

## THEORIES OF MONETARY POLICY – FROM THE MERCANTILIST PRAGMATISM TO THE MODERN MONETARY THEORIES

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### **Abstract:**

*The purpose of this article is to perform an incursion into the monetary theories, from the mercantilists to the modern theories. The monetary area is an important component of the economic system which has always been and still is tormented by anxiety and uncertainty. The currency can be considered a barometer that promptly and precisely registers a country's economic oscillations and the fundamental problems that torment the human society nowadays is mainly expressed in monetary terms.*

*Being one of the major tools the state uses to balance the economy, the monetary politics has permanently generated fervent controversies and discussions. Scientific research of the monetary phenomenon, facing the complexity of the currency problems with a diversity of currency types and with the complex currency role within the company, as well as the explosive evolution of the financial institutions, structures and monetary and financial products has always kept the monetary theory in the beginning of a new research program.*

*The monetary theory center, around which the economists' thinking is founded, is formed of: emphasizing the money role in the economy, the money measurement, the money offer and request with their influence factors, the monetary balance theory, the monetary impulse transition modality as well as the monetary behavior on the part of the economic agents.*

*It was established that each economical thinking movement marked the social, economical and political life for a certain amount of time, each school has criticized or supported their predecessors' ideas contributing to the enrichment of the monetary theory and the economic development, implicitly.*

**Key words:** monetary theory, monetary policy, inflation, keynesianism, classicism and neoclassicism

**JEL classification:** E31, E40, E12, E13

### **INTRODUCTION**

The evolution of the ideas concerning the monetary theory is strongly related to the important movements in the economic theory, so that the monetary research evolved together with these economic movements, considering many coordinates, related to the generalizing degree, the attitude towards the state role or the correlation on the time horizon (Popa, Bandoi, 2004).

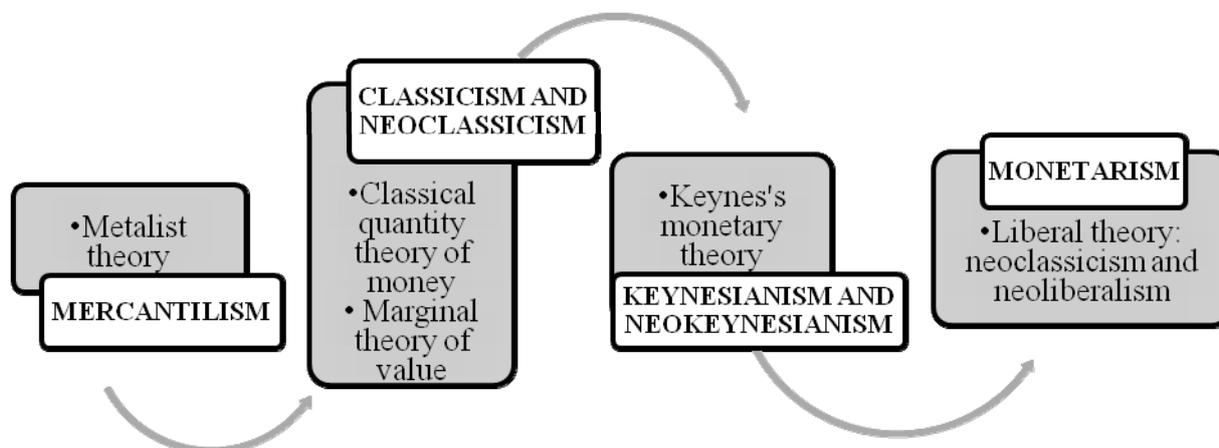
In the presentation of the monetary policy's history, Gheorghe Manolescu said "it is hard, or almost impossible, to establish the exact moment the new way split from the road of the conventional economical thinking. The monetary policy has a long scientific history and it is hard to find an area for major or radical innovations or a breach in the richness of ideas, from the mercantilists to physiocrats, from the classic economists to Keynes and Friedman, and from Don Patinkin's study of the discrepancy between what is monetary and what is real, to the first real success with the value theory" (Manolescu, 2009).

The monetary phenomenon complexity as well as the effects this induces in the economic and social life of the countries around the world has been and still is the subject of many controversies and disputes. The current organizing forms of monetary circulation from various countries and, also internationally, represents the result of a continuous innovations and transformations process in the monetary field.

There are many studies on the monetary policies, especially after the crisis of July 2007. The most remarkable reflections on the monetary policy are written by authors with profound knowledge in the matter of the monetary theory and practice history. Their capacity to deeply comprehend the evolutions in this area, their rich knowledge, help them complete a detailed

analysis in this area under the current conditions, dominated in these past years by major modifications, controversies and multiple risks.

The main economical thinking movements' influence on the monetary theory can be transposed into a figure of the monetary theories maintained until today, as follows:



**Figure 1. Main monetary theories evolution**

One can observe that the monetary historical evolution can be divided into the following periods: metal theory period, classic and neoclassic quantitative theory, “Keynesian revolution” period and the “monetary counter-revolution”. These monetary theory differentiation are not precisely delimited, they represent approximate periods of time in which those theories were dominant and not exclusive.

### **MERCANTILISM AND THE BIRTH OF THE MONETARY THEORY**

Although the fluctuations regarding the currency and its meaning in economy and society are much older, the first current economic thinking on which we focused is mercantilism. Great discoveries and conquests in the late fifteenth century and early sixteenth century lead to a considerable increase of trading. Between the sixteenth and eighteenth centuries, trade capitalism will develop spectacularly and so the conditions for the transition to the industrial revolution and the flourishing of industrial capitalism will be met. Mercantilism was an economic doctrine that dominated the XVI-XVIII centuries, separating the medieval society from the industrial capitalism. Among the most prominent representatives of the movement there were: Antoine de Montchrétien, Jean Bodin, Thomas Mun, John Law and Jean Baptiste Colbert.

I believe wealth and state power were the main objectives pointed by the mercantilists. From the mercantilists' point of view a state's wealth was expressed only by the amount of precious metals existing in the economy. The coins made of these metals were considered a necessary commodity and the only form of the nation's wealth. In the presence of money, business and commerce can develop. For mercantilists wealth equals money and the wealth increasing factors can be generated by: population growth, money abundance and state intervention in the foreign trade.

Various mercantilist authors such as Antoine Montchrétien, Jean Bodin, Thomas Mun, argue that monetary abundance has very favorable effects: actuates economic activity and allows currency price to decrease, i.e. the interest rate. In economies where precious metals inflows existed, and the economic activity registered an involution or regress, a "phenomenon" similar to the inflation

nowadays appeared. In fact, there was a mismatch between the actual economy - the amount of commodities and services available on the market at a certain time, and the nominal one – currency value.

State interventionism in foreign trade must not exist only because the monetary abundance stimulates the economic activity, but also because the export development is in itself favorable to the national industry and employment flourishing.

The state must intervene in the economic life to create public manufactories and provide aid and subsidies to private entrepreneurs. Inspired by Montchretien's "Treaty of political economy", Colbert develops his theory. Internally, colbertism advocated for the massive state intervention to create manufactures and installation and commissioning bonuses, as well as low-interest loans and decreased inland revenue. Externally, Colbert insisted on import restriction and exports stimulation, the goal being an active trade balance. Colbertism's greatest quality resulted in a powerful and competitive industry.

An emblematic author on theory and monetary practice in the late seventeenth century and the beginning of the next century, is the famous English economist John Law (1671-1729). He focused on the active role of money on economy and the macroeconomic phenomena in the eighteenth century Scotland and France. Law concludes that the economic recession occurs due to a higher currency offer than the demand and excess money offer leads to the appearance of inflation. Analyzing a number of problems such as the exported inflation mechanism, the financial model that he wanted to implement in the Royal Bank of France (known as The "Mississippi" System), the monetary aspects that determine economic stagnation and incomplete use of the labor force, Law managed to instill his ideas to the monetarists of the time. He believes that the economy suffers not only when there is a currency deficit, but also when we have an excessive currency. Achieving equality between the money supply and demand in terms of full employment in the labor market represents the optimum level.

Some mercantilists such as Jean Bodin (1530 - 1597), argue that increasing the coin amount in circulation leads to higher prices, thus outlining what would later become the coin's quantitative theory. He also emphasized the reverse relationship between the money purchasing power and the money amount in the economy. Therefore, mercantilists revealed the famous formula  $MV = PT$ , attributing to monetary increase the role of an economical increase centre. Bodin did not anticipate, however, that it is not the increasing of money amount in circulation that causes such price growth, but increased demand for commodities that the additional amount of currency in circulation allows. Mercantilism was sharply opposed by the currency's quantitative theory.

Thomas Mun (1571 - 1641), a representative of trade mercantilism, leaving from the existence of an excess trade balance, observes the link between England's foreign trade results and that of the internal market price levels. He notes that in the event of a large amount of currency in economy, price levels also rise for the export commodities, imports commodities become cheaper, and the balance is evened by leakage of money to the other countries. Thus, the monetary economy - actual economy relationship, in Mun's opinion, is determined by coin that is inextricably linked to the foreign trade: "money help trade and trade increases wealth in money" (Lupu, Trifu, 2006).

## **THE COIN AND THE MONETARY PHENOMENON IN THE CLASSIC AND NEOCLASSIC SCHOOL**

The money quantity theory can be considered a fundamental pillar in the analysis of monetary policy theories. It has known many adjustments and transformations over the years, since the sixteenth century to the early twentieth century, being accepted both by the classical economists: Adam Smith, David Ricardo, Jean-Baptiste Say, and so on, and by the neoclassical ones: Léon Walras, William Stanley Jevons, Alfred Marshall, Arthur Cecil Pigou, Irving Norton Fisher, etc.

From the late eighteenth century to the early nineteenth century, the quantity theory knows various transformations and updates, thanks to the contribution of some great economists. The

classic vision on monetary problems is still encountered in the works of Adam Smith, David Ricardo and Jean Baptiste Say, if we are to mention most classical liberalism representative exponents.

One of the earliest representatives of the classic movement is the English philosopher David Hume (1711 - 1776), who formed a thinking system with clear ideas that will be the foundation for many of the subsequent developments.

The main ideas and concepts systematically formulated in Hume's theses refer to the fact that prices in a country are determined by the currency amount in circulation, money that pass into a country have a correspondent in the movement of the commodities in that country, if money stock increases, the commodities prices rise and the money value decreases, if the commodities increase as quantity, their price decreases or the money value increases.

Hume's merit is that of having enunciated and supported the currency neutrality principle, basic principle in the economic classicism, which stipulated that the money stock had no influence on the production, but the increase in the amount of money led to proportionate modifications in prices.

From the classics' point of view, the monetary policy is non-existent money not having an important role in the economic activities. Salaries and prices are flexible and the money market balance is determined by the interest rate.

The classical theory, whose initiator was Adam Smith (1723 - 1790), argues for the lack of state interventionism at the economy level, the general economic equilibrium settling automatically, market forces leading to its restoration, according to the theory of the natural order. For the author of the "invisible hand" theory, there are four methods in which precious metals are used: as currency, as reserve fund, as international payments compensation fund and for the jewelry manufacturing. Smith rejects the mercantilist doctrine according to which a nation's wealth consists in cash and precious metals. In his opinion, the circulation costs being unproductive, they must be minimized by replacing gold and silver coins with cheap paper money. Hence his concept that: in economy, money stock is composed of two elements: money from precious metals and paper money which must be circulating in a relation of equality, that is, paper money stock cannot be higher than that of the coins.

Englishman David Ricardo (1772 - 1823), another important name of the classical school, is considered a supporter of the money quantitative theory. Ricardo believes that money only function as a medium of exchange. Ricardo insists in favor of demonetization of precious metals and introduction of paper money in circulation, but also for a fixed exchange rate to be established by the monetary authorities in order to avoid the depreciation of money (Smith, 2000). The English author was concerned that the money depreciation, due to the high price of gold was immediately followed by the rising prices. He believes that a normal amount of money in circulation should be determined by the sum of the commodities value. In regard to price fluctuation, this is due to changes that occur in the commodities production manner, due to labor productivity. French economist Jean-Baptiste Say (1767 - 1832), in his 1803 reference paper "Traité d'économie politique" emphasizes the role of money in the economy and is concerned with the economy performance problem.

The author of the market law considers that on the money market there is a permanent balance because "supply creates its own demand". The French author believes that the offer is the one that triggers the functioning economy mechanism. Everything moves according to some dynamics clearly-defined by the sentence: "products are exchanged for products". Referring to the role of money in the economy, the markets law author says: "In reality, we do not buy items for personal consumption using cash, money in circulation to pay them. First we must have bought this cash by selling our products" (Say, 1998).

In the last third of the nineteenth century a new group was formed with the purpose of forming a paradigm of thinking and explaining the mechanisms of the actual economy and society fundamentally different from previous ones. When it was believed that science finally discovered and convincingly explained the economic mechanisms, some technician-intellectuals, started to

develop a new paradigm. This task was assumed by the neoclassics. Thus, beginning with 1870 - 1871, a new paradigm of economic thinking appears- neoclassicism or economic marginalism. This school, through its complexity, represented on the one hand, a reaction against the economic classicism, and on the other hand, rebelled against the German historical school which, until then, had suffocated the theory with empirical facts. The Neoclassical liberalism of the economic theory or the marginalism has, as a characteristic, the preservation of the classical theory's fundamental assumptions, that is, the automatic balance, the state's non-intervention and the money neutrality, but it has brought several new elements: in the general economic balance (L. Walras, V. Pareto, I. Fisher) the marginal theory of value was launched, it introduced the dynamic analysis of achieving economic balance. Monetary theories, also called neoclassical, had an anti-Marxist feature, but also had concepts that have used Marx's ideas (the theory of imperfect competition or the theory of the economic cycles) revealing some contradictory aspects of the process of achieving economic balance. The neoclassics only provide the explanation for the market prices' oscillation around value, but not that of the nature of value itself.

### **KEYNESIAN SOLUTIONS FOR THE ECONOMICAL PROBLEMS CONCERNING MONEY**

Currency and interest accounted for one of the first advocates of Keynesianism and the deepest concerns throughout their theoretical and practical activities. Publishing several economic works, John Maynard Keynes addressed monetary issues throughout his entire work. Of all the published works that give shape to the Keynesian thinking physiognomy, there are "Treaty on the coin", "Treaty on Monetary Reform" and "General Theory". Apart of being a theory of the global balance, Keynes's "General Theory" is a theory of the monetary balance. In order to understand the mechanism of achieving Keynes's monetary balance, it is necessary to make a brief incursion into the elaborations of Knutt Wicksell and those of his followers at the Swedish School.

Daianu (1993) argues that Knutt Wicksell's fundamental idea is that monetary balance is expressed by equality and not by identity. He examines the indirect relationship between money and prices through interest rate. Wicksell highlights two interest rates, the natural (real, normal) one, noted with  $r_n$  and the monetary (market) interest, noted with  $r_m$ . The inequality of the two interests is the one to create economic issues and imbalances.

For the existence of monetary balance, an interest rate is required, which: corresponds to the marginal capital productivity, ensures equality between capital supply and demand and maintains price stability (Alexa, 2002). This balance being impossible to achieve, the currency neutrality is invalidated.

Wicksell supports the role of monetary policy in the fight against inflation and explains the effect of savings and investments on the global demand. He is a follower of the quantitative theory, emphasizing the interest rate's decisive role in explaining the adjustment of the global demand in regard to the money supply. Keynesians thought that monetary policy, by changing the money offer, could influence the aggregate demand and can lead, therefore, to manpower's full use without inflation. Keynes considered that full occupation of the workplaces is the central objective, that cannot be achieved for itself and on which the whole economic system relies. Keynesian theory argues that central banks should aim at achieving a compromise between inflation and unemployment, but has often favored the latter objective.

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In the interest analysis, unlike classics and neoclassics, Keynes proposed new versions. For him, the interest rate is not the price of savings, it is not a reward for giving up consumption, but a

simple "residue" left after consumption, a reward given for quitting hoarding. This saving in Keynes's view, can be stored in liquid form, or can be invested. The Keynesian analysis, as opposed to classics, does not find that equality between savings and investments, but between currency supply and demand and interest is formed on the money market, where money supply and demand are balanced.

John Maynard Keynes adds a new note, more personal, to the theory that he builds, in the sense that he believes that the interest rate too, in its turn, depends on two important factors: the preference for liquidity and the money amount in the economy. Thus, an increase in the money amount the economy leads to reduced interest rate, provided that the preference for liquidity would increase at a slower rate than the amount of money existent in the economy. Unlike the neoclassicists, for Keynes, the coin is not neutral in relation to the level of production and employment. Money demand and money supply have a direct action on interest rate, which in turn acts on the investment demand, influences volume production and employment levels.

Keynes was the first economist who showed that capital markets are not able to spontaneously guide the economy toward a satisfactory balance, being necessary to perform anticipations regarding the markets or future income. He modifies the classical analysis in a single point: for him, the coin demand depends on the interest rate. To the cashing request from transactions he adds cashing request from speculation, cashing that will be higher during financial costs increase and lower during the decrease period. Keynes did not fail to present and explain the conditions to be met to achieve the ideal situation of full employment, but he placed the explanation under uncertainty.

### **MONEY AND INFLATION - FUNDAMENTAL CONCERNS OF THE CHICAGO SCHOOL**

The beginning of the 70's eclipses the Keynesist theories and the monetary ones know a certain progress. Monetarism enters a stage of its revolution both as a syndrome and as a doctrine. Between 1970-1972, despite numerous efforts, prices have continued to increase, inflation generalized, unemployment increased and economic growth slowed down, so the first monetarist attempt ended in failure.

The beginning of the monetarist theory is marked by the Milton Friedman's publication in 1956, of the quantitative money theory. Friedman's and the Chicago School's greatest achievement was to show that money stock is not influenced by the interest rate. In their view, money stock is a useful variable in the economic revival policies. Also, another idea proposed by Friedman, was that only unanticipated shocks in money stock have effects on the real economy, an idea rejected by the economic practice.

Barro (2007) considers that Friedman has an essential contribution in the area of the monetary policy. In his articles Friedman argues that changes in the money stock are independent of those in the money demand. Emphasizing this, he sees positive correlation between money and production as a reflection of causality from money stock to production.

Promoting a monetarist theory of a rather general nature, the Chicago School explanatorily covers all forms of market economy. Cerna (2012) shows that monetary theories are supported by prestigious economists, one of them being Milton Friedman, author of "Inflation and monetary systems" (1968). Economist awarded with the Nobel Prize in 1976, Friedman builds a new inflation and unemployment theory, recommends monetary rules that can lead to stabilize the economy and acknowledges that on short term, we can fight against unemployment by means of a "creative inflation", but on the long term, the result is an inflation spiral. For him, the keywords are monetary stability and credibility. The basic rule proposed by Friedman is constant money stock increase with a certain percentage each year, its public announcement and keeping it unchanged for a long period of time. From here you can form some principles on which the monetarist doctrine is based:

- Monetarism attributes the decisive role in the development of the economical activity and in the price establishment to the coin, to the money stock, to its modification and its money circulation;
- Money stock is adjustable, the economic balance is achieved by the official control of the money stock;
- "The immediate cause of inflation is always and generally the same: an abnormally rapid increase in the quantity of money related to volume production" (Friedman, 1969). Monetarism only recognizes from the multiplicity of inflation causes the money stock growth rate as crucial and unique, and the anti-inflationary solution is imposed automatically;
- fiscal policy can't do anything without monetary policy unless , it is on short-term;
- the coin demand is relatively stable, it keeps the economy real and the roots of instability are found in the nominal economy- uncontrolled fluctuations of the money stock;
- monetarism is particularly concerned with inflation and less with unemployment;
- it is a doctrine built on liberal positions and his followers do not want the state intervention in the economy;
- Externally, monetarism wants exchanges at flexible courses; currency should be allowed to float freely like any other commodity, the law of supply and demand – it is the only way we can create mechanisms to even up the balance of payments.

The economy's main opponent is identified by Friedman as the suffocating state, which through the central control of wages and prices is a source of inefficiency due to distortions in the price structure. For Friedman, the market is the most effective way of adjustment leaving to the prices the task of signal providers which allow rational economic calculation and resources allocation. Another important element of the Friedmanian contribution is the privatization program of some sectors considered to be state monopolies, especially in public education.

### **THE AUSTRIAN SCHOOL'S VIEW ON CURRENCY AND INFLATION**

The Austrian School was founded by Carl Menger (1840 - 1921), and its main representatives in the twentieth century are Ludwig von Mises and Friedrich von Hayek. Their main concerns were economic problems of vast interest such as currency, inflation and unemployment.

In relation to inflation, according to the Austrian school, this phenomenon is purely monetary. The Austrian school representatives believe that the currency is never neutral, neither on short term, nor on medium term and neither on long term. In their opinion, banks should be built on universal principles that would prevent "counterfeiting" the relative prices in strictly monetary ways. These forgeries lead inevitably to crisis and recessions.

Austrians share the view that the interest rate is determined independently by the value rates of time preference – commodities supply and demand present in exchanges with future commodities - and that productivity or marginal efficiency of capital is limited to merely affect the present value of commodities' capital. On the market, the price (cost) of a capital commodity tends to equal value – discounted as interest rate - of its future stream of rents, or series of values corresponding to the marginal productivity of capital equipment. Therefore Austrians argue that it is the capital's marginal productivity that tends to follow the interest rates, and not vice versa, and that only in balance - which is never really reached - the two values become equal.

According to representatives of the Austrian school, the leaving point of the imbalances causing economic and financial crisis is the banking system. They accuse the maintaining of central planning performed by the central bank, called the money printing press, the state monopole through the forced legislating course and massive interventionism in the economy through various regulations.

Ludwig von Mises, an apostle of the pure liberalism, noted that his ancestors' deficiency is, without a doubt, the money analysis. In his view, prices, wages and interest rates are indicators of the production factors' degree of scarcity, and inflation followers may artificially alter these

indicators creating a false illusion of wealth. He draws attention to stabilization policies of the general level of prices, not only because they mask the credit expansion during the periods of economic growth, but also because of the widespread mistaken belief that the currency should be neutral. Inflation occurs when, after an increase of the amount of money issued by the government, the monetary unit's purchasing power decreases and thus the amount of commodities that can be purchased in exchange, decreases. Mises emphasizes that people often misunderstand this phenomenon, attributing it to increase of prices and not to the increase in the amount of money. He also added that inflation is not the consequence of the way in which money is spent by the government, but of the way one obtains it. If the government would increase taxes, taxpayers would spend less, and prices would remain the same, but if it would print money, then inflation would occur as a result of the decrease of their purchasing power. This phenomenon affects differently the segments of the population, namely: for the first persons to profit from it, inflation is not harmful, but for those who arrive too late to the „new” money, the earlier losses remain incorrigible.

Another great coryphaeus of the Austrian school is Friedrich von Hayek. Based on Mises's monetary theory he shows that if the amount of money in circulation is maintained at a constant rate, it becomes incompatible with the required money function regarding the coordination of the economic agents' decisions and behaviors at certain periods. Hayek arrives at the following conclusion: "We must accept, as contrary to the predominant vision as possible, that the instability of the money power purchase is not one of the most important disorder sources in the economy, that came from money. On the contrary, this source is the tendency manifested in the case of all commodity currencies, stabilizing the money power purchase even when the situation of the general offer is changing, tendency that has nothing to do with any fundamental determinant of economic activity" (Hayek, 2005). According to him, an infusion of money shatters the price structure especially that of the interest rate that falls below the normal rate. In various articles, he particularly takes into account the development of the inflationary pressures. Austrian author agrees that the inflationary phenomenon is purely monetary in nature, and the main cause of inflation must be sought in the monetary policy, not anywhere else.

For Hayek, the unions represent a serious threat for price stability, because they produce a suboptimal allocation of production factors instituting laws, regulations and minimum wages. This attitude determines him to criticize Keynes's theory, according to which workers and unions are victims of monetary illusion, while all the economic agents anticipate increasingly the consequences of inflation and start reasoning in real terms (Friedrich von Hayek, 2005).

In regard to unemployment, Austrian authors agree with Friedman, stating that, if a policy to reduce unemployment below its equilibrium level through monetary means is maintained, the result will only be the supplying of the inflationary phenomenon (Braila, 1998).

What Austrians have to reproach both to Friedman and Keynes, is that the unfolded analyses are too global, ignoring the effects of the monetary expansion at a micro-economic level. These effects are important because the coin inflow into the economy does not occur uniformly throughout the entire territory and in all activity departments, or at the same time. Both Hayek and Mises advocate for the currency freedom without the government's intervention and control in the field and are convinced that the currency is one of the most relevant and important aspects of the economy. Murray Rothbard in "The Case for a sound currency", states that the actual commercial freedom requires a commodity which plays the role of money, be it gold or silver.

The monetary policy advertised by the monetary authorities in the late twentieth and early twenty-first century is based on a number of theories that include issues such as direct inflation targeting or deduction of an empirical rule to be followed based on existing data. Inflation targeting is a problem that concerns all developed countries.

## CONCLUSIONS

As a conclusion, monetary theories have emerged and developed in close connection with economic reality and have taken into account the role that the currency has in the macro-economic

process. The evaluation of the monetary theories is difficult and always susceptible to be questioned by historical developments.

Reflecting on the above, there is variety of theoretical approaches that are considered circumscribed to money theories. However, it appears that in this area, as in other areas as well, it is wrong to expect from the economic theory what it cannot provide, admitting that what the monetary policy empirically acquired cannot be obtained with theoretical models even if they are the most ambitious ones.

Even if you currently one cannot speak of generally valid dogmas, the economic life acutely felt the need for structure and order. It requires taking ideas from several doctrines, combining them with innovative ideas and experience to find viable, reliable and globally accepted solutions. In the future, a process of unification of current directions regarding monetary policy, as well as an integration process of the money phenomena regarding the contemporary economic universe are expected. Currently, in the developed market economies the monetarist theory is mainly predominant; however, it is the Keynesian theory the one to enjoy a remarkable audience. If we consider that most monetary theories that have succeeded themselves throughout history were transient stages in the science of economics, it would be expected for this phenomenon to repeat.

We can state that the balance between the money supply and demand is the most complex problem of the monetary policy. The monetary policy is engaged in explaining the main structures of variables and causal links involved in the balance achievement, providing money analysis and practice possibilities of choice and logic connection of the monetary-economic values quantities with which they operate.

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