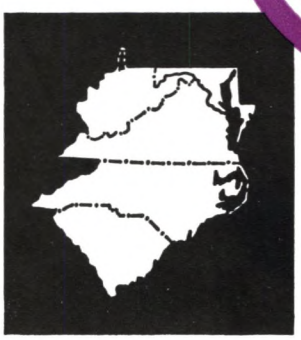
FEDERAL RESERVE BANK OF RICHMOND

MONTHLY REVIEW

The Monetarist—Nonmonetarist Debate

Regulations Affecting Banking Structure in the Fifth District



DECEMBER 1970

THE MONETARIST–NONMONETARIST DEBATE

Some 19th Century Controversies Revisited

Standing on opposite sides of the current debate over monetary theory and policy, and delineating the major issues, are a monetarist group and a nonmonetarist or credit school contingent. Generally, the monetarists: (1) make a sharp distinction between money and other liquid assets; (2) argue that the money stock determines total spending, the price level, and the nominal level of national income; (3) believe that the central bank can control the money supply by controlling a narrowly defined monetary base (currency plus bank reserves); (4) are critical of the central bank's past performance in controlling the money supply and argue that inappropriate policies may have been the source of economic disturbances; and (5) wish to replace the central bank's discretionary powers with rules.

The nonmonetarists, on the other hand, generally: (1) view money merely as a component of a broad spectrum of liquid assets that have an important bearing on total spending; (2) argue that the money supply is largely an endogenous variable, i.e., determined primarily by (instead of itself determining) the level of economic activity and by the public's preferences for money and other types of liquid assets; (3) hold that, in the short run at least, the slippage between the monetary base and the money supply renders the central bank's control over the latter weak and uncertain; (4) believe that economic disturbances stem chiefly from nonmonetary factors instead of from inappropriate central bank policies; and (5) defend the central bank's discretionary powers by alleging that rules are too simple and too narrowly circumscribed to handle all contingencies.

The intensity of the current monetarist-nonmonetarist debate tends to obscure its origins and its lineage. The current controversy is the latest recurrence of a debate that has been going on for a long time. The essentials of the debate can be traced back to the Bullionist-Antibullionist and Currency-Banking School controversies that took place in Britain in the 19th century. This article traces the development of the controversy and shows how similar in essentials are the prevalent monetary doctrines of today and their counterparts in the 1800's.

The Bullionist-Antibullionist Controversy In 1797, under the stress of the Napoleonic Wars, Britain departed the gold standard for an inconvertible paper standard. A series of poor harvests, necessitating extraordinary wheat imports, had weakened England's trade balance. The trade-balance deterioration combined with heavy military expenditures abroad had depleted the Bank of England's gold holdings and had forced suspension of specie payments, i.e., bank notes and deposits were no longer automatically convertible into gold. The suspension of specie payments and the corresponding increase in the stock of paper money was followed by a rise in the paper pound price of bullion, foreign exchange and commodities. A debate arose between the Bullionists and the Antibullionists centering on two questions: Was there inflation in Britain? If so, what was its source?

The Bullionists argued that inflation did exist, that overissue of banknotes by the Bank of England was its cause, and that the premium quoted on bullion (the difference between the market and the mint price of gold in terms of paper money) was the proof. Price indexes were not in use then. The Bullionists used the gold premium as we use price indexes today to measure the extent of inflation.

The Antibullionists denied the existence of inflation. The premium on gold, they said, was not due to note overissue and rising domestic prices, but to the unfavorable balance of payments that had lowered the exchange rate of the British pound relative to gold and foreign currencies. The Bullionists replied that the cause of the persistent unfavorable trade balance *had* to be currency inflation rather than the commodity-sector disturbances cited by the Antibullionists. This was an early example of monetarist-nonmonetarist disagreement over the source of economic disequilibrium, the monetarists (Bullionists) finding it in the inappropriate actions of the central bank and nonmonetarist (Antibullionists) in monmonetary factors, notably crop failures and heavy military outlays abroad.

Indicting the Bank of England for its tendency to overissue notes, the Bullionists stressed several points that thereafter became key components of

monetarist doctrine. First, they stated that the money supply is the major determinant of the price level and that changes in the money stock cause price level changes. The Bullionists may have had a fairly refined and subtle theory of money, but, when discussing policy matters or interpreting events, they resorted to the simplistic notion that prices always vary directly and proportionally with changes in the money supply.

Second, the Bullionists implied that the Bank of England had the power to control the money supply within close limits via control of a narrowly defined monetary base. This point was brought out in their treatment of the relation between the volume of Bank of England notes and the volume of notes issued by country banks. The money supply at that time included gold and banknotes both of the Bank of England and country banks. The link between the entire money supply and the Bank of England note component might have appeared tenuous because of the possibility of the country bank note component expanding and contracting independently of the behavior of Bank of England notes. But the Bullionists denied this possibility on two grounds. First, the country banks tended to keep as a reserve Bank of England notes equal to a relatively constant percent of their own note liabilities. Second, any overissue of country bank notes (and consequent rise in local prices relative to London prices) would drain Bank note reserves from the countryside to London via a regional balance of payments mechanism, thereby forcing the country banks to contract their note issue. Because of the foregoing reasons, asserted the Bullionists, country bank notes would be passively tied to Bank of England notes by a virtually rigid link and could expand or contract only if the Bank's issues did.

Third, the Bullionists felt that the Bank of England's discretionary policy should be limited and the conduct of monetary policy prescribed by a rigid rule. In this case, the rule prescribed was that the Bank should limit its issues of inconvertible paper to the volume that would exist if the notes were convertible into gold, i.e., that the bank limit its note issue to the amount consistent with equality between the mint and market price of bullion.

Defending the Bank of England against the Bullionist charge of note overissue, the Antibullionists employed the *real-bills doctrine* which, thereafter, occupied a vital position in nonmonetarist thought. Overissue of inconvertible paper currency would be impossible, argued the Antibullionists, as long as new notes were issued only on the discount of sound commercial paper. The rationale of the real-bills doctrine was that the creation of money would be tied to the production of additional output and that the money would be extinguished as the paper was redeemed with the sales proceeds. Since money creation would be limited to the expansion of goods, no inflation would occur.

The Currency-Banking School Controversy The monetarist-nonmonetarist controversy flared up again in the discussion surrounding the Bank Charter Act of 1844. The protagonists at this time were known as the Currency School and the Banking School, but they were the intellectual heirs of the Bullionists and Antibullionists.

The Bullionists, in their search for a rule limiting the discretionary powers of the Bank of England, had established a precept which was adopted by the Currency School. According to this precept, a mixed gold-paper currency should be made to behave exactly as would a purely metallic currency. The Bullionists had thought that convertibility as such would be sufficient to insure that the paper currency would respond automatically to gold flows consistent with this precept. Convertibility alone, they thought, would be sufficient to prevent currency overissue, to keep the foreign exchanges at par, and to maintain equality between mint and market price of gold. Thus, the Bullionists were satisfied when England resumed specie payments, i.e., went back on the gold standard in 1821.

To members of the Currency School, however, the requirement of convertibility was not sufficient, by itself, to prevent overissue. They feared that even a legally convertible currency could be issued to excess with the following consequences: rising British prices relative to foreign prices, unfavorable balance of payments, gold outflow, depletion of gold reserves, and, ultimately, suspension of convertibility. The rate of reserve depletion would be accelerated, they noted, if the external gold drain coincided with an internal drain as domestic residents, pessimistic about the maintenance of convertibility in the future, sought to convert paper currency into gold.

The apprehensions of the Currency School were well founded. Experience following the 1821 resumption of specie payments had demonstrated to the Currency School that mere convertibility was not enough to preserve the gold standard (the primary policy objective in those days). In the three decades following resumption, British financial history was punctuated by frequent external gold drains—some so severe as to endanger convertibility—and by periodic overexpansion of credit followed by panics

and liquidity crises. Moreover, to many members of the Currency School, it appeared that the actions of the Bank of England had been sluggish, perverse, and destabilizing during these periods. It seemed that the Bank's reactions to external drains were often too late to protect the gold reserve and served instead to weaken public confidence in the Bank's ability to maintain convertibility. Furthermore, when the Bank finally *did* apply restrictive policies to stem the gold losses, these policy actions tended to coincide with and to exacerbate the domestic liquidity crises. What was needed to prevent the recurrence of gold drains, exchange depreciation, and domestic liquidity crises, the Currency School thought, was convertibility *plus* strict regulation of the volume of Bank notes.

The Currency School was successful in enacting its ideas into legislation. The Bank Charter Act of 1844 embodied its prescription that, except for a fixed amount of notes which the Bank could issue against government securities, new notes could only be emitted if an equivalent amount of gold or silver was brought to the Bank. In modern parlance, the Charter Act established a marginal gold reserve requirement of 100% behind note issues. With notes tied to gold in this fashion, external gold drains would be accompanied by reduction of a like amount of notes domestically.

Monetarist Doctrines of the Currency School It is easy to detect the monetarist doctrines in the Currency School's arguments. First, of course, was the Currency School's prescription for stabilizing prices, securing convertibility, and preserving the gold standard by tying the note issue to gold. This prescription was based on the monetarist notion that money stock changes *cause* price level changes. The Currency School held that the channel of influence ran from domestic note overissue to rising prices to a weakened trade balance and deterioration of the foreign exchanges and ultimately to gold outflows. Similarly, domestic price rises would be reversed and the foreign exchanges strengthened by reducing the note issue. By tying notes to gold with a 100% reserve requirement, stability of the foreign exchanges would be achieved automatically.

Second, the Currency School displayed monetarist traits in focusing on a narrow concept of money. The strict separation of money from "near money" is a monetarist characteristic. At a time when bills of exchange and demand deposits were being employed increasingly as exchange media, the Currency School advocates concentrated on notes only. They felt justified in excluding near money—bills of exchange and demand deposits (now, but not then, defined as part of the money supply)—from their policy analysis. They thought that the entire credit superstructure could be controlled by control of the note base. In particular, they thought that the note issue set a limit on the creation of deposits so that control of the former implied control of the latter. This argument bears some resemblance to the modern monetarist doctrine that control of a narrowly-defined stock of "high powered money" implies virtual control of the money supply. In justification of the sharp distinction they made between money and near money, they pointed out that in crises near moneys were poor substitutes for money strictly speaking (gold and notes), because only the latter would be accepted in final payment.

Third, the Currency School wanted the Bank's discretionary powers in policy making severely constrained. The Charter Act's provision for tying note issues to gold instead of to the discretion of the Bank's officers was intended to serve this purpose.

Real Bills and the Commercial Loan Theory In contrast to the Currency School, members of the Banking School thought that convertibility was sufficient to assure monetary stability. They thought that no further regulation of note issue was needed. Their arguments relied on the *real bills doctrine* and the *law of reflux*. As noted earlier, the real bills doctrine asserts the impossibility of note overissue as long as banks restrict their loans to self-liquidating commercial or agricultural paper. The Banking School advocated discretionary control of bank notes by banks themselves. Banks, they thought, could judge the volume of notes required to meet the legitimate needs of trade. But Banking School advocates went further, noting that, even if the real bills criterion was violated, the law of reflux would operate to prevent overissue. If notes were emitted in excess of legitimate working capital needs, the public would not wish to hold the excess notes, and the notes would flow back to the banks. Because of this reflux mechanism, convertibility alone was sufficient insurance against overissue. Accordingly, the central bank did not need to be constrained by a rigid rule because the supply of money and credit would regulate itself automatically through the force of people's self-interest. This notion probably influenced later antimonetarist opposition to monetary "rules."

The Banking School never explained adequately the rationale of the law of reflux. Apparently, it consisted of little more than the notions that (1) the

public determines the amount of currency it needs to make purchases at current prices, and (2) if the currency in existence exceeds the desired amount, the public would return the excess to the banking system. The banks were viewed as being entirely passive. They could not force an excess issue on the public. The current price level and the volume of transactions were treated as given data (instead of as variables determined within the economic system) by the Banking School in its discussion of the reflux.

Nonmonetarist Doctrines of the Banking School Like present-day nonmonetarists, the Banking School emphasized the overall structure of credit rather than a narrowly defined money supply. It criticized attempts to make a watertight distinction between money and near money. The Banking School argued that the use of bank deposits, bills of exchange, and other forms of credit (i.e., money substitutes) would defeat the Currency School's efforts to control the credit superstructure via control of the banknote base. The Banking School thought that the volume of credit that could be erected on a given monetary base was extremely variable and unpredictable. Here is the nonmonetarist notion that the volume of credit is independent of, as well as quantitatively more significant than, the money stock.

It should be noted that in the Banking School's terminology the word *credit* was largely synonomous with the term *means of payment*. Today a distinction is drawn between the two concepts: bank credit refers to the earning assets of banks whereas deposit and note liabilities of banks serve as means of payment. However, the tendency to meld or fuse the two concepts persists in banking circles and may account for the central bank's emphasis on qualitative control of loans in the 1920's and for its primary policy focus, until quite recently, on credit and credit-market conditions instead of on the money supply.

Contrary to the Currency School's contention that the channel of influence runs from money to prices, the Banking School argued that the channel of causation runs in the opposite direction. That is, when prices, total money income, and aggregate demand are increasing, the demand for loans would increase and the banking system would respond to the increased loan demand by supplying additional credit and circulating media. In the determination of the volume of currency in existence, the public (borrowers) played an active role and banks (issuers) a passive role. The volume of currency was demand determined. Here is the origin of three more nonmonetarist doctrines: (1) changes in economic activity precede money supply changes, (2) the supply of circulating media is not independent of the demand, and (3) the central bank is often not an active controller of the money supply but, instead, is an agency responding to prior changes in the demand for money.

Outcome of the Currency-Banking Debate What was the outcome of these 19th century debates? It was largely a standoff. Although the Currency School's prescription of fixed exchanges, maintenance of the gold standard, currency convertibility, and strict control of notes (but not of deposits) became part of British monetary orthodoxy in the second half of the 19th century, the Currency School's once dominant position had eroded significantly by the turn of the century. It was clear by then that the Currency School had grossly underestimated the significance of deposits. The Currency School wanted monetary control to be automatic, but the failure of the 1844 Bank Charter Act to regulate deposits permitted the Bank of England to exercise discretionary control over this part of the money supply. Growing recognition of the Bank's responsibility as a lender of last resort, together with the Bank's successful use of its discount rate in protecting its gold reserve, further strengthened the case for discretionary control. In addition, attention was swinging away from the Currency School's concern with maintaining stability in the external exchanges to the problem of domestic price level stability.

It is also true that the Bullionists' and Currency School's quantity theory of money had gained widespread acceptance among academic economists by the end of the century. But this advantage was offset by the survival in banking circles of the Anti-bullionists' and Banking School's real bills doctrine. The real bills doctrine had been subjected to sustained criticism throughout the 19th century. The monetarists had demonstrated that as long as the loan rate of interest is below the expected yield on new capital projects, the demand for loans would be insatiable. In such a case the real bills criterion would not effectively limit the quantity of money in existence. Despite this and other criticisms, the real bills doctrine survived in banking tradition and was incorporated as a key concept into the Federal Reserve Act of 1913. The Act provided for the extension of reserve bank credit (chiefly loans to member banks) via the Federal Reserve's rediscounting of eligible (short-term, self-liquidating) commercial paper presented to it by member banks.

In summary, the dominant position that monetarists had gained by their initial victories had de-

teriorated by the turn of the century. As evidence that the monetarists did not gain the upper hand, we may cite the Stabilization Hearings before the U. S. Congress in the 1920's. American monetarists, wishing to limit the discretion of the central bank, proposed the adoption of a legislative mandate requiring the Federal Reserve to stabilize the price level as measured by a price index. Federal Reserve officials employed Banking School arguments in their opposition to the proposal. The proposal was not enacted into law.

The Current Debate The main lines of the 19th century debates remain essentially unchanged up to the present time, and the debate today is a standoff just as it was at the turn of the century. Today's monetarists are no less critical of the central bank than their Bullionist forebears were of the 19th century Bank of England. Some modern monetarists attribute both the Great Depression of the 1930's and the inflation of the late 1960's to inappropriate central bank policies. Monetarists still advocate that the central bank's discretionary monetary management be replaced by a rule—in this case a rule fixing the annual growth rate of the money stock at a steady figure roughly corresponding to the long-term trend growth rate of output. Monetarists still argue that money-stock changes precede and cause changes in national income. They still argue that the central bank has full control over a well defined monetary base which is sufficient to enable it to control the money supply.

On the other side of the debate nonmonetarist doctrines are still very much in force. A large body of literature questions the distinction between money and other liquid assets and belittles the efficacy of actions to control the stock of money in a financial system that can produce an endless variety of money substitutes. Similar issues were, of course, raised by the Banking School. Moreover, the monetarist conception of the money supply as an exogenous variable under the control of an independent central bank is being questioned. Countering the monetarist conception is the Banking School notion of the money supply as an endogenous variable, determined by the level of economic activity and by the public's preferences for money as against other financial assets. Even the old law of reflux has reappeared in a new version which holds that the public will adjust its volume of deposits so as to eliminate any excess. In addition, while the central bank no longer adheres to the real bills principle, until fairly recently it still defined its actions and formulated its policies largely in terms of Banking School concepts (e.g., credit market conditions) instead of in terms of the money supply. In the past year, the central bank has given greater consideration to the money supply as a policy target. But it still uses credit-market conditions as supplementary policy guides, and some monetarists charge that it continues to give too much weight to the objective of credit-market stabilization. Finally, nonmonetarist interpretations of economic disturbance are frequently heard. Inflation is said to result from cost-push forces, administered prices, sectional demand shifts, and bottlenecks in the economy's structure rather than from an oversupply of money. Nonmonetarist explanations of the cause of the Great Depression, e.g., vanishing investment opportunities, collapse of confidence, and the stock-market crash, compete with monetarist explanations.

Conclusion The longevity of the monetarist-nonmonetarist controversy is remarkable. Despite two centuries of innovations in monetary thought, policy, and institutions, the two sides still argue over basically the same issues. One can only speculate as to why the debate has not long since been laid to rest. Maybe it is because some of the commentators have not been sufficiently aware of the work of their predecessors. Or perhaps it is because until very recently statistical analysis was not sufficiently advanced to permit rigorous testing of the opposing theories. More likely it is because neither side has a monopoly on the truth. If this is the case, it is unlikely that the controversy will be resolved in the near future. Even with sophisticated empirical techniques, it will probably take a long time to identify conclusively the valid elements of each position.

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