high. The exchange ratio at the value level was determined by the relative quantities of labour power embodied in each of them. There is a logical problem of transforming these values in price which he tried to solve by addressing the problem of 'transformation problem'. One must admit that he left the problem unresolved ,but that in no way questions his theory of distribution – the distribution is addressed separately, by the bargaining power of capital and labour. A reconstruction of the problem following the Ricardian labour theory of value leads to the same conclusion, as was pointed out by P. Sraffa in his book 'Production of Commodities by Mean of Commodity'.

A Keynesian answer to the stability problem is also based on the same type of logic. The value of money is decided by fixing its value with respect to one particular commodity, namely labour. This is done by allowing money wages to be rigid. The rationale of rigidity of money wages was sought from outside the Keynesian system. It is the anchor that provides s stability to the value of money also in Keynesian logic.

But neither Max nor Keynes could address a basic question. How does the system maintain its long term stability? I would explain the problem. If the value of money in anchored within a period (recall Keynes's short term static model or Marx's value theory), how is it maintained over periods? If the commodity prices are determined through *ex ante* nominal wages , and profit margin is settled by bargaining power between capital and labour, there will be a tendency towards accelerating inflation if the economy is pushed beyond a limit. No solution to this problem can be found by 'Philip's curve' approach to the relation between inflation and employment. The reality, however, is that the value of money remained remarkably stable across periods, even when the days of Bretton Woods Agreement had been over. There had of course, been 'crisis', but the system bounced back in course of time, there was no 'breakdown' of capitalism. How can it be explained within the theoretical construct where value of money is pegged with a money wage rate determined through negotiation between capital and labour in a static framework?

Other problem is rooted in the issue of 'steady state' under capitalism. The only stable steady state, as Kalecki pointed out, can theoretically be perceived under capitalism at a point

where the growth rate is zero. But floor below which the economy cannot move, cannot be at a level of zero growth rate, at least for one reason – meeting the debt commitment.

For solution, one must go beyond 'closed economy' and extend the discussion on open economy macro beyond what is there in so called mainstream economics.

Patnaik's work contributes much in this area of macroeconomics. As Patnaik rightly pointed out, the theoretical puzzle can be solved by considering the fact that the capitalist economies could work with stickiness in wage rates for a long period without facing the problem of deceleration of growth rate at floor level. In case of any decline in the domestic demand , it could easily access the market in the periphery -the underdeveloped countries. In fact, the remarkable stability that currencies of the developed countries could maintain during the golden days of colonization, can largely be explained by this phenomenon. However, the power to extract raw materials at cheap price and even importing the wage goods at cheap price from the periphery, worked as shock absorber for price instability arising out of conflict between capital and labour. Needless to say, this could be kept economically viable by maintaining adverse terms of trade - adverse to the periphery. Economically, this was feasible because the bargaining power of labour market remained unorganised there, and therefore, the bargaining power of labour in the periphery was weak. The Kaleckian problem could thus be avoided. Inflation also could not touch a ceiling, as would have been possible in a closed economy with stickyness in money wage rates.

I think, the post 2nd world war phase when the big powers had to reconcile with the reality of de-colonisation, the economies, at least for first two decades could still maintain stability, because of post war reconstruction when 'new demand' was coming; there had been low inflation and growth rate never faced the problem of moving towards floor level. The problem, however, re-appeared when this phase of 'golden days' was over. Volatility was increasing even the money market, and ultimately dollar had to delink itself frown a fixed amount of gold for a unit of dollar. The law of demand- supply was working in the exchange market without gold or any precious metal at the beck of it. After or short while, dollar bounced back as the major international currency in open economy macro.

In fact, this was also a phase of financial globalization backed by full capital account convertibility of major currencies. Dollar faired remarkably well under this dispensation as well, ever though there had been increasing current account deficit that should logically lead to devaluation of dollar and high inflation. The USA could avoid this by its ever rising liability in the capital account. This was for several reasons, mostly, political. Be that as it may, this is bound to turn the real sector fragile. In fact, this is the basic reason for 2008 crisis. The crisis turned to a global crisis because the financial market is now a globalised market. Since money is non neutral to the real sector, volatility and stagnation are bound to take place.

Would it lead to collapse of capitalism? I do not think so. What will happen, and in fact it is already there, is that there would be new negotiation and re-negotiation between capital and labour on wage share. The era of globalization is also the era of 'outsourcing' of labour. Many jobs are silently being shifted from centre to periphery when the wags rate is low. There exists a vast reserve army of unorganised labour in the periphery where the jobs can be transferred with low cost of logistic movement, thanks to revolution in information technology; the wage rate there is low. Again, price of peripheral goods which are used as raw materials can be kept at low level maintaining adverse terms of trade – a reality since the colonial days. All these work as shock absorbers for price instabilities arising out of class conflicts in the developed hemisphere in determining the share of capital and that of labour. I should add that the working class in the developed countries is losing it bargaining power because of the threat of 'outsourcing'. The crisis of capital is silently being passed over to labour. The collapse of the system to this avoided. Capitalism survives with volatility and stagnation.

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