

WHY DO MONETARY ECONOMISTS DISAGREE

Joe Cobb*

Abstract

The subject matter of monetary economics is seen traditionally in a political context, since money has been "in the breast of the king" for millennia. Disagreements among monetary economists arise because their discipline lacks a market-process or opportunity-cost model, such as economists are able to use in microeconomics to analyze problems and resolve differences.

There are three levels of disagreement: (1) differences in political opinion arising from different degrees of trust in the self-stabilizing nature of the market; (2) political assumptions, or personal preferences, that are mistaken for technical considerations; and (3) technical considerations that are relevant only because tacit political assumptions impose constraints on a macroeconomic model.

There is a "common theoretical framework" in monetary theory, but it is a model of a statistical/mechanistic system that cannot be expected to yield a consensus about economic relationships. Its flaw is the attempt to discover empirical, direct relationships between aggregates like money supply, price levels, total employment, etc. The challenge to Keynesians by the Chicago School, to perform empirical research, is a meta-political strategy to eliminate the advocacy of macroeconomic planning.

Monetary economics views money as a unique kind of good, but a confusion exists between money as a good and the role "the name of the monetary unit" plays in the price-quoting system. The idea that money is a proper field for government intervention has its roots in this confusion.

A market-process model in monetary theory that could put it on a microeconomic foundation may be emerging from research into currency substitution. A new model in monetary economics would make use of a correct understanding of opportunity cost, which is not part of the conventional view. An example of a difference this makes is in present-value analysis, and possibly in resolving a question about how to model "world money supply."

* Senior Economist for Monetary and Fiscal Policy, Joint Economic Committee, Congress of the United States.

It is not an overstatement to say that monetary theories and proposals for monetary reform are among the most controversial issues in economics. From our vantage point with a Congressional Committee principally concerned about the structure of the payments system in the United States and the conduct of monetary policy, it is often amusing to realize that our subject matter intimidates the average member of Congress. He knows it is important, but he doesn't know which of many conflicting experts to follow. The average member of Congress also receives many letters from constituents who care deeply about monetary and banking questions. The regulations and institutions of the status quo, to a large degree, are arbitrary, so the myriad proposals for reform are seldom disinterested.

While economic change in a competitive market can shift the relative fortunes of participants, the impact of change in a politicized market is magnified: in a heavily regulated sector of the economy, any movement from the status quo benefits some people and hurts others suddenly and dramatically. As economists, however, we have some obligation to identify the opportunity costs and marginal benefits of different courses of action. In most sectors of the economy we can rely upon microeconomic models. Economic theory provides the competitive equilibrium model as a baseline against which we can project, and sometimes measure, the costs of regulations.

Yet, in the theory of money, and macroeconomics generally, we don't start with a free-market model. From the earliest days, political leaders have dominated the market.

The coining of money is in all states the act of the sovereign power;

... The denomination, or the value for which the coin is to pass current, is likewise in the breast of the king.¹

The focus of monetary theory in our tradition is upon giving advice to the king, helping to write his regulations. One common item of agreement in monetary economics seems to be that existing institutions are unsatisfactory: the king needs our advice.

The rationale for political intervention has differed through history, but it has seldom been avoided. King Croesus supposedly took over coinage in Lydia only to help his merchants standardize their monetary units, like weights and measures, in the classical liberal spirit of America's Mint Act of 1792. In the Roman republic, coinage was not a government monopoly, but after seizing power Augustus prohibited competition in coinage, in the spirit of modern exchange controls. This might have been prompted by the fact that Brutus celebrated the assassination of Julius Caesar by coining and issuing denarii.

As a general proposition, we would conjecture that the absence of a free-market model, in which "outside" money is a competitively supplied good,

is one major source of disagreement among economists. What would be the degree of consensus today among economists in price theory, for example, if all retail marketing for 2,000 years had been exclusively conducted by a strictly policed merchants' guild?

Three Kinds of Political Disagreement

A fundamental question, then, is whether disagreements in monetary economics have origins in economic analysis or are they basically political disagreements? There may be a consensus among politicians and some economists that a free market cannot be expected, or permitted, to operate under existing political arrangements. The monetary system, therefore, has to serve as one tool of regulatory policy, perhaps to compensate for concentrations of political power in different economic sectors.

Even if he is not engaged in partisan advocacy, the economist would be asked to provide technical advice about using the monetary system to affect other things. In a political environment with no criteria for optimal policy except whatever the king (or a temporary political majority) wanted, it could be impossible for economists to find common ground. Even as disinterested technicians, economists would have to make subjective estimates about how fast the public might learn ways to frustrate any particular policy. The monetary authority would have to experiment continually to find new tricks to compensate for old policies that had begun to fail.

The Keynesian contribution to our modern view of an otherwise free market system is the analysis of rigid prices and suboptimal equilibria, and the role of economists in making policy — offering "second best" solutions as opposed to analyzing markets and identifying the cost of regulations.²

Whether an economist supports a system of generally fixed "rules" or flexible, decision-making "authorities" for monetary control will hinge on his degree of belief in the competitive market model as self-stabilizing in other areas of the economy. If the economist has faith in the equity and efficiency of the market process, his bias will favor some rule for monetary institutions that is relatively fixed. If he has questions about the outcome of the market process, his bias will favor entrusting monetary policy to a decision system that can steer it with more flexibility in directions he prefers.³

We also find, however, there is disagreement among economists about the best objectives for a monetary system in a free-market economy. The concept, "best," may be founded on technical economic criteria, or it might be strictly a judgment of personal taste. Sometimes the distinction is not clear; for example, is it technical reasoning or a political opinion behind one widely advanced criterion of optimal monetary policy: an average level of prices that neither declines nor rises?⁴ The monetary system could arguably have the

classical goal of maintaining the integrity of the monetary unit, without primary concern for the trend-movement of some average level of prices. As an aid in communicating specific utility information, the second kind of criterion has some advantages.

There are clearly differences of opinion among economists about some monetary systems' technical abilities to yield desired results after political decisions, setting objectives for economic policy, have been made. Most economists agree on the desirable framework of a competitive market, stable prices, full employment, etc., but the range of issues in disagreement about the best operating rules for a monetary system is still large — quantity rules (Friedman, Brunner, Meltzer), price rules (Laffer, Yeager), international rules (Mundell, Kindleberger), to name some common technical debates.

It should be noted that most technical disagreements among monetary economists arise in models that axiomatically accept details like central banks and national currencies. In other words, the analysis is constrained in advance by embedded political considerations. This habit of limiting an inquiry to familiar institutions and data could be a source of controversy and error, just as Medieval scholasticism limited itself to Aristotelian physics and dogmatic theology, because it does not allow for certain kinds of questions that relax those restrictive assumptions.

Our first specific suggestion, therefore, is that agreement among monetary economists may depend upon development of a paradigm that is free of all political assumptions, so that theoretical models as well as opportunities for reform of monetary policy can be evaluated rationally on technical or methodological grounds.

Methodology in Monetary Theory

One view of disagreements in monetary theory is that all of them are matters of insufficient empirical research. Milton Friedman has argued that all monetary economists implicitly accept a "common theoretical framework." He has stated his view of why monetary economists disagree as follows:

One purpose of setting forth this framework is to document my belief that the basic differences among economists are empirical, not theoretical: How important are changes in the supply of money compared with changes in the demand for money? Are transactions variables or asset variables most important in determining the demand for money? How elastic is the demand for money with respect to interest rates? With respect to the rate of change in prices? When changes in demand or supply occur that produce discrepancies between the quantity of money that the public holds and the quantity it desires to hold, how rapidly do these discrepancies tend to be eliminated? Does the adjust-

ment impinge mostly on prices or mostly on quantities? Is the adjustment process cyclical or asymptotic? Is the adjustment to sharp changes over short periods different in kind or only in degree from the adjustment to slower changes over longer periods? How long does it take for people to alter their anticipations in light of experience?

Much of the controversy that has swirled about the role of money in economic affairs reflects, in my opinion, different implicit or explicit answers to these empirical questions.⁵

Friedman presents us with a challenge: is agreement among monetary economists just a matter of collecting statistics about the behavior of our fellow men? Or is there something more fundamentally at fault in the study of monetary theory?

Is the prevailing "common theoretical framework" in macroeconomics the best model of reality we can formulate, or is it a circular puzzle with continuously shifting empirical relationships? Physicists in the 19th century held a "common theoretical framework" also — until the Michaelson and Morley experiments failed. To the extent questions are posed and inferences arrived at in monetary theory differently from the other branches of economics, we have a source of disagreement that arises from economic analysis itself. Monetary economists have some unresolved issues in methodology.

Friedrich A. Hayek commented on the state of monetary theory in a series of lectures at the London School of Economics in 1931. His criticism of methodology still applies to Milton Friedman's "common theoretical framework" and to the work of most monetary economists:

This may seem paradoxical, but I think anyone who has studied the monetary literature of the first half of the nineteenth century will agree that there is hardly any idea in contemporary monetary theory which was not known to one or more writers of that period. . . .

What I complain of is not only that this [statistical/mechanistic] theory in its various forms has unduly usurped the central place in monetary theory, but that the point of view from which it springs is a positive hindrance to further progress. Not the least harmful effect of this particular theory is the present isolation of the theory of money from the main body of general economic theory.

For so long as we use different methods for the explanation of values as they are supposed to exist irrespective of any influence of money, and for the explanation of that influence of money on prices, it can never be otherwise. Yet, we are doing nothing less than this if we try to establish *direct* causal connections between the *total* quantity of money, the *general level* of all prices and, perhaps, also the *total* amount of production. For none of these magnitudes *as such* ever exerts an influ-

ence on the decisions of individuals; yet it is on the assumption of a knowledge of the decisions of individuals that the main propositions of non-monetary economic theory are based. . . .

If, therefore, monetary theory still attempts to establish causal relations between aggregates or general averages, this means that monetary theory lags behind the development of economics in general. In fact, neither aggregates nor averages do act upon one another, and it will never be possible to establish necessary connections of cause and effect between them as we can between individual phenomena, individual prices, etc. I would even go so far as to assert that, from the very nature of economic theory, averages can never form a link in its reasoning:⁶

If Hayek's criticism is correct, the "common theoretical framework" of macroeconomics and monetary theory is not a particularly useful description of economic reality. This defect could explain why economic forecasting, which is almost exclusively a product of different twists on the common model, is usually in error. The "common theoretical framework" is certainly no guide for an activist, Keynesian economic-political agenda.

Frank H. Knight supposedly once said, "It is not the things you don't know that can kill you — it's the things you 'know' which ain't so." Perhaps this is the most important teaching of the Chicago school. If the quote from Frank Knight is not apocryphal, he taught his students well: challenge the ignorant to discover how ignorant they really are, so they will leave the rest of us alone. Of course, advocacy of *laissez faire* is itself a meta-political position, so empirical research may be just the subtle way to argue for the political agenda of classical liberalism.

The entire field of monetary economics as a separate specialty may be a dinosaur. Energy or transportation economics certainly can claim as wide a domain in the modern economy as monetary economics, touching every other product and service, and yet no theorist has attempted to create an E-1 or a T-1 macroaggregate to explain nominal GNP or unemployment. Monetary economists could possibly be concerned, and contentious, therefore, about issues that *may not* be central to anything except partisan political competition in a Keynesian world.

The Confusion of Money with the Price-Information System

In the economic process, individual choices among alternative uses of time, labor, resources, and a business firm's perennial make-or-buy problem, are resolved by examining information about relative prices. The price system is the very heart of any market, because it provides the information that makes decentralized coordination possible. Prices are quoted "in the name" of the

monetary unit, just as a computer memory uses a tiny quantum of magnetism called a "bit."

The appreciation of the price system as an information-processing facility was not articulated until after the Keynesian revolution.⁷ The insight that human subjective marginal evaluation of resources is more important than their physical quantities also happens to be a more recent development in the history of economic thought than the central propositions of the quantity theory of money.

Why is there a separate study of monetary economics? Prices are quoted "in the name" of money, but in principle money does not otherwise have to exist.⁸ Is monetary economics properly a subdivision of capital theory or finance? (Or political science?) Supposedly monetary economics is special because money is a unique phenomenon: it is a public good, a natural monopoly, and something exogenous to the process of market choice (i.e., an ideal money is neutral and costless).

- *Money is not a public good.*⁹ The money one individual owns is excluded from ownership by anyone else, and the liquidity services provided by that money cannot simultaneously be enjoyed by anyone else.
- *Money is not a natural monopoly.* A government's monetary monopoly is about as natural as the pistols carried by its border guards and the barbed-wire fences on its frontier. Exchange controls would never be imposed if money were a natural monopoly.
- *Money is never neutral nor costless.* It has a positive marginal utility, and a non-zero opportunity cost, to the extent money is held in an individual's portfolio in preference to some other asset.

An operational price-quoting system, which necessarily makes use of the name of the monetary unit, is a public good; but money itself is simply a divisible asset generally acceptable in payment. Stamping a royal design on coins may once have been useful for developing an efficient price-quoting system, minimizing transactions and information costs, but no longer: private, competitive interbank clearings are more important today. Monetary assets are created, transferred, and redeemed entirely in the private sector without active government participation. Government's role in the market today is that of a manipulator or speculator — a role we would not tolerate if it were anyone else.

The natural-monopoly argument is correct, of course, if it is applied to the price-quoting information system; but this is something quite different from the present payments system. The production of monetary assets has real resource costs that obviously do not continuously decline. If there were anything naturally monopolistic about money, we would expect to observe one

form of money worldwide, because of declining marginal transactions costs; the optimal currency area for international trade is the world as a whole. Currency unification among nations should have long-since occurred, but of course, the opposite has been the dominant trend in the past 100 years.

Even in the case of a common price-quoting system, we might wonder why different national money-names persist — is it all due to regulation by jealous governments, or cultural factors? A common money is a lot like a common language, but the world has several major languages; none seems to be falling into disuse, although second-language proficiency may be increasing world wide, just as the U.S. dollar has become a parallel currency for most national economies.

Is an "ideal" money both neutral and costless, or is this hypothesis also a confusion of thought between money and the price-quoting system? If the economist is primarily analyzing the real sectors of an economy, his paradigm might be the pattern of exchanges a barter economy would execute if its members could perfectly match their demands with their supplies. In this view, money is a "veil," a lubricant, a numeraire in a process of *tatouement*, facilitating exchange, and not itself a factor of production. Some classical economists who first analyzed the relationships in economics found it convenient to assume a neutral, costless money.

Observing the free market's development of efficient money-substitutes, Adam Smith commented favorably on the economization of resources.¹⁰ Monetary economists subsequently have adopted the view that a superior monetary system is one that minimizes objective resource costs, without attending to the distinction between what the market might select through competition and what a government might select to maximize seigniorage.¹¹ It is interesting to note that Adam Smith did not make this mistake, although the tradition of identifying as less costly a fiduciary money supplied by a government is traced back to him.

Monetary Theory and Economic Costs

Our central argument is that the missing component in monetary economics is a market-process model. This vacuum gives rise to disagreements among economists about monetary theory because there is no basis to sort out political views, personal tastes, and technical errors. If investigators could formulate an opportunity cost model in monetary theory, the basis for improvement in both theory and policy could be laid. Some of the theoretical and empirical work about currency substitution in a system of floating exchange rates may provide the breakthrough that is needed.¹²

James M. Buchanan's discussion of the theory of cost should be required reading for students of monetary theory:

There are few modern economists who would dispute the elementary definition of opportunity cost. Statements that are presumably well understood abound in the standard textbooks. . . .

Opportunity cost tends to be defined acceptably, but the logic of the concept is not normally allowed to enter into and inform the subsequent analytical applications. My aim is to utilize the theory of opportunity cost to demonstrate basic methodological distinctions that are often overlooked and to show that a consistent usage of this theory clarifies important areas of disagreement on policy issues. . . .¹³

The disagreements among monetary economists could be substantially eliminated if they would consider this advice. This can be illustrated by examining one standard assumption of neoclassical monetary economists, that a stable price level and "monetary stability" are the same thing. Buchanan's discussion points out the central role of the *point in time* to the costs of choice:

The essential element in this concept is the direct relationship between cost and the act of choice, a relationship that does not exist in the neoclassical predictive theory. . . . Cost is that which the decision-taker sacrifices or gives up when he makes a choice. It consists in his own evaluation of the enjoyment or utility that he anticipates having to forego as a result of selection among alternative courses of action.¹⁴

It is the neoclassical method to define "monetary stability" in terms of some price index and conclude that if a chart of the index (or a chart of some relevant monetary aggregate) is a straight horizontal line over time, monetary stability will have prevailed.

The economist who argues that "real resource costs" are minimized, and macroeconomic stability becomes feasible with a "managed money supply" aimed at a horizontal chart-line, doesn't have a sensible concept of opportunity cost. In spite of horizontal chart-lines in the United States today, real interest rates fully reflect the version of Murphy's Law that says,

If monetary policy *can be* changed, it *will be* changed, and anyone on the wrong side of an investment decision at the time it happens will get burned.

In a world of monetary manipulation, investors have to have a higher defined threshold for marginal decisions to hedge against policy risks — and they are willing to pay for more information. These risks explain both high real interest rates today and the high real salaries commanded by ex-Federal Reserve employees who are retained by investment firms as "Fed-watchers."

To an individual, however, who is attempting to perform a present-value calculation to choose between two investments with different cash-flow characteristics, all points on the chart that would be filled in subsequently are unknowable. He can't step out into the fourth dimension and examine whether

“monetary stability” were going to be achieved, particularly since the line on the chart could be influenced by real supply and demand shocks as well as monetary policy changes. One way such an individual *could* determine *his own* monetary stability, in terms of utility, which is the only context in which a present-value calculation can make sense, is to define his monetary unit in terms of some specific, *deliverable* commodity — like gold coins. In this way both the relative present-utilities of each investment and the utility of the immediate outlay (foregone alternatives) can be made intelligible at a single point in time. His choice is made between identified utility alternatives at his own rate of time preference, not based on some speculation about fluctuating market interest rates and monetary depreciation rates in the future.

One of the requirements for a market-process model, the development of which is beyond the scope of this paper, would be a focus upon the role that the choices of individuals would play regarding the *forms of money* they demand. The demand for money is not just a demand for an amount of consumable value in liquid form, but also a demand for particular forms of liquidity that satisfy different expectations. The property of money that allows it to be summed is one of the basics of the quantity theory, but the leap from an individual’s demand at the margin for an additional unit of money to “the money supply” and aggregate demand buries economics in a fallacy of composition.

Coins, banknotes, demand deposits, liquid time deposits, as well as each of them denominated in a diversity of units — U.S. dollars, Swiss francs, troy ounces of gold — make up a money supply that should be expressed as a vector $[X, Y, Z, \dots]$ rather than a scalar aggregate; certainly if we are alert to the open, international nature of our economic system today, this could be the only way to model the “world money supply.” The demand for cash balances should then consist of a related vector of utility functions $[X, Y, Z, \dots]$ and the model would attempt to explain and predict changes in relative prices between money and goods as well as among money supply components in terms of the theory of opportunity cost.

One primary advantage of placing monetary economics on the same methodological basis as the theory of finance and price theory would be to rid it of all tacit political assumptions. Explicitly imposed political barriers to fungibility could be analyzed just as economists analyze regulations, taxes or subsidies in other economic studies. There would be more than one kind of “outside” money in the system, even if individuals had a zero utility preference for some kinds (e.g., Argentine pesos). The view of money as “in the breast of the king,” becomes somewhat different when each king finds himself in competition with others, or with money-market baskets of liquidity with no vulnerability to seigniorage.

FOOTNOTES

- ¹ Sir William Blackstone, *Commentaries on the Laws of England* (American ed., 1771-73), p. 276.
- ² For two trenchant criticisms of the economist in this role, see W. H. Hutt, *Politically Impossible . . . ?* (London: Institute of Economic Affairs, 1971), and James M. Buchanan and Richard E. Wagner, *Democracy in Deficit* (New York: Academic Press, 1977).
- ³ The classic presentation of this case is Henry C. Simons, “Rules Versus Authorities in Monetary Policy,” *The Journal of Political Economy*, XLIV (1936), 1-30.
- ⁴ Cf. the comment by Milton Friedman in *The Optimum Quantity of Money* (Chicago: Aldine, 1969), p. 48: “I simply took it for granted, in line with a long tradition and a near-consensus in the profession, that a stable level of prices of final products was a desirable policy objective. Had I been fully aware then of the analysis in this paper. . . .”
- ⁵ “A Theoretical Framework for Monetary Analysis,” in Robert J. Gordon, ed., *Milton Friedman’s Monetary Framework* (Chicago: University of Chicago Press, 1974), p. 61.
- ⁶ *Prices and Production* (New York: Kelly, 1935), pp. 2-5.
- ⁷ F. A. Hayek, “The Use of Knowledge in Society,” *American Economic Review*, XXXV (1945), 519-30.
- ⁸ Fischer Black, “Banking and Interest Rates in a World Without Money,” *Journal of Bank Research* (1970), 9-20; and Eugene F. Fama, “Banking in a Theory of Finance,” *Journal of Monetary Economics*, VI (1980), 39-67.
- ⁹ “We are indebted to Lawrence H. White for this analysis. See his “Competitive Money, Inside and Out,” *The Cato Journal*, III (1983), 291-92.
- ¹⁰ *Wealth of Nations* (1776), bk. ii, ch. ii.
- ¹¹ Cf. Milton Friedman, “Commodity-Reserve Currency,” *The Journal of Political Economy*, LIX (1951), 203-32. His argument is most interesting for its lack of any marginal utility analysis on the part of holders of money balances to support his claim that “a pure fiat currency issued by the government . . . is essentially costless. . . .”
- ¹² To cite only two of many recent articles from this perspective, see Roland Vaubel, “Free Currency Competition,” *Weltwirtschaftliches Archiv*, CXIII (1977), 435-61, and “The Money Supply in Europe: Why EMS May Make Inflation Worse,” *Euromoney* (1978), 139-42.
- ¹³ *Cost and Choice* (Chicago: Markham, 1969), pp. viii-ix.
- ¹⁴ *Ibid.*, pp. 42-43.