Classical Theories of Money, Output and Inflation

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Classical Theories of Money, Output and Inflation: A Study in Historical Economics. By Roy Green. (London:Macmillan, 1992. Pp. xii+271. ISBN 0 333 56562 2)

"Never trust anyone older than thirty" was a popular slogan for rebellious youth in the late 1960s and the early 1970s. "Never trust any theory of money older than ten years" might seem a reasonable adaptation of this aphorism for current economic analysis. For over the last decade there have been enormous changes in the technology, institutional arrangements and the regulation of monetary and financial transactions, and in the scope for, and methods for implementation of, monetary policy. It would seem reasonable to be sceptical that theories developed to explain the phenomena of past monetary environments can be usefully applied to a current environment which is so different, even from that of a mere ten years ago.

Indeed there is an urgent need for the development of new macroeconomic theory which can better incorporate the characteristics of the new monetary environment. Even the most up-to-date open economy models of current orthodoxy (for example "Dornbusch-type" models, which combine short run product market price stickiness with rational expectations) still rely on the assumption of an exogenously determined "quantity of money" to provide a long run anchor for the price level (and consequently the exchange rate) and to drive the short run dynamics. Such an assumption seems dubious given the current monetary environment and the manner in which monetary policy operates both nationally and internationally.

One might well doubt, then, that there is much value in another journey through the history of the development of classical theories, other than for historical interest. Roy Green's book, which traces the significant developments and controversies in monetary theory from the sixteenth and seventeenth centuries to the late nineteenth century, is however very valuable reading for those interested in the analysis of current monetary issues.

This is not only because of the general value of studying the history of economic thought - in terms of improving one's understanding of how theory came to reach its current state, and of avoiding "re-inventing the wheel" in attempting to further develop theory. Whatever new definitions of "money" may be appropriate in the light of a changing institutional and legal framework, the same fundamental roles for the concept of money in economic models remain - medium of exchange and liquid store of value. More specifically, Classical theorists also faced watershed changes in the institutional and legal framework for monetary transactions, and it is instructive to reflect on how they sought to modify and develop established theories of money to accommodate these changes - the shift from metallic money to fiduciary paper currency, and the shift from fiduciary paper currency to bank issued credit money.

It is through these developments and the accompanying theoretical debates - the "bullion controversy" and the "currency school - banking school controversy" that Green's book takes us. His main thesis is that the Monetarist version of neoclassical economics cannot be seen as "a unilinear progression from classical to neoclassical quantity theory" (p3). The latter, interpreted in terms of the identity MV = PY, implies a "left to right" reading, and with velocity, V, institutionally determined and output, Y, given at full employment, exogenous changes in the Money Supply, M, result in proportional changes in the price level, P.

It is clear that for long run analysis, classical theory reads the equation of exchange from right to left - with output determined by accumulation, and "natural" price levels determined by production costs, MV adjusts to a given level of nominal output. The Classical position with regard to the short run was more confused, and led to divisions of opinion about the causes of short run disturbances and bouts of inflation. The Anti-bullionists and the Banking School maintained that a right to left reading was appropriate for the short run with disturbances the result of real shocks reflected in changes in the costs of production. The Currency School, following Ricardo, read the equation of exchange from left to right in the short run and regarded disturbances as the result of monetary shocks.

Green argues that the apparent eventual dominance of the left to right reading in Classical theory results from the absence of a theory of the short run determination of output (for which we had to wait for Keynes' theory of effective demand). The Quantity theory interpretation won by default. But, since it is only if the price level is regarded as being simultaneously determined with output by the interaction of aggregate supply and aggregate demand (with MV representing nominal demand), rather than changes in the price level being the result of changes in production costs which may occur independently of the level of output, that a left to right reading is a *necessary* implication, the Quantity Theory is not an essential integral element of Classical analysis.

I am not sure that Green's argument will prove his case to the satisfaction of all. I am even less sure that he has established what he believes to be the converse of his argument: "that the monetarist approach to inflation *is* a necessary component of (all) neoclassical theory". Nevertheless his book provides clear and insightful analysis of the monetary theories of, for example, Hume, Smith, Ricardo and Marx, and the less well-known (to this reviewer) views of Steuart, Fullerton and Tooke. The fact that the analysis of these theories as logical constructs, is placed in the context of the contemporary historical experience of monetary phenomena, makes them all the more intelligible.

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