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A Note from the Editors

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Congratulations

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Economics Graduates (May 2002)
From the Editors

In the last two years, we have used the editor’s corner to report on the economics club activities, and the economics departments’ various seminars. The most important accomplishment of this semester is the number of student’s participation in professional meeting this year. Graduate and undergraduate economics students presented papers in some of the most prestigious economics meeting in the US. They presented papers, chaired sessions, and served as discussants at the following four meetings:

1. Annual Meeting of the Association for Institutional Thought (AFIT) – Albuquerque, New Mexico – April 10-13, 2002.
3. 28th Eastern Economic Association Annual Conference in Boston (MA), March 15-17, 2002.

More detail on these conference participations is provided in the new “Congratulations” page in which we list students’ accomplishments as well as the names of all economics graduates (May 2002).

As usual the economics department is keeping its faculty and students super busy by the various weekly seminars organized by Professors Lee, Wray, Bell, and Webb. One of the highlights of this semester’s seminars was the visit of Professor Larry Hickman, Director of the Dewey Center at the Southern Illinois University. Hickman presented a lecture on: “Reconstructing the Fact/Value Split: Habermas, Dewey, and third Generation Critical Theory.”

The economics club co-sponsored a major local event featuring Michael Moore, director of the movie “Roger & Me,” author of the best-selling books Downsize This, and Stupid White Man, and Star of the Emmy-Award-Winning series “TV Nation.” Michael Moore spoke before an audience of 600 people at UMKC, and signed copies of his book to economics club members. We thank Dr. Stephanie Bell for all the effort she made behind the scene to make this event happen.

Once more, we would like to thank the UMKC writing lab staff, especially David Foster, for their kind help in the editing process of many articles in Oeconomicus.

The Editors
Fadhel Kaboub & Ben Young
On the Move with Capitalism

Minsky’s Financial Instability Hypothesis

By Eric James Embry

I. Introduction

The essence of “The Financial Instability Hypothesis” is derived from the works of Keynes, Fisher, and other economists who have attempted to explain the reason for the Great Depression and other economic crises. Minsky’s model modifies Keynes’s General Theory by relating it to the current financial structure. Minsky also draws upon Fisher’s idea of “over-indebtness” and “debt deflation.” The idea behind the Instability Hypothesis is to explain the upward and downward movement of capitalistic economies. In doing this, Minsky challenges the classical economic precept that the market is always seeking and sustaining equilibrium. The main focus for Minsky is that investment is fueled by expected profits and, in order to make this investment, the entrepreneur takes the borrower position. It is the relationship between firms and banks that tilts the scales of instability.

In order to understand the workings of the financial instability hypothesis, it is important to understand previous explanations of the capitalistic economy. The highly criticized classical model states that the market is always moving toward equilibrium. The idea is that there is an invisible hand [Smith 1937, 423] that moves according to human desires and needs that causes supply and demand to reach a certain point of agreement. If this agreement is not met, it is not the fault of the internal economic system but of the external environment (e.g. sunspots or forest fires). In 1933, Fisher opposed this view by stating that there are many forces that are constantly disequilibrating the economy. If the economy always works itself out, then why are firms either overproducing or underproducing, why are consumers either over- or under-consuming? There are so many variables in the economic system that it is impossible to assume that everything will work itself out. Fisher is concerned about debt and the role of over-investment and over-speculation functioning off borrowed money. His reasoning is that in a state of over-indebtness, borrowers will try to liquidate their loans, beginning a run to money. Then, as more and more borrowers try to liquidate their loans, price levels fall because of “distress selling” leading to the sluggish exchange of money, which starts a decrease in profits and an increase in bankruptcies. Fisher further explains that it is the combination of over-indebtness and debt-deflation that causes a downturn in the economy. However, because these two share a causal relationship they are normally analyzed together.

The two diseases act and react on each other… deflation caused by the debt reacts on the debt. Each dollar of debt still unpaid becomes a bigger dollar, and if the over-indebtness with which we started was great enough, the liquidation of debts cannot keep up with the fall of prices, which it causes. In that case, the liquidation defeats itself. While it diminishes the number of dollars owed, it may not do so as fast as it increases the value of dollars owed. Then the very effort of individuals to lessen their burden of debts
increases it, because of the mass effect of the stampede to liquidate in swelling each dollar owed [Fisher 1933, 10; emphasis added].

Keynes’s *General Theory* recognizes the instability of capitalist economies, however, his idea is that capitalist economies are inherently unstable but not violently unstable. He supports this with the behavior of the marginal propensity to consume i.e., when a community’s output increases because of an increase in employment, it will not have a drastic effect on the multiplier \((I=Y=C=Y=C)\). As employment increases, consumption will also increase, but not by as much as real income increases. Employment will diminish, causing consumption to fall, but less than the fall in real income. The second reason for stability is that, as the prospective yield of capital or rate of interest changes, because of the behavior of the MEC, the rate of new investment will not be greatly impacted. Keynes believes that if interest rates or prospective yields change because of the increasing costs of output, the rate of new investment will not be excessively responsive (up or down). The third condition is a statement of the stickiness of wages and the stability of prices. This condition ensures that wages will not fall immediately because of labor contracts and the high propensity to resist declining wages. In the fourth condition of stability, Keynes addresses recession and recovery. His main focus is on the rate of investment and how the decrease in investment sooner or later will lead to an increase in the MEC, so that it is “merely a question of time” before the MEC increases enough to bring about investment. It is Keynes’s works that form the basis for Minsky’s instability hypothesis.

**II. The Instability Hypothesis**

The Instability Hypothesis characterizes the economy as an extensive, complicated financial system based on real capital assets. The hypothesis takes into consideration that most firms finance investment and that liabilities and profits are recognized by a series of cash flows. In other words, firms sacrifice present interest costs in expectation of profitable future cash flows. In order to finance resources needed now for future profits, a peculiar relationship develops between banks and firms. It is this relationship that governs the needed return on investment in accordance with interest rates. Suppose both parties sit down at the contracting table. The firm brings documents that forecast future costs and profits. The banker then decides the interest rate that is suitable for the amount of risk at hand. A monthly payment is then decided and, as soon as the firm takes control of the funds, a credit is realized on the firm’s balance sheet. Now the firm is not only under pressure to meet costs of production and other product-related costs but is also responsible for the loan payments that are required.

It is in the relationship between firms and bankers that the “veil of money” is derived. There are two theories of money. The predominant view is the Quantity Theory of money, which characterizes money as a medium of exchange for real goods. In this exchange, it is not the possession of money that is desired but the possession of some good. The other “veil of money” concept belongs to Keynes and attempts to explain the cyclical behavior of the transfer of money with the bank centrally located. In this model, money is realized as the vessel in which real wealth is held.
The “veil of money” leads us to the characterization of banks and their relationships with firms. The instability hypothesis places banks in the same category as a profit-seeking firm in respect to innovation. Banks want to loan, and in order to do so, they must be at the top of their game, so to speak. A bank must find ways to differentiate themselves from competing banks. In doing this, a bank finds new ways to make loans and different methods of honoring the loan. Because of fewer restrictions on banks concerning lender/borrower relations, more contracts are supplied, which in turn is directly related to the supply of money. For example, let’s suppose that I want to buy a car and I currently hold a checking account with a commercial bank. When the bank issues me the desired funds, it will either credit my checking account or issue me a check drawn on my loan account. When I purchase this vehicle with a check and the dealer deposits it into his account, a debit is applied to my account and I incur a liability on that account. In this transaction, actual cash was never exchanged. Instead, an agreed-upon amount of bankers’ money exists between my bank and the dealer’s bank. This is one way that banks can increase the money supply and the velocity of money through cash transactions. This conflicts with the classical idea that the money supply is controlled only by the Federal Reserve and has a constant velocity. In other words, if you can’t issue money and money is always being reinvested in the market, then the velocity of money must remain close to constant.

The instability hypothesis realizes three different income-debt categories for economic units: hedge, speculative, and ponzi finance. The first of these economic classifications, hedge financing, occurs if the firm or economic entity can meet all its liabilities with equity or cash flows. Speculative finance is the economic position in which actual cash flows and expected cash flows aren’t enough to cover current liabilities on the balance sheet without rolling over debt. Thus, a speculative unit does not have much of a safety margin or cannot meet debt with the recognized or expected cash flows generated by a particular capital asset; therefore debt must be incurred in order to pay debt. Ponzi financing is the economic position in which the firm is mainly concerned with holding on. Profits are no longer an option; the firm is borrowing just to pay interest on past debts. This is the point at which the firm is operating only to pay fixed expenses.
I believe that speculative financing requires the most attention. When a firm is engaged in speculative financing, it is very dependent on the interest rate and financial market conditions. With market pressure being applied, the consideration of both factors influences the firm’s decision to incur debt. If the firm is covering operating expenses and production costs with cash flows but cannot meet dated liabilities like loan or dividend commitments, the chances are that the firm will incur debt. As market conditions and interest rates change, the speculative firm can easily become a ponzi firm. However, unless demand goes up and interest rates fall, the chances of the firm going the other way are unlikely. And since the economy possesses disequilibrating forces, a firm staying at its current speculative position for a long period of time is unlikely. It is when a firm operates under ponzi conditions that the economy is at its most fragile point. This is the condition Fisher describes in his debt-deflation theory that causes a run to money because of distress selling. Instead of firms paying back their debt and returning to a speculative position, they pay back their debts, causing inflation in the dollar’s value because of the increased demand and limited supply. As Fisher put it, “the more the debtors pay, the more they owe.” This leads to the idea that the government should intervene as a last-resort lender at this point. However, the common argument here is that if government fills this position too frequently, it will negatively affect the economy and promote risky lending because the government is acting as a safety net.

III. Conclusion

In the previous works discussed here, Minsky follows the capitalist economy from The Great Depression to present times. He recognizes the two-price structure of current output and the prices of assets (capital and financial). He notes that it was the failure of this structure and the lack of a strong central bank that brought about the depression of 1929. He traces the changing models of capitalism, the changes in government, and the effect these had on the economy. Minsky is highly skeptical of the banking industry and stresses that they are profit-seeking intermediaries and have superior knowledge of their customers seeking loans. He believes that the innovation of banks creating money, the ability of households to consume more than their incomes via credit cards, and conflicting governmental policies are all reasons for the economy changing from robust to fragile. However, Minsky realizes that governmental programs like unemployment insurance, sound fiscal policy, and the role of lender of last resort keep the economy from being violently unstable. The instability hypothesis focuses on the internal dynamics of a capitalist economy and attempts to explain why recession and recovery occur. Fisher, Keynes, and Minsky all agree that the combination of government control and the properties of investment together will speed recovery and limit recessions.

References


1979 Policy Change

By Franziska M. Pircher

In the last 15 years, the Federal Reserve has experimented with a number of targets for monetary policy, and each target has supposedly been linked to inflation [Wray and Papadimitriou 1994, 10]. This paper will cover the most well-known target switch by the Federal Reserve. In October 1979, the Federal Reserve made a major announcement for change in the target of monetary policy. The Federal Reserve had a new chairman, Paul Volcker, and a monetary target change needed to take place to take control of the inflation that had been experienced throughout the 1970’s. The new target was control over the growth of the money supply. This paper will examine the 1979 policy change and the theory behind it. First, I will begin with the events that led up to this major change, the affairs of the economy, and the changes that took place in unemployment, inflation, interest rates and the money supply. Then, I will take a look at why control by the Federal Reserve did not materialize and what else was happening to make it harder to control the money supply. Next I take a look at what effectiveness really means and whether this policy was effective. I will explain what role the Federal Reserve decided to play after this, what the new target was, and why there wasn’t an announcement concerning the change back to the old methods.

The Goal

The major reason for the Fed’s change of monetary targets was to combat the increasing inflation that was being experienced throughout the 1970’s.

Figure 1: Consumer Price Index for all Urban Consumers: All Items 1982-84=100, Seasonally Adjusted.¹

As the graph shows, the CPI increased from 46.8 in January of 1974 to 74.4 in September of 1979 (indexed). During the 1970's inflation was becoming a problem. The inflation rate had risen from 6.4 percent in 1976 to 8.9 percent in 1979, and the CPI had risen from 4.8 percent to 13.3 percent, respectively [Friedman, 1988, 53]. The Fed adopted the target of non-borrowed reserves, which were to be kept at levels consistent with the goal of monetary growth designated at each FOMC (Federal Open Market Committee) meeting. The previously targeted federal funds rate band was widened by an enormous amount, and the rate was allowed to fluctuate freely [Gilbert 1994, 35; and Friedman 1988, 53]. The idea was to reduce, over time, the rate of growth of the money supply in order to curb the fear of an uncontrollable inflation spiral [Friedman 1988, 53]. In the late seventies, the Federal Reserve had a main policy goal in mind, ensuring price stability and promoting financial market stability [Wray and Papadimitriou 1994, 7]. The switch to monetary aggregates, particularly to M1, was implemented to offer an alternative in the fight against the uncontrollable inflation experienced in the 1970’s. The Federal Reserve believed it could announce its growth targets and simply hit them [Wray and Papadimitriou, 1994, 11]. What actually happened came as a surprise. The idea that control of the money supply would lead to stable prices came from the widely discussed monetarist theory.

Monetarism

The father figure stands as Milton Friedman, credited mainly because of his modern quantity theory of money approach to the economy. Friedman initiated the replacement of the original quantity theory of money with his theory of the demand for money [Snowdon et al. 1994, 139]. This brought back the importance of monetary impulses in explaining changes in money income or prices. The demand for money is assumed to be a stable function that depends on permanent income, wealth, rate of interest, and expected inflation, and this leads to velocity being stable [Peterson 1984, 380]. In the short run, output, employment, and prices can be affected temporarily by changes in the money supply. Friedman concluded “that substantial changes in prices or nominal income are almost invariably the result of changes in the nominal supply of money” [Snowdon et al. 1994, 140]. Monetarists stated that monetary authorities could control the money supply, and Brunner (1968) furthered this argument. Brunner shows that “pronounced accelerations in monetary forces are followed subsequently by accelerations in the pace of economic activity” and vice versa. The framework for the monetarists is that the money stock (M) is a product of a multiplier (m) and the monetary base (B) [Brunner 1968, 16].

\[ M = m B \]

Brunner concludes that there are two clear facts about the control of the money supply. First, Brunner argued, the monetary authorities directly issue the base money and, second, the differences in the base money are “the single most important factor influencing the behavior of the money stock” [Brunner 1968, 21]. For Brunner, the movements in the base money are the sole responsibility of the monetary authorities, and the interaction of the public and the banks are a response to it. One of the central tenets to the monetarist position is that authorities can control the money supply if they choose to
do so [Snowdon et al. 1994, 145]. Friedman demonstrated that “inflation is always and everywhere a monetary phenomenon” [Snowdon et al. 1994, 159]. Monetarism puts inflation in terms of the growth of the money supply [Laidler 1990, 50].

This theory laid the basis for policy in 1979. The Federal Reserve believed enforcing tight money policy (monetarism) and hitting the targets, the Fed would have control over inflation and induce only temporary effects on the economy [Wray and Papadimitriou 1994, 14]. The primary operating target became non-borrowed reserves [Mishkin 2001, 470]. However, Poole (1982) argued that the key decision variable for the Fed was actually the level of borrowed reserves. The Fed targeted low growth of the reserves, which through the deposit multiplier should have resulted in low growth of monetary aggregates by placing pressure on the banking system to slow the economy; the end result would be the elimination of inflation [Wray and Papadimitriou 1994, 14]. Unfortunately, things did not go as smoothly as planned.

What Else was going on?

Economists in building economic models and suggesting policy prescriptions usually prefer that one variable change at a time. In mathematical economics, it is hard to determine the validity of a policy when even two variables have changed at the same time. Ceteris paribus, meaning all else held constant, is a phrase favored by many economists. During the time when the monetarists’ theory was being implemented into prescribed monetary policy, the relationships between the variables would have been easier to evaluate if other major changes had not been going on in the economy. Several external shocks hit the system at the same time as this policy change. The imposition of credit controls in July of 1980 and the recessions in 1980 and 1981-1982 lessened the ability of the Fed to control the economy through monetary policy [Mishkin 2001, 471]. The biggest shock that made monetary control difficult was the bank deregulation of 1980. Along with this came accelerating financial innovation, which included adding new categories of deposits such as NOW accounts [Mishkin 2001, 471]. This type of innovation contributed to the changing of the definition of monetary aggregates (e.g. M1).

The bank deregulation act was officially called the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). It changed many facets of the banking system. First, it changed the reserve requirements for all banks within the system. Before this legislation, only member banks were required to hold a reserve ratio; afterwards, every bank within the system had a reserve requirement (however, some state banks had reserve requirements before this legislation). Banks were defined, for this Act, as commercial banks, mutual savings banks, savings banks, savings and loan associations, and credit unions [McNeill 1980, 444]. Before this legislation, there were 16 different categories of reserve requirement percentages, up to a ceiling of 16 percent [Vorst 2001]. Afterwards, there were only two categories: 3 percent for transaction accounts of $25 million or less and an initial ratio of 12 percent for total transaction accounts in excess of $25 million [McNeill 1980, 444]. These benchmarks get changed in December of every year and are not $25 million now.

The second major change for banks came hand in hand with the new reserve requirements and had been proposed years before. This was brought up in the Board of
Governors *Fifty-First Annual Report* (1964): “The interests of equity and efficiency would best be served if all commercial banks were obligated to observe the same reserve requirements and if, at the same time, such banks were afforded access to the Federal Reserve Bank discount window” [McNeill 1980, 444]. The discount window was opened to all banks to help them meet the established reserve requirements. This can be seen as one of the explanations for the historical height of the federal funds rate during the policy change period. Many banks, new to the concept of reserve requirements, were scrambling for funds to meet the required reserve ratios. Banks first turn to the federal funds market for these funds, and so the high demand drove the rate sky-high. In turn, the discount rate also increased to as high as 14 percent in May of 1981. The banks were trying to get funds, and yet the Fed’s new policy was for control of the money supply. The Fed was trying to hold on to its targets, and the only thing that could give was the interest rate.

The pricing of services offered by the Fed to the banks changed as well. Before DIDMCA, only member banks were allowed to use the services offered by the Fed, and they were priced at zero (that does not imply that they cost zero) [Vorst 2001]. After DIDMCA, the Fed had to publish a set of pricing principles and a schedule of fees for services like check-clearing and collection, wire transfers, Federal Reserve float, automated clearinghouse, securities safekeeping, and currency and coin services of a non-governmental nature [McNeill 1980, 447]. In addition, the Board of Governors had to price these services explicitly and offer them to non-member banks as well. The Board was also required to give due regard to competitive factors, which means to price the services based not only on costs but also on a market determined price [McNeill 1980, 448].

There were three other major parts to the DIDMCA of 1980, and they contributed to the difficulty the Fed was having controlling the money supply. The first was a minor change that was added to the Banking Act of 1933; it increased the deposit insurance from $40 thousand to $100 thousand dollars per account [Vorst 2001]. Another part of the DIDMCA was that it allowed interest to be paid on checking accounts. This changed another part of the Banking Act of 1933. This change turned banks into more competitive institutions, so as they are scrambling to meet their reserve requirements, they also had to beef up their interest options on checking accounts to keep business. NOW (negotiable order of withdrawal) accounts became available in states where they weren’t previously available. This was part of the financial innovation that banks were establishing to avoid some legal bounds. This Act of 1980 changed the banking system at a very volatile time, and increased dramatically the difficulty the Fed faced in its new monetary control target.

**Endogenous or Exogenous Money?**

There are two ideas surrounding the money supply and its control. Monetarism holds one of the ideas, that the money supply is exogenous and under the control of the central bank. For Monetarists, money is used to facilitate exchange and evolved from a barter economy. Money is a neutral component in the economy.

The other idea, which is becoming a more popular view in recent literature, and is held as a central tenet to the Post Keynesian theory, is the endogenous approach to the
money supply. Keynes argued in his General Theory that money must become a unit of account before it can be used to facilitate exchange. Keynes ideas also differed greatly from those of the Monetarists about the origins of money. Now I will briefly describe the Monetarists’ approach to money, which can be described as the exogenous approach. Then I will compare with it the Post Keynesian endogenous state money approach.

Money, for Monetarists, is “merely a neutral link between transactions in real things and real assets” [Keynes 1973, 408-9]. Monetarists believe in the orthodox view of money and prices. An auctioneer is assumed to set up the prices of all goods in relative terms of all other goods. The auctioneer adjusts this price vector until there is no excess supply or demand for any good. This price vector is set before any trading occurs and everyone knows the final prices (perfect knowledge). Every commodity could possibly function as “money” because every price is known in relative terms of every good. Money, as we know it, came about to serve as the nominal price of the goods.

Monetarists are very well known for their belief that the central bank can control the money supply. This is referred to as the exogenous money approach. Monetarists believe that the money supply consists of a multiplier times the monetary base. The monetary base is said to be under complete control of the central bank and government because it is the reserves and fiat money in the system. The variation of the multiplier was “proven” by Brunner (1968) to be an insignificant part of the variation of the money supply, so any instability in the multiplier can easily be offset by the control of the monetary base. Friedman came up with an explanation of the effects that money had, stating that money can have a short-term effect on the economy. However, he was in line with the orthodoxy stating that long-term effects were neutral. Friedman and other monetarists believe that prices and the supply of money are directly linked. Any increase in the supply of money will produce a proportionate increase in prices. Friedman believed inflation was “always and everywhere a monetary phenomenon” [Snowdon et al. 1994]. This exogenous approach to money leaves banks as passive intermediaries in the economy, constrained in their lending by the given level of reserves in the economy at any point in time.

The Post Keynesian approach is developed from many well-known monetary theorists. Influences are mainly from J.M. Keynes, Abba Lerner, and Georg Knapp. Their idea of the origins of money is very different from the monetarists’ approach. Lerner explained “the modern state can make anything it chooses generally acceptable as money... But if the state is willing to accept the proposed money in payment of taxes and other obligations to itself the trick is done” [Lerner 1947, 313]. Lerner emphasized, “The basic condition for its effectiveness is that it should be generally acceptable” [Lerner 1947, 313]. Knapp (1924) argued, “the state does play a critical role in determining what will serve as the unit of account” [Wray 2001]. Wray states that Keynes endorsed this view [Wray 2001].

The state theory of money is explained by the taxes-drive-money view of the origins of money. The government’s ability to tax sets the acceptance of that which is necessary to pay taxes (twintopt). The government has the monopoly on high-powered money, and the population needs it to pay the taxes, which have been imposed upon them. The government can set the conditions for the population to obtain it, and it is within this scope that money receives its value to the population. The government must normally spend more money than it takes in (taxation) because the public will want to
hold some extra money (in case they may lose some in the wash). So, deficits should be accepted as the norm [Wray 1998].

The Post Keynesians have a very different view of the money supply as well. They believe that the money supply is endogenous. This means that they view banks as active, profit-seeking intermediaries and believe that they are not constrained in their lending practices. The central bank or the government cannot control the money supply, and the public actually decides how much money they want to hold.

Post Keynesians describe the leveraging of fiat money that takes place in the economy. Banks are required to keep a reserve ratio on their deposits, and reserves are the means of payment among banks (clearing of checks) and to the central bank. If the banks do not have the reserves, to say, meet a payment, then the central bank must be able to step in and make sure that reserves are lent to that bank’s account so it may resume its activity. If the central bank cannot or will not step in when needed, then banks might have checks bounce and thus the population would no longer trust that bank, or maybe any bank, with their deposits. This would end up causing a nation-wide bank panic, so the central bank must be able to add reserves and reduce reserves as necessary. Reserves do not earn interest, so the banks buy government bonds to get an interest-earning alternative. This keeps the overnight lending rate (Federal Funds Rate) on target. Too many reserves in the system and the rate would fall to zero. However, currently we have a lagged reserve accounting system, and banks have time to check their required amount and borrow or lend the necessary reserves through the overnight lending window. So, the credit activity of banks accommodates as the demand for loans changes. A new supply of money is created with bank loans and is endogenously (within the system) determined by the demand for bank loans [Wray 1998, 77-94]. The banks do not make loans only if they have extra reserves (Monetarists view); if they need extra reserves to meet the requirements, they can borrow through the discount window. Banks are profit-seeking intermediaries and lend out of the willingness to borrow by the private sector. This is the ‘loans create deposits’ view [Minsky 1993].

These two views of the monetary system are quite different in economic reality and lead to extraordinary differences in policy conclusions. The Post Keynesians seem to have a better grip on reality with the endogenous approach, but it does seem to leave monetary policy clueless. The Monetarists’ exogenous approach does not seem to be attainable in our present economy, but it does try to use monetary policy as a useful tool.

Effectiveness

Defining effectiveness is a hard thing to do. Do you look at the explicit policy aim, or do you look at the economy as a whole, or do you look at single parameters within the economy? The Federal Reserve has set out its main policy goals, and so I believe it should look at them, all of them, when deciding whether a certain policy is effective or not. Looking at the economy is the best way to determine effectiveness.

The Economy

The Federal Reserve or any central bank usually mentions six major objectives for the aim of monetary policy: (1) high employment, (2) economic growth, (3) price stability, (4) interest-rate stability, (5) stability of financial markets, and (6) stability in foreign exchange markets [Mishkin 2001, 454]. The policy aim of 1979 was strangely
focused on only one of these objectives, price stability (occasionally, however, it also focused on the foreign exchange value of the dollar) [Wray and Papadimitriou 1994, 9]. The other objectives are placed in the boxing arena for a series of knockouts; they seemed to be essentially ignored and empirically show just that. Some believe that this stable price pursuit since 1979 has contributed to high levels of unemployment, low productivity growth, and reduced economic growth in the U.S. throughout the 1980’s (and 1990’s)(in comparison with the performance between World War II and the early 1970’s) [Wray and Papadimitriou 1994, 10].

Benjamin Friedman argues the opposite; that the Fed did carry through on its commitment to contain and then reduce the growth rate of the M1 money stock [Friedman 1988, 54]. He states that the “gradualist” objective at the Fed in these years was to reduce the growth rate of M1 by around 1 percent per year” [Friedman 1988, 54]. In 1978, 8.2 percent was reported, and so targets could be implied at 7 percent for 1979, 6 percent for 1980, and so on. Friedman stated,

Although M1 had grown at a 9.0 percent pre annum rate in the first three-quarters of 1979, with the sharp policy shift in the final quarter the growth for 1979 as a whole was 7.9 percent. A continuation new policy delivered 7.3 percent M1 growth in 1980, and 5.1 percent in 1981. For this three year period viewed as a whole, the new policy did manage to achieve results roughly consistent with the objective of reducing money growth by one percent per year [Friedman 1988, 54].

![Graph of M1 and M2 Money Stock](http://www.stls.frb.org/fred/data/monetary/m1sl)

![Graph of M1 and M2 Money Stock](http://www.stls.frb.org/fred/data/monetary/m2sl)

**Figure 2:** M1 Money Stock Seasonally Adjusted Billions of Dollars; and M2 Money Stock Seasonally Adjusted Billions of Dollars.²

This graph shows the M1 and M2 amounts from October of 1979 to December of 1982. The increases year to year are very stable, making it a very smooth upward sloping

² Source: H.6 Release -- Federal Reserve Board of Governors.
http://www.stls.frb.org/fred/data/monetary/m1sl
http://www.stls.frb.org/fred/data/monetary/m2sl
line. Gilbert also argues that the Fed did achieve its objective of reducing inflation during that period [Gilbert 1994, 36].

![INFLATION](image)

**Figure 3:** Consumer Price Index For All Urban Consumers: All Items 1982-84=100, Seasonally Adjusted.³

These economists and many others do believe that the 1979 policy change can be counted as effective in its ultimate policy goal at that time, to fight inflation. However, many important aspects in the economy were disregarded because of this single pursuit of stable prices. Looking at the interest rates over that period, it is obvious that the Fed disregarded one of its other main policy goals.

![INTEREST RATES](image)

**Figure 4:** Federal Funds Rate Averages of Daily Figures Percent; and 3-Month Treasury Bill Rate, Secondary Market Averages of Business Days, Discount Basis Percent.⁴


This graph shows the Federal Funds rate and the 3-month Treasury bill rate from October of 1979 to December of 1982. The interest rate was allowed to increase to a high above 20 percent in the third quarter of 1981 [Wray and Papadimitriou 1994, 10]. The unemployment rates were the highest since the Great Depression, and negative rates of real GDP growth also resulted from the high interest rates [Wray and Papadimitriou 1994, 14]. Wray and Papadimitriou argue that a long list of “other maladies can be traced at least in part to the great monetarist experiment (S&L fiasco, a burgeoning trade deficit, record govt. deficits, and rising debt ratios of domestic firms and foreign countries)” [Wray and Papadimitriou 1994, 14]. The Fed pushed the economy into a severe recession and so, of course, prices began to fall, but it was not because there exists a link in monetary aggregates and inflation.

Conclusion

The Fed’s 1979 policy change can be seen as a disastrous experiment with the US economy. By 1988, most economists were raising questions regarding the usefulness of monetary targets [Wray and Papadimitriou 1994, 15]. The Fed had realized its mistake as well, opting by sometime in 1982 to drop the target of monetary aggregates. It returned to interest rate control as the main objective of policy. This switch was much quieter than the 1979 change; I believe in order to keep face. It is hard for people in such a prestigious position to admit that they were entirely wrong in their recommendations.

It is hard to believe that any variable under the control of the Fed can or could be shown to be closely or reliably linked to inflation [Wray and Papadimitriou 1994, 13]. There is no way that the Fed will discover a target that could lead it to direct control over any aspect of the economy. The Fed’s policy has only indirect effects, and those must not be completely relied upon because there is uncertainty in our economy that the Fed will never be able to measure. As Wray and Papadimitriou stated,

Given these uncertainties and the inherent vagaries of economic projections, we believe it is best for the Federal Reserve to take a less active role in the economy [Wray and Papadimitriou 1994, 13].

The Fed’s fine-tuning idea has turned out over the last few decades to be impossible. Charles Freedman asserted, “Monetary policy should take a longer-term perspective and focus on one or more nominal quantity variables or the nominal exchange rate, and not on real variables or interest rates” [Freedman 1989, 5].

References

Franziska M. Pircher


St. Louis Federal Reserve Website: www.stls.frb.org


Transitional Economy and Financial Crises: Propositions for Ukraine

By Ganna Pogrebna*

Introduction

All capitalist economies display some degree of instability. However, transitional economies are subject to even more violent endogenous fragility. The last ten years turned out to be critical for the states of Central and Eastern Europe in general and for Ukraine in particular.

In 1991 Ukraine gained its independence and embarked on a path of market reforms. However, the efforts of both the government and private sector brought neither financial stability nor sustained economic growth. The economic situation in Ukraine was significantly worsened by the acceptance of the structural adjustment program of the International Monetary Fund (IMF) in September 1992. The integration of Ukraine into the global financial market provoked systematic speculative financing.

Investigations, based on Keynes’ Income-Expenditure Model and Minsky’s Financial Instability Hypothesis, explain that the poor macroeconomic performance of the Ukrainian economy during the 1990s was a result of insufficient aggregate demand, financial instability, and a long history of social pessimism. The importance of the topic for the Ukrainian economy is difficult to overstate. A sharp decrease in investment threatens the possibility of achieving economic prosperity for the country.

Uncertainty of Transition and Financial Instability Hypothesis

One of the main peculiarities of transition economies is financial and economic destabilization. During the process of transition the risk reaches a qualitatively new level and the economic system becomes fundamentally uncertain. Like many other Post-socialist countries, the Ukraine started building up a market infrastructure after the decline of the USSR. Today, its economy consists not only of the government, but also of companies, households, funds, banks and other institutions. All elements of the new system engage in full-circle interaction. The government taxes households and firms and issues bonds for the market. The households receive wages from the firms and purchase goods and services. The function of banks is to give loans to different economic actors – either companies or households – for the purposes of investment and consumption. In their turn, households and firms agree to service their debt and return money to the banks in the form of interest and principle payments. All economic units that participate in the process of exchange act under conditions of uncertainty. Uncertainty about the future, which was described by John Maynard Keynes as one of the most important factors in economic activity, creates a divergence of opinions:

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It is interesting that the stability of the system and its sensitiveness...should be so dependent on the existence of a variety of opinions about what is uncertain. Best of all that we should know the future. But if not, then if we are to control the activity of the economic system... it is important that opinions differ [Keynes 1936, 172].

There is no economic actor who would be able to anticipate with 100% accuracy or who would have full knowledge about the future. Companies making investment decisions are always 'guessing' about what is going to happen. A company will invest when and only when it expects the future cash inflows to exceed its commitments. However, there is no guarantee that future profits will materialize. The most efficient model that deals with the problem of uncertainty is Hyman Minsky’s analysis of financial fragility.

It is necessary to note that Minsky’s approach is concerned only with capitalist economies, or, in other words, economies with private ownership of the means of production. However, as we see later, this analysis is amenable to economies in transition. For Minsky, the heart and soul of any type of capitalist system is finance. According to him, finance is the power that puts the chaotic world of exchange in order. In this world of uncertainty debt financing is not necessarily a zero-sum game, where the firm always fails. At least in theory, if the calculations or guesses of the company are more or less accurate, investment brings cash flows that greatly exceed commitments. If not – the lenders (banks and funds) incur losses along with the companies, which fail to service their debts, and this creates a ‘domino effect’ in the economy. When firms are optimistic about the future, they borrow more and hence create ‘upward instability’; when companies become pessimistic about future profits, they cause ‘downward instability’ of capitalism. In order to deal with the complex and abstract phenomenon of uncertainty, Minsky introduces the theory of financial fragility. Minsky’s financial instability hypothesis (FIH) is based on the fact that firms borrow to invest. The FIH distinguishes between ‘hedge’, ‘speculative’, and ‘Ponzi’ financing [Minsky 1982], where:

1. **Hedge financing** reflects the situation when economic actors can easily meet both their interest, and principle commitments;
2. **Speculative financing** refers to the case in which prospective cash flows are sufficient to pay off the interest, but not the principle;
3. **Ponzi financing** describes the event of default on both interest and principle, or, in other words, Ponzi financing occurs when enterprises are incapable of servicing their debts [Minsky 1982].

Over time, the reactions of economic actors shift them from hedge financing to speculative financing and from speculative to Ponzi. Minsky states:

A main theorem of the financial instability hypothesis is that the internal dynamics of capitalist economies leads, over a period dominated by the successful operation of a capitalist economy, to the emergence of financial structures which are conducive to debt deflations, the collapse of asset values and deep depressions [Minsky 1991, 160].
In other words, the financial system changes from robust to fragile due to the tendency of companies to borrow more and finance riskier projects because of their more optimistic expectations. By borrowing more, firms shift from a hedge to a speculative posture. Over time, as loans become more and more risky, speculative units switch to Ponzi and have to “make position by selling out position” in order to survive. The aggregate situation in the economy depends on the share of units in each category of finance. So, the larger the share of hedge units, the more robust the economy is. The dominance of speculative and Ponzi units causes financial fragility.

The Problem of Insufficient Aggregate Demand in Ukraine

Before testing the hypothesis of financial fragility using Minsky’s approach, it is necessary to look at the problem of insufficient aggregate demand. The Ukrainian government reported five percent GDP growth during 2000 (Figure 1.1). Even at a glance, this number seems overestimated, since at the same time the components of the gross domestic product declined.

![Figure 1.1 Ukraine: Change in GDP](image)

**Source:** National Bank of Ukraine: Statistics, Kyiv, 2001

In order to investigate the phenomenon of rapid economic growth and to gain insight into this paradoxical situation, it is necessary to examine each of the components of aggregate demand. Using the standard formula:

\[
GDP = C + I + G + (X - M)
\]

Where \(C\) – level of consumption in the economy; 
\(I\) – aggregate level of investment; 
\(G\) – government spending; 
\((X-M)\) – net exports
Consumption

The level of consumption in Ukraine never was a significant number. Historically, the marginal propensity to consume, which determines the change in consumption spending that will be induced by a change in income, has been low. Moreover, the percent of barter operations in the economy surpassed 50 percent in 1999. All this led to a lack of cash in the banking accounts of the enterprises. As a result, the majority of Ukrainian workers (especially blue-collar) were receiving their salaries in the goods that they were producing. Service workers such as medical personnel, teachers, etc. suffered delays in wage payments of up to six months. For all of these reasons, the level of consumption has declined sharply since 1991.

Investment

In Ukraine, investment spending has declined substantially over the last 5 years. In real terms, it dropped by an estimated four percent in 1999 and by 5% in 2000 (Figure 1.2). Even though the decline in investment spending in 1999-2000 could not be compared with its 20 percent drop in 1996, the cuts in investment have had harsh consequences for the Ukrainian economy. Given that investment is generally considered the engine of growth in a capitalist economy, it is strange that GDP “growth” could remain strong in the face of such sizable reductions in investment spending. As we can see from the Table 1.1, the material sphere of the Ukrainian economy receives nearly 72% of total investment, while services and education are ignored by investors. Entrepreneurs prefer to receive profits from selling raw materials and reject financing long-term scientific projects, even if they are very promising.

![Figure 1.2 Total Investment (real percentage change)](image)

Table 1.1 Main Spheres of Investment in Ukraine (share in the total investment, %)

<table>
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<tr>
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<tbody>
<tr>
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<td>40.3</td>
<td>41.6</td>
<td>39.4</td>
<td>39.6</td>
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<tr>
<td>Agriculture</td>
<td>7.8</td>
<td>7.1</td>
<td>5.2</td>
<td>4.6</td>
</tr>
<tr>
<td>Construction</td>
<td>1.8</td>
<td>1.3</td>
<td>1.7</td>
<td>2.3</td>
</tr>
<tr>
<td>Transport and Communications</td>
<td>12.8</td>
<td>13.4</td>
<td>20.1</td>
<td>22.3</td>
</tr>
<tr>
<td>Trade and other material services</td>
<td>1.8</td>
<td>2.2</td>
<td>2.3</td>
<td>3.1</td>
</tr>
<tr>
<td>Housing</td>
<td>19.5</td>
<td>19.3</td>
<td>17.3</td>
<td>16.1</td>
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<tr>
<td>Services</td>
<td>16.1</td>
<td>15.1</td>
<td>13.9</td>
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<tr>
<td>Education and Research</td>
<td>0</td>
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Source: IMF: Ukraine – Statistical Appendix, NY, 2000, 8

The decline in investment spending can be traced to the unwillingness of banks to lend. However, the main paradox of the system is that even though entrepreneurs are optimistic about future economic conditions, banks and other financial institutions remain pessimistic. In this context, the main function of banks collapses. Thus, instead of facilitating real investment, Ukrainian banks are focused on the day-to-day short-term profit opportunities from speculating on movements in exchange rates.

**Government Spending**

The alleged “enormous” government expenditures so often mentioned by the Ukrainian officials of the highest ranks is not substantiated. As the state’s statistics report, the last time the government ran a deficit over five percent of GDP was in 1997 (Figure 1.3). Between 1998 and 2000, Ukraine reported budget deficits that did not exceed three percent of GDP. Desperate for dollar or euro loans, Ukraine committed itself to the implementation of urgent and, for the most part, very painful monetary policies and other supply-side regulations. Moreover, the state’s budget cuts and privatization, both pushed by the IMF, which are reflected in the declining levels of output and employment, exacerbated the increase in the rates of unemployment (Figure 1.4). The government reported that unemployment rose from near zero to 4.2 percent over the last eight years. However, analysts at the Independent Economic Development Center in Kiev believe that the actual level of unemployment reached 7 percent, which is almost twice as high as the official number.
Net Exports

Ukraine is highly dependent on external trade, especially on energy imports. This creates a threat to its economic freedom, as the major sources of oil and gas are Russia and Kazakhstan, which lobby their interests on Ukrainian territory. Since the collapse of the Soviet Union, the Ukrainian economy has imported far more than it has sold on the global market. The balance of international trade in 1999 was estimated at negative 482 million USD. According to state statistics, the export quota of Ukraine exceeds 60%. However, the IMF data shows that exports in Ukraine have been constantly falling. Therefore, remembering the formula for export quota:

\[ Q = \frac{X}{GDP} \times 100\% \]
It is possible to conclude that if the level of exports is falling, the high value of the index could be accounted for only by a substantial decline in GDP. As we saw earlier, all the components of the aggregate demand in Ukraine decreased. Therefore the figures for overall macroeconomic performance have been greatly overstated by the Ukrainian Central Bank (NBU).

**Speculative Financing and Economic Crisis**

It is obvious that today the Ukrainian economy is highly speculative. Under the conditions of speculative financing, borrowers and lenders need to review their balance on a regular basis. The shift to fragile finance reveals itself as “increasing difficulty rolling over debts as they mature” (Minsky, 1992, 4), which causes an increase in demand for bank loans. However, banks themselves behave like speculative units and their short-term liabilities escalate their own problem of refinancing. If banks are unable to refinance their own positions, they will not extend credit to companies. Therefore, it is the state’s job to monitor the mechanism which banks use to refinance their own activities.

![Figure 1.5: The Dynamics of Financing in the Ukrainian Economy](image)

The experts of the Kiev-Mohyla Academy investigated Ukrainian enterprises and divided them into those that can meet their liabilities and those, who have difficulties paying off their debts [KMA Entrepreneurship Analysis, 2000]. The research of Kiev-Mohyla Academy showed that soon after the break-up of the USSR, the Ukrainian economy moved from a system comprised almost entirely of ‘hedge’ units, in large
subsidized by the central government, to one in which speculative financing became prevalent (Figure 1.5).

By 1998, optimistic predictions of the national producers reached a peak. However, the euphoria soon led to financial crash, as the Ponzi pyramids fell, paying tribute to the collapse of the Russian financial market. The expectations of both Ukrainian entrepreneurs and bankers, therefore, failed to materialize. This created the current situation of pessimism along with a credit crunch, which means that bankers simply refuse to support even the most brilliant business plans.

When the economy is not ‘doing that well’, finance may most profitably be employed by betting on the movements of exchange rates and speculating on the secondary stock markets, neither of which benefits firms or the economy as a whole. The weakness and instability of the real sector give incentives only for speculative opportunities in the financial sector, which pushes the emergence of new layers of debt. In this case, capital markets fail to play an important role in providing liquidity or in servicing investment needs. All those factors cause fragility in the rest of the economic system, hence ruining macroeconomic performance.

**Conclusion**

To sum up, insufficient aggregate demand, the credibility problem, debt deflation, and a host of supply-side actions have contributed to the macroeconomic instability and internal failures in the banking system. The solution to the problem lies in the strengthening of the role of government in the economy. Government is the only actor that has the actual economic and legal ability to intervene in a critical situation before it is too late. By increasing its budget expenditures it can encourage long-term investment, create new job opportunities and promote financial stability.

The commitments of the government are different from the debt of the private sector, because cash is its own liability. Moreover, government appears to be the most efficient institution for preventing the default of other economic units for the simple reason that it can always service its own debt. Controlling and tracking the balance of its inflows and outflows, government provides for the continued acceptance of its liabilities as cash.

However, another problem arises when we come across the problem of corruption in transitional economies as a whole and in Ukraine in particular. The share of economic crimes in the total recorded offences is only 10%. But most of the actual criminal activities (over 70%) remain unsolved because of the direct involvement of government officials. The influence of mafia groups on political and economic decisions in the state has become catastrophic. The integration of criminal and government officials poses a threat to society. Therefore, before talking about any kind of economic measures, administrative reforms should be the top priority for Ukraine. In order to solve the economic crisis in Ukraine, the state needs to implement the following:

1. reforms targeted at macroeconomic stabilization, banking-system development, and the creation of a new infrastructure,
2. an increase in government spending on retraining programs for the unemployed, educational projects, and research,
3. policies such as tax relief for entrepreneurs and incentives to encourage investment.
To rely on market forces would force all of the pain of the transition onto the shoulders of the Ukrainian people. So, the government should step in and solve the problem of insufficient aggregate demand in order to find a way to stability and democracy. Achieving an optimal combination of free market principles and modest state intervention is one of the most important tasks for Ukraine.

References

Today’s currencies exist within the context of State powers. These powers endow the State with the ability to move desired resources from the private to public sector using economic policies targeting full employment and price stability. This paper explores the basis for understanding modern monetary systems as rooted in the monopoly powers of the State. In the first section, the case of colonial Africa will be used to demonstrate how State powers are used to give value to the currency. The second section further explores historical issues in the development of these powers and their institutional basis. The present-day monetary system and the role played by the government are then examined. In particular, the way in which certain powers of the State turn bank money into State money is explored in this section. This third part is intended to alleviate any doubts with regard to the government’s monopoly powers in the presence of bank credit creation. In the fourth part, a mathematical framework is employed to demonstrate the exogenous pricing power of the State. Finally, a conclusion is offered in which the employer of last resort approach is identified as an appropriate policy framework for full employment and price stability.

Colonial Africa: An Illustration of a Tax-Driven Currency

Historians of the African colonial experience have often remarked on the manner in which the European colonizers were able to establish new currencies, to give those currencies value, and to compel Africans to provide goods and services in exchange for those currencies.

* This paper was presented at the ASSA meeting in Chicago, January 1998. The author has benefited tremendously from extensive discussions with Mathew Forstater, Warren Mosler and L. Randall Wray, none of whom is responsible for any remaining errors.
[In Malawi there was an] imposition of a Sh.3 annual hut tax over the whole colony in 1896. This was a high figure for the northern areas. And undoubtedly stimulated further labor migration [to find work paying shillings]. In the south of Malawi, however, Africans preferred to meet the tax by [selling products]. Southern [European] planters therefore were short of labor and pressed for an even higher tax. As a result the tax was raised in 1901 to Sh.6, with a Sh.3 remission for those who could prove they had worked for a European for at least one month. This 'labor tax' had an immediate effect. The labor market in the south became flooded... Taxation, then, if it were high enough...could force men into wage earning [Stichter 1985, 26-28].

African economies were monetised by imposing taxes and insisting on payments of taxes with European currency. The experience with paying taxes was not new to Africa. What was new was the requirement that the taxes be paid in European currency. Compulsory payment of taxes in European currency was a critical measure in the monetization of African economies as well as the spread of wage labor [Ake 1981, 33-34].

In those parts of Africa where land was still in African hands, colonial governments forced Africans to produce cash-crops no matter how low the prices were. The favourite technique was taxation. Money taxes were introduced on numerous items-cattle, land, houses, and the people themselves. Money to pay taxes was got by growing cash crops or working on European farms or in their mines [Rodney 1972, 165; original emphasis].

Taxation as a method of forcing out laborers but it did not distinguish between the various sources of the cash. Most Africans who could simply sold produce or livestock [to Europeans at administered prices] in order to pay the tax. But where Africans were poor in items to sell, or were distant from markets, taxation could produce laborers [Stichter 1985, 26].

The case of Colonial Africa illustrates how taxation can serve as a launching vehicle for a new currency. Prior to colonization, African communities were engaged in subsistence production and internal trade and, therefore, had little need for European currency. After colonizing Africa, the Europeans employed a system based on taxation that endowed the new currencies with value. The colonial government, in need of real goods and services such as cash crops and wage labor, imposed a tax liability on the population, denominated in European currency. Taxation compelled the members of the community to sell their goods and/or labor to the colonizers in return for the currency that would discharge their tax obligation. Taxation turned out to be a highly effective means of compelling Africans to enter cash crop production and to offer their labor for sale.

In any system—democratic or authoritarian—the government can ensure the value of any currency through these three basic powers: the power to levy taxes, the power to declare how tax obligations must be satisfied, and the power to issue currency. These powers are the basis for securing the purchasing power of State money. Contrary to the conventional idea that taxation “finances government expenditures,” here the
primary function of taxation is guaranteeing that a particular monetary unit—the one issued by the government—will be demanded in exchange for any and all other real goods and services and will, thereby, dominate a country’s monetary system.

The government becomes the “money monopolist” through exercising these powers. Just like colonial governments, modern States need to obtain goods and services from the private sector. In order to induce the private sector to sell to the government, the State imposes a tax obligation on the population in currency, which the private sector can obtain only from the government. The population, pressed by the necessity to pay its legal requirements, sells to the government in exchange for currency. Currency may therefore be viewed as a tax credit to the population that drives the transfer of real goods and services from the private to the public sector. Of course, over time, secondary markets will develop so that State money becomes the general means of payment, unit of account and medium of exchange. In addition, and as it will be discussed below, governments can turn other money—such as bank money—into State money by declaring it acceptable for payments at public offices with appropriate restrictions. But these developments do not change the underlying causal forces at work in determining the value of the currency.

The government is the only institution that has the power to impose a tax liability on the entire population. Thus it can choose at will what it will accept for settlement of tax obligations. It must be noted, however, that the government must ensure that the tax liability is denominated in either something unobtainable, or taxed in sufficient quantities to induce scarcity. Suppose the government decides to accept anything else at its pay offices—wheat, for example. The private sector can easily obtain the wheat by engaging in wheat production. As the private sector has control over the means of settling the tax liability, there is no guarantee that the government will be able to purchase any goods and services from the private sector. Should the government, however, decide to tax more wheat than the crops can yield in a given year, then the private sector will automatically price its goods and services in the scarce wheat and will sell them to the government in order to obtain it. Legal tender laws by themselves do not give the government monopoly powers. It is the government’s power to determine what it will accept in payment of taxes that gives it its “monopoly” position.

Further Historical Examination of State Currency

This section briefly discusses some aspects of monetary evolution, in particular how money became State currency and how the State became the “money monopolist.” We are concerned mainly with the historical developments after the establishment of private property. In the beginning there was debt.

As L. Randall Wray notes, with the introduction of private property, the task of providing the means of subsistence becomes increasingly uncertain [Wray 1993, 11-12]. He coins the term "existential uncertainty" and argues that it is the primary reason why borrowing becomes the fundamental form of market exchange:

The role of existential uncertainty can be seen in the behavior of individual landowners who are unable to meet their needs from their own personal productive efforts. Their existence thus depends on being able to borrow means of subsistence from other individuals. This is the basis of the first
economic exchange and it takes the form of a loan in which one private producer extends physical product which he has accumulated as his margin of security to a borrower who in exchange promises to furnish his labor whenever the lender should require it in order to ensure his own survival [Wray 1993, 11-12].

This quote illuminates the process by which credit money emerged. Wray echoes Heinsohn and Steiger's claim about the purpose of markets: “The market, then, ‘is not a place of barter… but a place for earning the means of settling debt’ [Heinsohn and Steiger 1989, 193]" [Wray 1993, 16]. In other words, markets emerged to provide individuals with the opportunity to obtain and settle debts. It is not our purpose to study how markets emerged. The focus of this paper is to why people use a particular means to settle debts and how they obtain it.

As markets emerged, a variety of institutional arrangements sprang up. These institutions insured that the credit extended to a party will be converted into some kind of commodity (initially wheat and later gold). Convertibility was desirable as it partially reduced the risk of default on the part of the debtor.

...loans and credit money generate the desire to hold small reserves of commodity money in order to ensure convertibility... [Wray 1993, 25].

Commodity-backed credit money, however, did not eliminate financial crises—periodically there were runs on banks in the particular commodity. The development of commodity money was mainly due to institutional arrangements. More importantly, though, those institutional arrangements constituted a pyramidal structure. On each level of the pyramid agents issued liabilities, where the most accepted liabilities were the ones issued by the agents at the top of the pyramid.

In the case of England, for a brief period, London banks were at the top of the hierarchy.

Each economic agent would issue liabilities made convertible into liabilities of a higher agent in the pyramid. Thus, a firm would make its liabilities convertible into country bank notes...The country banks, in turn made their notes convertible into notes issued by London banks. These London Banks would hold the "reserves" of a country bank... If a run began on a country bank, the London bank would lend its notes against the reserves of the country bank [Wray 1993, 28].

Since the London banks were private lenders they still didn't manage to ensure convertibility at all times. A lender of last resort was needed that was not constrained in its ability to issue liabilities. In England, that institution was the Bank of England. It must be noted, however, that the Bank of England acquired its special status because its notes could be used for tax payments, regardless of the available gold. As any central bank, it was an agent of the government that was granted exclusive rights to issue notes. De facto, the English government stood at the top of the pyramid. The reason why bank notes were accepted is because they have been declared by the State as acceptable for payment of taxes. In the words of Kna):
Bank-notes are not automatically money of the State, but they become so as soon as the State announces that it will receive them as epicentric payments [payments to the State]. By virtue of this "acceptation", bank notes become State currency… [Knapp 1924, 135].

The government took steps toward securing its purchasing power by giving the Bank of England monopoly rights to issue government liabilities. Most importantly, however, the government secured its purchasing power by declaring that it would accept Bank of England liabilities for tax payments and/or for any other debt settlement between the private sector and the government. Thus, Bank of England notes became State currency.

In sum, markets are the place where agents try to obtain the means of settling debt. The highest form of debt is the one owed to the government—the tax liability. The most accepted notes are the ones issued at the top of the pyramid—namely the government notes. As a result market activity is dominated by government notes and all other types of liabilities become extinct.

The government's currency was accepted, because (1) all tax obligations had to be paid in government notes and (2) because the government (or the Bank of England as its agent) had the monopoly power to issue these notes, which the State then exchanged for desired real goods and services. The government was at the top of the financial pyramid because it had a set of powers, which no other institution had, all at the same time. It has the power (1) to tax, (2) to determine what it will accept for settlement of tax obligations, and (3) as every monopoly, to determine prices.

Regardless of the type of currency, as long as it is scarce and accepted by the government for payment, it automatically becomes government money. It is the government that will have exclusive single supplier monopoly powers in providing that currency to the population.

**Modern System: The Integration of the Banking System and the State**

Today we settle tax liabilities by writing a check on our account at the bank. That check is bank money. Thus, implications of a banking system that can provide money to the private sector through credit creation must be addressed head on. It will be shown that regardless of the process of credit expansion the government remains the “money monopolist.”

We will first describe how the Fed and the Treasury supply currency to the population by “financing” government expenditures. Secondly, we will incorporate the banking sector to show that it cannot provide currency independently from the government. Credit creation in conjunction with taxation imposed by the government does not alter the fundamental role of the State as described thus far.

The ability of the government to spend is unlimited. The Treasury can have all the expenditures it desires without any constraints from the private sector. That is a reflection of its single supplier monopoly status. Government expenditure is an income to the private sector. To incorporate the banking sector let the government engage in capital asset acquisition. Suppose it wants to upgrade the computer network of the Federal Reserve and purchases computers and software from IBM for the amount of $100
We will discuss what happens if 1) the $100 million expenditure is less than the population’s tax obligations and 2) it is in excess of the tax obligation.

The money involved in the transaction is deposited in the banking system. The bank account of IBM is credited with reserves. The government has provided for the creation of deposits. Since loans create deposits, banks can increase the amount of money circulating in the system by making loans. Banks use a portion of these deposits to lend to other agents in the private sector. They also maintain a reserve requirement for each deposit. If IBM leaves the $100 million in its bank account, that bank has excess reserves, which it will attempt to lend to other banks in the interbank market. If the bank merely makes a loan to another customer and the money stays in the bank but this time in the other customer’s account, the bank will still be looking to hit a bid in the interbank market.

Any expenditure made by the government creates deposits. Any payment of taxes reduces them. Suppose the government taxes more than $100 million. The population has to draw more money than they have initially deposited (from the sale of goods and services to the government). The banking sector as a whole will not be able to meet its required reserve ratio, as required reserves are determined after the deposits are recorded.

In this case, two things can happen—either banks will fail or, more likely, will turn to the Central Bank (the lender of last resort) for the funds. As the population pays its taxes by writing checks to the Treasury, it draws more money from the banking sector than the available bank reserves. How can this happen? The Central Bank clears interbank checks even if a bank does not have sufficient clearing reserve balances. A shortage of reserves in the system can be alleviated only by the Central Bank through the purchase of securities, for example. This purchase of securities is needed to keep the system in balance. The Central Bank is the monopoly supplier of reserves in a system where the government is the monopoly supplier of securities. Therefore, should the State impose a higher tax liability than the deposits it has initially created, the government will quickly find itself in the position of providing the funds before they are taxed out of the public. In effect, even if bank money is accepted for settling of tax obligation, it is ultimately the government (The Federal Reserve and the Treasury as its agents) that provides the currency (dollars).

By accepting bank money the State is de facto agreeing to advance credit (currency needed to discharge tax liability) to banks. In order to insure that it will get value for this credit, the State demands collateral for loans in the form of bank capital or net worth. If there is a shortage, even though the central bank must add reserves through lending, the central bank still sets the terms of that loan. One of the terms is the interest rate. In addition, the Fed demands collateral for the loan in the form of actual securities or the bank’s net capital. Thus, the Federal Reserve maintains strict capital surveillance of member banks. Otherwise, if the Fed had no capital or collateral requirements and made unlimited unsecured loans, the State would indeed lose its supplier monopoly status and the value of the currency would be at risk of immediate hyperinflation.

In sum, the State purchases goods and services by paying with its own currency. Thus, the government has provided for the creation of deposits. Any tax receipt results in depletion of reserves. Only the State has the power to determine the tax level. It is the only institution that can create and/or destroy reserves. Regardless of the multiplier process, the State is the “money monopolist” of what it demands for payment of taxes.
We now consider the second scenario. Assume that from the inception of the currency the system is in balance. In this case, however, the government decides to run a deficit, i.e. expenditures are greater than taxation. Using our previous example, suppose that the transfer of money from the Treasury account at the Fed to IBM's account at Nations Bank, for example, is in excess of taxation. The system is flooded with excess reserves. In an attempt to earn interest on those excess reserves, Nations Bank lends to other banks. Since all banks have an account at the Fed, the reserves only get passed from bank to bank as the Fed transfers funds from one account to another. The aggregate level of reserves, however, does not change. If there is no counter action that drains reserves from the system as a whole, the overnight interest rate will naturally fall down to zero. Let banks extend loans to firms or households, in an attempt to get around the falling interest rate. These loans are deposited at other banks and the banking system is in check as the new deposits account for the new loans. That however, still does not change the amount of money banks have in reserve on deposits with the Fed. The banking system is still flooded with reserves and the interest rate keeps falling down to zero. It is the interest rate, not reserves, that is the only factor under the direct control of the Federal Reserve. To support the overnight rate the Fed steps in and drains those excess reserves through the sale of government securities. As Warren Mosler points out:

If [the Fed] wire-transfer[s] extra money to the banks because the Treasury wants to spend it, all else equal, the banks don't need it. So [the Fed] sell[s] securities so there is someplace to earn interest on that money [Mosler 1994]

The same applies to the Treasury. When it sells Treasury securities it also drains reserves. If, however, the Treasury sells securities to the private sector and does not spend, shortage of reserves results and the Fed has to offset again. The Central Bank buys securities from the private sector and supplies enough excess reserves. Similarly, if the Treasury taxes the population and does not spend the dollars first, the Federal Reserve buys securities first and then provides the dollars to the public for tax payment.

To recapitulate,
1. From inception, the government cannot collect more money in taxes than it spent. Expenditure comes first.
2. Any sale or purchase of securities is done only to provide an interest-bearing alternative to non-interest bearing reserve accounts. These are transactions that support the overnight interest rate and do not finance government spending. The government, consolidating the Treasury and Federal Reserve, has unlimited dollars at its disposal.

Mathematical Framework: Analyzing the Implications of the State as a Single Supplier of that which it Demands for Payment of Taxes

This section presents a basic mathematical framework that relates the level of taxation, the prices paid by the government for goods and services, and other factors to overall government expenditures. The model provides understanding of the government’s status of single monopoly supplier and illuminates its option to act as an employer of last resort.
Conceptual Framework

We will begin by showing the basic relationship between prices paid by the government and the quantity received by the government from the private sector, based on the following cause and effect, as outlined in Mosler’s analysis "Soft Currency Economics":

1. The government needs real goods and services (g&s).
2. The government imposes taxes, in dollars, in order to create sellers who offer real g&s in return for the needed dollars.
3. The government purchases the desired g&s.
4. The government is the monopoly issuer of its currency. Therefore, it has the ultimate power to determine the price it pays for g&s; i.e. prices are exogenous.

The Model

The terms and conditions are defined as follows:

Population (M): 10 people.
T: tax liability of the economy.
PL: wage paid by the government for one fire fighter.
QL: quantity of labor that works for the government as fire fighters.
0<QL<M, where QLM is the maximum capacity of the economy (M=10 people).
G: government spending.
Gd: government deficit.
I: aggregate investment.
S: aggregate savings.
H(nfa): net nominal savings denominated in the currency demanded for payment of taxes in the economy.

Assumptions

1. T is fixed (a fixed property tax is a good example).
2. There is only one tax period.
The model will start with the accounting identity:

\[ G + I = T + S \]

The equation above can be restated: \( G = T + (S - I) \), where \( S - I = H(nfa) = Gd \).

Case 1

Supplementary Assumptions

1. The economy produces one service only, fighting fires.
2. The only expenditure of the government is paying wages to the fire fighters.
3. H(nfa)=0 (assume that in our model there is no provision for a government deficit; in other words, the private sector has no desire to net save).
4. T= $10—total tax bill for the entire community.
5. Labor is not divisible (only 1, 2, 3 fire fighters can be hired).
6. Labor hours are not divisible. Every worker is hired on full-time basis for the entire tax period.
7. The lowest unit of account is $1.00.
8. PL—the price of labor is set by the government.
The following is a general formula for the level of government spending for a given tax period:
The expression indicates that, the amount of dollars necessary to pay taxes, are equal to the sum of the revenue of the sale of quantity $Q$ real goods and services offered by the private sector, where each good $Q_i$ is sold for some corresponding price $P_i$. Since in this model the private sector offers only one service—working as fire fighters—and government’s only expense is paying wages, the expression is simplified to the following:

$$P_L \times Q_L = T,$$

From this equation we can extrapolate that, in order to obtain $T$ dollars for taxes, the private sector must sell $Q_L = T/P_L$ services to the government. In Figure 1, points A, B, C, and D indicate the quantity of labor ($Q_L$) that is transferred from the private sector to the government at a corresponding wage level ($P_L$); i.e. how many people sell their labor as fire fighters, at different wages, given the aggregate tax obligation ($T$) of $10.00.

Since labor and wages are not divisible, the graph in Figure 1 consists of specific points as opposed to a continuous curve. For example, the government cannot hire 1.5 fire fighters and, under the initial assumption, it cannot offer 2.5 dollars as a price for labor.

Point A indicates that if the government offers $10 per fire fighter, only one will be hired. Points B, C, and D show that a wage of $5, $2, and $1 will result in 2, 5, and 10 fire fighters, respectively. No other point exists, since $H(nfa)=0.$
The example illustrated in Case 1 establishes the following inverse relationship: **An increase in prices paid by the government corresponds to a decrease in the quantity of goods and services it receives.** Conversely, higher prices result in fewer goods and services purchased.

**Case 2**

Supplementary Assumptions

1. \( H(nfa) = 0. \)
2. \( T = $10. \)

This case removes supplementary assumptions 4 and 5 from Case 1, allowing labor-hours and wages to be divisible; i.e. labor can work less than full time for a given tax period and the smallest unit of account is no longer $1.00. The inverse relationship between the price the government pays for labor and the amount it receives from the private sector continues, and is now represented by a function, instead of discrete points:

\[
P_L = \frac{T}{Q_L} \quad P_L (\text{min}) = $1 (\text{minimum wage})
\]

**Figure 2**

Figure 2 demonstrates the following:

1. With \( H(nfa) = 0 \), there is only one unique curve.
2. Since \( Q_{LM} = 10 \) defines the limit of the capacity of the economy, it also defines the minimum wage \( P_L(\text{min}) \) the government can offer. In Case 2 this wage is denoted by point A.
3. The curve is asymptotic to the y-axis. It never crosses it because the existence of any tax means that some labor will always be attracted.
Case 2a
Supplementary Assumptions

1. \( H(nfa)=0. \)
2. \( T=\$10. \)
3. The government chooses to set the price of labor (\( P_L \) is exogenously determined).
   This case will be described by the same continuous graph as in Figure 2. The graph demonstrates that at any given \( P_L \) the government knows the amount of \( Q_L \) it will receive. \( P_L \) does not change via market forces.

Case 2b
Supplementary Assumptions

1. \( H(nfa)=0. \)
2. \( T=\$10. \)
   The government forfeits its option to set \( P_L \) by choosing to pay a market price for labor (\( P_L \) is market determined). This case, where \( G=T=P_L \times Q_L \) is described by Figure 3.

Without the government setting \( P_L \), as in Case 2a, this model shows that the possible outcomes for the time period include all points on the line.

In Figure 3, the market price of labor will not fall below \$1, because then there will be no solutions for \( P_L \times Q_L = T \). The market price also can never exceed \$10, because the government is spending \$10 only (since the desire to net save is zero in this case). In order to fulfill its tax obligation, the private sector will have to “sell” only one unit of labor. Therefore, in this case the market price of labor has boundaries:

\[
\frac{G}{Q_L} \text{ (min)} > P_L > \frac{G}{Q_L} \text{ (max)} \quad \text{or} \quad \frac{10}{1} > P_L > \frac{10}{10} \quad \text{or} \quad \$10 > P_L > \$1.
\]
In Case 2a, the government sets the price of labor, making it an exogenous variable. In Case 2b the government pays a market determined (endogenous) price of labor and thus it does not know the price it will pay and the corresponding number of firefighters it will receive. By allowing the taxpayer to set prices, the government also gives him the power to determine quantity. This could pose an interesting dilemma. For example, an organized labor pool could see to it that PL would be 10 at all times, and that any tax increase would be answered with a corresponding price increase. Therefore, any attempt by the government to get more than the minimum QL would fail. Please note that it is the government's (exogenous) choice whether to implement policy 2a or 2b. Note that Case 2a is the African example and Case 2b illustrates the current practice in most of the world.

Case 3

Case 3 incorporates additional government expenditure—the purchase of park benches from the private sector. In Case 3a, the government chooses to set the wage of the firefighters, and to pay market determined prices for a bench. In Case 3b, the government decides to determine both the wage it offers for a fire fighter and the price it pays for a bench. And in Case 3c, it does not set any prices. (Case 3a is a basic outline for the full employment model discussed later in this paper).

Case 3a

Supplementary Assumptions

1. The government sets the price of labor (PL), and purchases benches at a market determined price (PB).
2. H(nfa)=0.

Case 3a illustrates how a change in the price of benches affects the number of people who will work for the government as firefighters. The graphs below show that, as the government increases the number of benches it purchases from the private sector, the number of firefighters it gets will decrease. The general relationship between the two variables is given by the formula:

\[
PB \times QB + PL + QL = T \\
PB = \frac{T}{QB} - \frac{PL}{QB} \times QL,
\]

where T, PL, and PB are given.

As the graphs below demonstrate, when QB increases, QL decreases.

\[\begin{align*}
T &= 10 \\
PL &= 1 \\
PB &= 3 \\
P &= PB \times QB + PL \times QL
\end{align*}\]

<table>
<thead>
<tr>
<th>Graph A:</th>
<th>Graph B:</th>
<th>Graph C</th>
</tr>
</thead>
<tbody>
<tr>
<td>QB=1 bench</td>
<td>QB=2 benches</td>
<td>QB=3 benches</td>
</tr>
<tr>
<td>10=3x1+1xQL</td>
<td>10=3x2+1xQL</td>
<td>10=3x3+1xQL</td>
</tr>
<tr>
<td>QL=7</td>
<td>QL=4</td>
<td>QL=1</td>
</tr>
<tr>
<td>PB=10-QL</td>
<td>PB=10/2-1/2 x QL</td>
<td>PB=10/3 -1/3 x QL</td>
</tr>
</tbody>
</table>
Consider prices $P_{B1}$ and $P_{B2}$ at every given level of purchase of benches by the government in Figure 5, which is identical to Figure 4. Notice that the government will attract fewer fire fighters with a high market price of benches than with a low market price. In other words, when market prices are high, the number of people working for the
government is low. When market prices fall, more public service jobs are taken to obtain
the needed dollars.

In Figure 5, point K is defined by the ratio T/P. If H(nfa)>0 then point K will
shift to the right and will be given by G/P.

**Case 3b**

**Supplementary Assumptions**
1. Government spending includes the purchase of labor and park benches.
2. Government sets both the wage of a fire fighter and the price of a bench.

**Conditions**
1. P—government determined price of a bench.
2. Q—the number of benches sold to the government.
3. H(nfa)=0.

The amount of goods and services the government will be able to purchase is given
by the following budget constraint:

\[ G = P B \times Q B + P L \times Q L, \]

restated:

\[ Q B = (G / P B) - (P L / P B) Q L. \]

Changing P alters the slope of the graph but not the x-intercept:

**Graph A:**

\[ \text{government price}=P_B \]

**Graph B:**

\[ \text{government price}=P_B+1 \]

**Graph C:**

\[ \text{government price}=P_B-1 \]

**Figure 6**
We have incorporated the purchase of another good by the government. The relationship between how much it pays and how much it gets continues to be inverse. If the price of benches (PB) is raised, all else equal, the quantity sold to the government (QB) declines.

Each point on the line represents a different basket of goods and services. The y-intercepts on all three graphs indicate the point at which the government gets only park benches and no fire fighters. The x-intercept is the point where the government only employs fire fighters and does not purchase any benches. Of course, the private sector may want to sell some combination of the two; point E is an example. The function does not give any specific equilibrium level of goods and services transferred from the private to the public sector, resulting in an uncertain quantity of labor and/or benches.

**Case 3c**

Supplementary Assumptions

1. Government spending includes the purchase of labor and park benches.
2. Government accepts market-determined prices for both the wage of a fire fighter and the price of a bench.

On Figure 6, the price and quantity of benches change but the x-intercept (point K) remained constant, since it is defined as G/PL. In this case, however, PL also fluctuates due to changing market conditions. Hence, Case 3c is similar to Case 2b, where there were infinite possible outcomes. Both Case 3c and 2b are characterized by the absence of exogenous price control by the government, with price and, therefore, quantity determined by the taxpayer.

**Case 4**

All cases so far have assumed that Gd=H(nfa)=0. Case 4 introduces different levels of H(nfa) to Case 2a.

Supplementary Assumptions

1. T=$10.
2. QLM=10.
3. The government sets the price of labor.
4. The government purchases fire fighters only.

This case graphs 3 conditions:

1. H(nfa)=$0
2. H(nfa)=$2
3. H(nfa)=$-2, where

   H(nfa)=$-2 means that the private sector dis-saves as it borrows from the government. Here is the data for the three cases and the graphs that describe the number of fire fighters that will work for the government at different wage-levels.

<table>
<thead>
<tr>
<th>Case 4a:</th>
<th>Case 4b:</th>
<th>Case 4c:</th>
</tr>
</thead>
<tbody>
<tr>
<td>H(nfa)=Gd=$0</td>
<td>H(nfa)=Gd=$2</td>
<td>H(nfa)=Gd=– $2</td>
</tr>
<tr>
<td>G=10+0=$10</td>
<td>G=10+2=$12</td>
<td>G=$8</td>
</tr>
<tr>
<td>PL=G/QL=10/QL</td>
<td>PL=12/QL</td>
<td>PL=8/QL</td>
</tr>
</tbody>
</table>
All three curves in Figure 7 are downward sloping: the more the government pays, the less it receives from the private sector (at a given tax level).

The three situations are characterized by different minimum wages that the government can offer. With full capacity confined to 10 people, in the first situation (curve $P_L=10/Q_L$), the government is not running a deficit ($H(nfa)=0$); hence $1$ is the minimum that the government can pay for a fire fighter. At that point (point A) it will attract 100 percent of the capacity and everyone will be working in the public sector, fighting fires. In the second situation (curve $P_L=12/Q_L$) when the private sector net saves $2$, the minimum wage is given by point B, $\$1.20$. Similarly for the third curve that wage is $\$0.80$.

Changing $H(nfa)$ does not change the basic relationship, it only shifts the curve. This shift can be expressed mathematically in general terms as opposed to using particular values for our variables.

**Proof**

Let $G=P_L \times Q_L = T + H(nfa)$  

$P_L = \frac{(T+H(nfa))/Q_L}{Q_L+H(nfa)/Q_L}$

Let net savings increase from $H(nfa)$ to $H(nfa)^*$, by a change of $\Delta H(nfa) = H(nfa)^*-H(nfa)$

$G^* = P_L^* \times Q_L = T + H(nfa)^*$

$P_L^* = \frac{(T+H(nfa)^*)/Q_L}{Q_L+H(nfa)^*/Q_L}$

$\Rightarrow P_L^* = \frac{T/Q_L + (H(nfa)+\Delta H(nfa))/Q_L}{Q_L+H(nfa)/Q_L+\Delta H(nfa)/Q_L}$

$\Rightarrow P_L^* = P_L + \Delta H(nfa)/Q_L$

Therefore, the curve has shifted by $\Delta H(nfa)/Q_L$. We have found a general expression for the shift of the curve.
Case 5

This case significantly modifies the setup of the model, however, the basic relationships are maintained. A couple of terms are added:

U: number of people seeking unemployment compensation
Uc: dollar amount of unemployment compensations one receives

Modified Assumptions

1. H(nfa)=0.
2. T=$100.
3. The government decides to spend a fixed amount on benches at market prices ($90) and offers to pay $2 to each unemployed individual in the form of unemployment compensation.

In this case total government expenditure will include the purchase of benches and the aggregate unemployment compensation it pays to the unemployed people that seek it. The equation for government spending is modified to:

\[ G = P_b \times Q_b + U \times Uc, \]

where \( P_b \times Q_b = 90 \) and \( Uc = 2 \). When the values are substituted, the formula yields \( U = 5 \).

\[ 100 = 90 + U \times 2 \quad \Rightarrow \quad U = 5 \]
Thus, we can conclude that when the government spends only $90 on goods from the private sector and offers $2 for unemployment compensation, at least five people will file an unemployment claim if the population is to meet its tax requirement of $100. Note that if the private sector decides to charge the government very high prices for a bench, it can easily lay off more than five people. Since the desire to net save is zero only five of those unemployed workers will show up for compensation, enough to obtain the means that settle the aggregate tax liability.

Case 6

The conditions of Case 6 are exactly the same as the ones in Case 5, with the exception of the level of net saving. We will study how many people will file unemployment claim with the government at different levels of H(nfa).

Figure 9 graphs three conditions:

1. H(nfa) = $10
2. H(nfa) = $20
3. H(nfa) = $50

The formula describing these three scenarios is:

\[ G = T + H(nfa) = PB x QB + U x Uc \quad \text{or} \quad 100 + H(nfa) = 90 + U x 2 \]

\[ U = \frac{(100 + H(nfa) - 90)}{2} \]

Figure 9 shows that the higher the desire to net save, the more people with claim unemployment compensation, given a fixed level of government expenditure on good from the private sector.
Conclusion: The Employer of Last Resort Option

In sum, price is an exogenous function in the case of a single supplier monopolist. The State has several available options when choosing a method of price determination. The current method of paying market prices for all purchases has been shown to have exactly the outcomes observed in the world today. Likewise, historical examples of other options are also consistent with this model. The case for employer of last resort (ELR) made by Wray [1998], Mitchell [1998], and Mosler [1995] uses the option outlined in Case 3a above. The currency is set exogenously for one purchase, ELR labor, and other prices are allowed to be determined by existing market conditions.

We have considered the driving force behind currency as well as the role of the government as a single supplier of currency both in the past and in the present. Finally, the mathematical framework presented in this paper outlines the inverse relationship between the price the government pays for goods and services and the minimum quantity of real goods and services it receives for a given level of taxation, considering that:

1. The government is the monopoly supplier of its fiat currency.
2. The government exogenously sets taxes and creates sellers of real goods and services.
3. The government has the ultimate power to exogenously set the prices it pays for real goods and services.

The inverse relationship is maintained regardless of the fact that the private sector may or may not have a desire to net save. Net saving equals the government deficit by definition, which can be incorporated into a fiscal policy that lets market conditions cause the deficit to float with the net desire of the private sector to save the currency, as outlined by Wray, Mitchell, and Case 3a in this paper.

To recapitulate, this mathematical framework outlines some basic relationships that can be considered in the selection of fiscal policy options. Taxation is the driving force behind the currency, the government is the single monopoly supplier of currency, and as such it has the power to set taxes and prices exogenously. Furthermore, there is an option open to the State that can eliminate the problems of unemployment and provide meaningful price stability as well.

Notes

1. “Monopoly” is used here in a general sense to indicate the exclusive powers and privileges of the State to create that which it demands for payment for taxes. It is not meant to imply the usual profit maximizing motives of private sector monopolists.
2. The private sector includes all participants holding dollars, domestically or abroad; i.e. everyone except the monopoly issuer of the currency.


Financial Inflation and Financial Convention

By Eric Tymoigne*

Evolution of asset prices is very important for economic evolution. By influencing investment decisions and policies, capitalists can play an important role in the evolution of the economy as a whole. This influence could be good if it would lead to revealing the “fundamental value” of the underlying capital assets because it would give a good vision of the future. Moreover, it would permit entrepreneurs to get a continuous flow of funds that could be engaged in the production circuit. However, financial markets are subject to excessive volatility and do not play an important and regular role in the productive financing or funding of firms. This has been all the more the case since the deregulation of the eighties, since which most financial innovations have been used for speculative purposes (capital gains) rather than to protect economic actors from future economic evolutions (purchase of the underlying asset for a given price at a given date).

Many authors, such as Keynes, Galbraith, Minsky, Shiller, and Orléan, have already studied how the sentiment of capitalists evolves in the financial markets and can affect the economic situation. All of them show that psychological and institutional aspects can play a major role in the evolution of the financial markets. This paper makes a synthesis of the preceding approaches by linking them and looks at how their interaction influences the perception of uncertainty. This will provide an endogenous explanation for the evolution of financial markets and will show that financial factors are at least as important as monetary factors in explaining how financial markets evolve. As for goods-price inflation, the blame is usually put on a too lax monetary policy. However, this condition is not sufficient to create an euphoric market. The blame should also be put not only on financial investors’ behaviors but also, and mainly, on the institutions that let these behaviors develop. These three distinctions (money/investors/institutions) is very important because it shows that, contrary to what is often thought, monetary factors and financial investors are often not directly responsible for the actual evolution of the financial markets. One has to go more deeply to understand why financial markets are so volatile.

In the first part of this article, a critical review of the different ways to explain the evolution of financial markets will be articulated. It will be shown that psychological and institutional aspects are very important in understanding the evolution of financial markets. The second part will make a synthesis of these aspects, and propose an endogenous evolution of the financial markets. In conclusion, the implications of this analysis in terms of policy will be briefly examined.

I. Asset-prices: A Review of the Literature

It is possible to regroup the major part of the literature (exhaustiveness is impossible) on asset-price formation in three categories: the rational approach, the
irrational approach, and the institutional approach – the last one including what is called the conventionalist approach. Each of these approaches provides its own explanation of the formation of asset-prices and of the ‘bubble’ that can appear in the market. It will be argued that most of the interesting elements to understand actual evolution of financial markets can be found in the irrational and institutional approaches.

A. The Rational Approach: “Herding” and Informational Problems

This approach is the most popular in economic analysis. It has been developed in two forms: the fundamentalist approach and the market efficiency approach, which, from a certain point of view, can be considered an extreme version of the first approach. Both approaches suppose that capitalists are rational in the sense that they only act on the basis of the public or private information available without looking at what other capitalists are doing. Thus, in both cases, the capitalists try to hedonistically maximize their utility, for the fundamentalist approach, or their expected utility, for the efficiency approach. Moreover, both analyses state that a “fundamental value” of the underlying asset evaluated on the financial market exists. When the market price is consistently different from this price, a bubble exists in the financial market.

The fundamentalist approach states that in the ‘long-run’ the market price of each asset converges toward its fundamental value, which is a price calculated on the basis of actualized expected cash flows. This convergence process lasts during the time that all available information is integrated by capitalists. Thus, this provides a predictability with regard to the future evolution of the market price and one should buy or sell financial assets in function of these expectations. However, sometimes because of speculative behavior in the financial market or because of an informational problem, the market price does not converge toward its fundamental value and can even move away from this value.

The efficiency theory, initially developed by Eugene Fama in 1965, postulates that financial markets are efficient in the sense that they integrate adequately all the information publicly available. This efficiency is more or less strong. In its strong version, it supposes that it is impossible to take advantage of information because this information is integrated immediately into the market price. In its semi-strong version, the efficiency theory states that it is impossible to profit from publicly available information when it is revealed. Finally, in its weak version, this theory argues that it is possible to observe short deviations from the fundamental value but that, contrary to the contention of the chartist approach, it is impossible to use past information and price data to predict the market price. Indeed, the market price evolution is totally unpredictable because it evolves with the information that arrives randomly in the market. Usually, because the market is efficient, the market price is the fundamental value, so it is impossible to have bubble in the market and what is seen as a bubble can in fact be explained by fundamental factors. However, because some situations of high price cannot be explained by an efficient fundamentalist approach, some authors [Blanchart 1979, Blanchart and Watson 1982] tried to explain the formation of a bubble in the context of an efficient financial market. In this case, bubbles are rational, in the sense that they result from rational expectations of the capitalists. One of the most important conclusions of these authors is that usually the financial market is not a good estimator of
the fundamental value because multiple equilibria exist, and in only one of these the market price is equal to the fundamental value.

However, these authors cannot explain why a bubble bursts and why it appears. This is why other authors have tried to endogenize this bubble by relaxing to a certain degree the rational hypothesis. Agents continue to maximize their expected utility but through Bayesian probabilities. This implies that capitalists take account of the behavior of preceding capitalists to make their choices. Then, bubbles are due to informational asymmetry, and the crash is implied by the existence of an information cascade or herd behaviors [Avery and Zemsky 1998, Banerjee 1992, Bikchandani et al. 1992, and Welch 1992]. In this way, it is possible to explain the 1987 crash by the incapacity of the clearing system to integrate all the stop-loss orders programmed into the computers that managed portfolios [Greenwald and Stein 1991].

The rational approach can be criticized on several points. Its main merit is to show that whatever the market (efficient or not) a bubble can appear because of informational problems (asymmetry, cascade, herding), which leads the market maker and capitalists to act rationally in a wrong manner. However, these two approaches have several flaws. First, concerning the fundamentalist approach, it is never explained why sometimes the market is consistently different from its fundamental value; this approach does not explain why speculative behavior can become dominant in the market. Second, the efficient market theory supposes that there is a sequence of decisions; investors act one by one in an exogenously predefined order. This approach does not take into account the interaction that exists in the market: everybody is looking at everybody at the same time. Third, this explanation supposes that it is perfectly possible to deduce information possessed by an investor from his behavior. However, Shiller (2000) shows that agents do not remember why they acted in a certain way when one asks them. During collective actions, what is important is the interpretation of the information, not the information in itself [Livet and Thévenot 1994]. Finally, this approach states that, in the end, a “true” value always imposes itself. As we will see further, this idea ignores one important characteristic of the financial market—namely, the autojustification process.

Because of these problems, it is necessary to go further and to integrate other elements in addition to informational problems to understand why the financial market can have a market price that seems unreasonable. The irrational approach provides its own explanation.

B. The Irrational Approach: Overconfidence

In this approach, authors argue that individuals are basically rational but they can become irrational for a moment because of psychological factors, human nature, or by pure accident. Therefore, here one goes further in the reappraisal of the orthodox hypothesis by considering that capitalists are not always rational. The main explanation rests on overconfidence, which leads some financial actors to choose probability distributions that are not identical to that of the fundamental value (expectations are more optimistic and the variance is less important). It is possible to make a distinction between the microeconomic approach to irrationality and the macroeconomic approach, which extends the explanation of irrationality by including other factors.
The microeconomic approach to irrationality developed during the 1990s to criticize Friedman’s statement that traders who do not act rationally are eliminated from the market. From an overlapping model with rational traders and noise traders, De Long et al. (1990, and 1991) show that noise traders can survive and be more and more important in the long run. This is due to a double mechanism: invasion and imitation. First, rational traders must take into account the risk implied by noise traders in their attempts to improve their yield; this leads them to imitate the behaviors of noise traders. Second, if noise traders do better than rational traders, more and more young traders will behave like noise traders. Kyle and Wang (1997) conclude also that overconfidence can develop and be dominant in the long-run because the managers of funds demand that their employees act aggressively to eliminate other competitors. However, these authors do not explain why some investors are irrational, and to attribute irrationality to pure coincidence is not accurate. Daniel, Hirshleifer and Subrahmanyam (1998) show that the psychological factors are important in explaining overconfidence. Indeed, traders have often a biased vision of the results concerning their past decisions. That is to say, they have a tendency to attribute the good results to their competence rather than chance whereas errors are analyzed as noises. Then, the more experienced a trader is, the more overconfident he will be. Therefore, experts have a bigger propensity to be overoptimistic. But Gervais and Olean (2001) show that novices are not immune to this tendency. Indeed, they do not know how to interpret the results of their past decisions and also tend to attribute good results to their own competence rather than chance. However, as they gain in experience, they learn that they can be wrong and so become more rational. Globally, the microeconomic approach to overconfidence therefore proposes a generational explanation of bubbles: the new generation does not know about the preceding crashes and tends to underestimate or ignore the lessons of the past.

The macroeconomic approach to irrationality is mainly represented by Galbraith (1954 and 1990) and Shiller (1987 and 2000). The first author extends Keynes’ analysis by analyzing the periods of massive speculation. This leads him to analyze the relationship between men and money: rich persons are assumed to be clever rather than lucky; individuals are fundamentally greedy and want to earn a maximum of money with a minimum of effort. He also includes in his analysis the importance of financial innovations that let capitalists believe that it is safe to go into the market and induce them to manage portfolios with very high leverages. Shiller, by regrouping many past contributions, gives importance to regret (those who have not yet invested in the market, see some capitalists making massive gains, and try to come quickly into the market), to rumors, and to the way information is dispersed (progressive deformation of the original information). Thus, he shows the importance of representativeness (people act and judge on the basis of rough assimilations) and of the conservatism principle (people are reluctant to dismiss an idea with which they agree) in the evolution of the financial market. These two elements are sufficient to influence the sentiments of traders concerning the future evolution of the market [Barberis, Sheifer and Vishny 1998]. Shiller and Galbraith also point out the importance of the media and financial analysts in the process of diffusion of an overconfident sentiment.

This approach is very interesting because it shows that what is important is not the information by itself but its interpretation. This opens the door to experts, politicians, and economists who can influence the evolution of the financial market by simple statements.
This approach also shows the importance of media in homogenizing and diffusing a positive or negative sentiment relative to the market. In a period of boom, newspapers try to rationalize *a posteriori* the evolution of the market to put capitalists’ mind at rest about a rapid evolution of the financial market that does not seem to be reflected in the fundamentals. There is an *autojustification* process during the boom. However, this approach still supposes that, intrinsically, agents are rational in an orthodox way. Thus if one could teach people how to behave in the market by using options to protect themselves and looking only at relevant information and not what the other persons are doing, it would be possible to eliminate irrational exuberance. Then, one should create new institutions internal to the financial markets that “encourage public attention to long-run fundamentals and deflect attention away from short-run speculation” [Shiller 2000, 229]. However, this proposition puts aside the autojustification process: a market price can be judged as irrational relative to the long-term expectations of profits, but it can be justified by other explanations or indicators that make the ‘old’ explanations ‘irrelevant’. Moreover, one must be sure that if people learn how to use derivatives to protect themselves, they will actually use them to do so and not mainly to speculate, which is not the case today [Toporowski 2000]. Finally, this approach gives too much importance to the psychological aspects. One needs to place more emphasis on the fact that choices are socially determined and not the result of hedonistic behaviors. It is also necessary to look at the impact of existing institutions on the behavior of capitalists. This is what the institutional approach does.

### C. The Institutional Approach: Mimetic Behavior, Institutions and Uncertainty

At the basis of the institutional approach is the recognition that the economic system and its environment evolve in uncertainty, and contribute to this uncertain world by their creativity and their highly complex interactions induced by positive feedback loops. Institutions exist to face uncertainty and manage complexity. These institutions are the product of *social interactions* and not the result of hedonistic behaviors. Thus, contrary to the preceding approaches, which analyze the financial market through the use of representative agents or sequential analyses, the institutional approach is considerably richer and more fruitful. Here again, it is possible to divide this approach into two parts even if both are linked: the Conventionalist approach and the Institutionalist approach.

In situations of uncertainty, which is usually the case in social science, individuals make decisions on the basis of *sensible expectations* [Davidson 1987]. That is to say, they act on the basis of implicit or explicit norms of the society. Here one finds the notion of convention developed by Keynes. The French convention school (Orléan, Thévenot, Livet, Dupuy) has developed this idea in great detail by following chapter 12 of the *General Theory*. Orléan (1988, 1989, 1993, and 1999) develops Keynes’ analysis of the financial market by showing that the market price represents the opinion of the majority resulting from an interaction among individuals, each of them trying to validate their own opinion by looking at what the others are doing. This leads to focalization on a particular price that usually has nothing to do with fundamentals but acts like them by stopping the mimetic process. Moreover, *there is a social pressure to have a speculative behavior*, as Keynes showed. In this context, *there is no fundamental value but only interpretations*
that autojustify the current market value. Thus, this autojustification process shows that economic myopia is a social construction and not an irrational phenomenon [Orléan 1999, 155] because it is not in the interest of capitalists to look at the anomalies and because the actual mode of interpretation leads to an unconscious ignorance of bad information (which is minimized in its importance or completely unseen, or even turned into good information). The conventional analysis also leads to making a crucial distinction relative to the preceding analyses. It is indeed necessary to draw a distinction between mimetic behavior and herding: the first one results from an interaction (everybody is looking at each other, knowing that everybody else is doing the same thing) whereas herding is a behavior that consists in following the preceding persons without any consideration for the environment. Mimetism is rational at the individual level, contrary to herding. Say alternatively, people have autoreferential rationality and this is perfectly normal in an uncertain environment where there is no point of reference on which to base decisions. Thus, individuals are usually rational; herding is an exceptional case and the ultimate point of a crash process (everybody is trying to sell whatever information they have, and the others are doing the same). In a herd process, no point of reference exists or can exist; it is just pure panic, and the market price goes down steeply.

The fact that, for the institutional approach, it is rational to look at what the other individuals are doing is reinforced by the existence of institutional factors that promote this kind of behavior. John R. Commons was very aware of that. The institutional set-up of the economy implies that we are looking toward the future. This implies that market valuation of securities, which is based on estimation of future incomes, is dependent on confidence, speculation, manipulation, propaganda, the banking system situation, and sentiment (liquidity, solvency, economic situation, etc.) [Commons 1961, 455-602]. Therefore, agents behave in an uncertain world and are subject to the “unseen pressure of society” to evaluate monetarily an “unseen future,” i.e. capital [Commons 1961, 440]. Individually, speculative behavior is a rational response of financial actors to the constraints they face in the financial market: it is not an aberration [Orlén 1999, 50]. As Keynes says:

This behavior is not the outcome of wrong-headed propensity. It is the inevitable result of a market organised along the lines described [Keynes 1936 (1964), 155].

This individual rationality does not necessarily result, however, in collective rationality because of the liquidity paradox (as a whole, the financial market is illiquid, whereas it is liquid for one individual). In addition to the institutional aspects internal to the financial market that aim at regulating liquidity, there are other very important institutional elements that affect the asset-price. Palley (1995) shows that a system of remuneration of the managers of funds based on relative performance leads to herding. Toporowski (2000) completes this analysis by showing that the current financial inflation in mainly caused by pension funds. As these have become Ponzi schemes, they are condemned to promote investment in shares: they cannot go out of the market without provoking high variations in the market price. Yet their capacity to develop is limited by their capacity to extend their management to customers who are able to fund a private pension. Because of the degradation of working conditions and the concentration of these
customers in developed countries, the flow of money to the pension funds can only decrease. Thus, “the flaws in the system of capital market finance are not insubstantial shadows, like market ‘sentiment’ or ‘confidence’. Those flaws are inherent in the way in which markets for long-term financial assets operate, but are most fully, if not obviously, incubated when the capital market is inflated” [Toporowski 2000, 136].

In this approach, one can find all the results of the irrational analysis: autojustification, importance of psychological factors. However, these authors go further and put forward four essential ideas. Firstly, individual rationality is not substantive but procedural (or interpretative), it is useless to try to reason with investors: there is no individual irrationality, “these behaviors are not the consequences of transitory whims or irrationality that one can regulate by providing an adequate teaching” [Orlean 1999, 188]. Secondly, an interaction between individuals is very important to stabilize the market price and to create a main (or average) opinion. Thirdly, the interpretative rationality [Livet and Thévenot 1994] generates a reflexive process going from this interpretation of the reality to this reality, and this can result in an autorealisation process. Finally, the institutional aspects that allow the existence of this kind of rationality are essential. The financial architecture and external institutional factors are the source of instability when they are all turned toward the promotion and the search for liquidity. This is one of the most important results of the Post Keynesian analysis [Lavoie 1983, Le Heron 1986, Brossard 1998].

D. Conclusion

An unstable financial situation requires a Ponzi process. The latter can only start if the first investors who came into the market can convince new investors to come into it to buy the titles owned by the first investors. For some authors, this process appears because of herding, whereas for others it results from mimetic behavior (herding being only a very special case). In the second case, the Ponzi process can appear only if the main opinion is very optimistic or pessimistic; it is not sufficient that few investors sell. A financial convention is established to justify high increases in asset-price and to persuade new investors to come into the market. When this process is started, it will necessarily finish in a brutal way because it is impossible for the economy to provide more and more funds to sustain the Ponzi process. This second approach (the mimetic approach) is very fruitful because it combines several explanations and takes account of the social context in which investors evolve. It is, however, difficult to understand how uncertainty and institutional and psychological factors are combined to explain the market price. The following gives a coherent explanation of the market level and of its evolution, by putting together the irrational and institutional approaches.

II. A Synthetic Approach to Financial Inflation

The preceding section has presented the different approaches to explaining how asset-prices evolve. This section is going to put together institutions, conventions, psychological factors, and the perception of uncertainty. The monetary channel will also be added to give a more complete explanation of the sources of financial inflation. This will provide an endogenous model of the evolution of asset-price and a clear picture of
the way things are going on. However, to really understand this model, it is first necessary to clarify the notion of convention. This will be done by making a distinction between financial and banking conventions. Then, it will be possible to deal with the complete model.

A. The Financial and Banking Conventions

To act under uncertainty, people tend to follow some norms or saliencies that help them to take their decision. Keynes and Post Keynesians have extensively analyzed the notion of convention applied to the financial and banking sectors. Shiller and Orléan have completed Keynes’s analysis by going further in the analysis of the financial convention.

1/ The Banking Convention

The banking system is mainly composed of banks and a central bank, which interact with each other. The banking system fixes the credit conditions: interest rates, amount of the line of credit, terms, and collateral. The supply of credits is endogenous, i.e. initiated by the demand for credits. This implies that the banking system offers all the funds needed until an amount of which rationing starts. This rationing induces an “unsatisfied fringe of borrowers” when the quality of the customers is too degraded or when there is a consensus inside the banking system that a maximum amount of loans has been extended. Therefore, the banking system controls the cost and, from a certain level of loans, the amount granted. This behavior is very dependent on the liquidity preference of banks, which determines the will to lend at more or less restrictive conditions as a function of the lender’s risk [Le Héron 1986]. In this context the banking convention plays a very determinant role in the lending behavior by setting the balance sheet ratios (leverage ratio, self-financing ratio, etc.) that are judged as normal. Following Keynes (1930) and Le Héron (1986), this convention can be studied at two levels: the relations between banks and the relations between banks and the central bank.

First, the convention exists in the relations between banks. Indeed, banks can never act independently without going bankrupt. This leads each of them to act by following the ‘main’ (or ‘average’) opinion:

If we suppose a closed banking system, [...] where all payments are made by cheque and no cash is used, and if we assume further that the banks do not find it necessary in such circumstances to hold any cash reserves but settle inter-bank indebtedness by the transfer of other assets, it is evident that there is no limit to the amount of bank money which the banks can safely create provided that they move forward in step. [...] Thus the behaviour of each bank [...] will be governed by the average behaviour the banks as a whole... [Keynes 1930 (1973), 23; Bold types added].

This implies a monetary system that is very unstable, where the evolution of the main opinion can be very brutal. Keynes extends his reasoning to a banking system with fractional reserves:

If some payments are made by cash, [...] the creation of more bank money by the banks as a whole will lead to a drain of cash out of the banks as a...
whole, which will set a limit to the extend that the banks can afford to create bank money unless they are in a position to obtain command of and increased quantity of cash [Keynes 1930 (1973), 24].

This shows that it is necessary for a bank to have to a level of analysis: one microeconomic to fulfill its targets, one macroeconomic to grow at the same pace as the other banks. Recently, Lavoie made the point:

The norms to follow are the average leverage and liquidity ratios of all the other banks of the same size. If all banks are expanding in step, all banks will experience similar transformations of their balance sheet. [...] If it happens that liquidity ratios of all banks fall during expansion, banks will not necessarily attach more risks to these lower ratios. The objective fragility of the banking system may be greater but, [...] its subjective assessment by bankers might not change [Lavoie 1996, 289].

Secondly, the behavior of the central bank is, as we have begun to see, also very important in understanding how the convention emerges in the banking system:

We now perceive that there exists, not only the check on individual banks that they must keep step, but also the banks as a whole. [...] Thus it is the aggregate of the reserve resources which determines the ‘pace’ which is common to the banking system as a whole [Keynes 1930 (1973), 25].

In the Treatise on Money, the relation between the central bank and the other banks goes through the rationing of reserves. Post Keynesian studies (Moore 1988, Lavoie 1992, 1996, Wray 1990, and 1992) have shown that today the supply of reserves is horizontal. Therefore, as Keynes said, there is no limit to monetary creation except that which banks impose on themselves.

Therefore, credit conditions and the method of selection of customers result from both microeconomic and macroeconomic forces that are made compatible by the banking convention:

Experience has led to the fixing of conventional percentages for the ‘margin’ as being reasonably safe in all ordinary circumstances [Keynes 1931 (1972), 152].

Now that one has seen in greater details what the banking convention is, it is possible to study the financial convention.

2/ The Financial Convention

In the financial market, the price is determined via supply and demand, which are largely dependent on conventional elements. Keynes developed this idea from 1930 to 1937 and since the middle of the 1980s the conventional explanation has been developed.

a/ The Financial Convention in the Treatise on Money
To explain how financial circulation evolves, Keynes puts forward the importance of the bearish consensus in the financial market. Depending on the existence or not of a bullish consensus, the financial inflation or deflation will have different effects on the financial circulation:

- A bull market with a consensus: $\hat{P} > 0$ with $P < P_0$. Asset-prices are going up but have not yet reached the level of price that is judged maximum. Thus, the amount of funds in saving deposits ($M_3$: deposits that are used to make portfolio arbitrages) goes down and there are less and less bearish investors in the market.
- A bull market with a divergence of opinion: $\hat{P} > 0$ with $P > P_0$. Asset-prices have increased beyond the level that financial investors judge as normal. $M_3$ goes up, and there are relatively more and more bearish investors in the market.
- A bear market with a divergence of opinion: $\hat{P} < 0$ with $P < P_0$. Asset-prices go down enough to compensate the bearish attitude. It follows that $M_3$ goes down because investors are coming back into the market, expecting increases in asset-prices.
- A bear market with a consensus: $\hat{P} < 0$ with $P > P_0$. Asset-prices have not gone down far enough to satisfy bearish investors, so $M_3$ increases and the number of bearish investors increases relative to the number of bullish investors.

Through this analysis, it is possible to see part of the financial convention namely norms. It is also possible to see that the amount of financial circulation is a function of the volume of transaction but also, and mainly, of the strength of the ‘bearish’ position.

b/ The Financial Convention in the *General Theory*

“How then are these highly significant daily, even hourly, revaluations of existing investments carried out in practice? In practice we have tacitly agreed, as a rule, to fall back on what is, in truth, a convention” [Keynes 1936, 154]. This conventional evaluation rests on a rationality based on three elements [Keynes 1937, 114]:

1. The present situation is a good indicator of the future state of the economy. Old past experiences are put aside or judged as less important.
2. The current opinion expressed in the asset-price is a correct estimation of the future expectations of profits: there is an autojustification process.
3. To make a decision, we look at the opinion of the other investors. Thus, we conform to the majority that we think as more informed. There is an autoreferential rationality that results in a conventional judgment stabilizing the opinion of the financial community.

As one can see, the notion of convention is enriched relative to the *Treatise on Money*. Now there are four factors that are important in defining a convention: norms, the existence of a consensus, the autojustification process, and mimetic behaviors. Shiller and Orléan complete this analysis.
c/ Shiller and Orléan on the Financial Convention

In *Irrational Exuberance*, Shiller shows that the financial convention is a function of cultural factors. It consists in looking at the investments in shares as the most profitable and not risky. The process of financial inflation leads to a convention of interpretation that is materialized by the autojustification process and the focalization on some information. In addition to this, Shiller shows that anchors are used by financial actors in decision-making. First, there are quantitative anchors that are saliencies for capitalists: a psychological price-level, the past evolution of prices. Moreover, some moral anchors are provided to financial actors to help them in their arbitrage process. These anchors are based on justifications that try to make financial actors confident to keep their illiquid assets in their portfolio.

André Orléan (1999) defines the financial convention through two other conventions: the convention of normality and the convention of interpretation. The first one supposes that current price are a good estimation of the real value of an asset and that the price evolves by following a ‘well-behaved’ law of probability (low variance and extreme values have a very low probability). The second convention provides *ad hoc* justifications, hypotheses, and new methods of evaluation to provide foundations for the actual market level. Indeed, it is necessary to convince investors by fundamentalist arguments in spite of the extravagance of the current price level. In addition, Orléan goes further in the process of mimetic interaction by showing that when no common references are available, the only rational solution is to anticipate the opinion of the group [Orléan 1999, 100].

d/ Conclusion: A Definition of the Notion of Convention

From what has been seen above, it is possible to give a clear definition of a convention. A convention can be defined by three characteristics: 1) some norms of behavior that determine the normality of a situation and give saliency to implementing decisions, 2) a particular vision of the future that justifies the norms chosen, and 3) a level of confidence in the provision given by the convention. *A convention permits individuals to act in a situation of uncertainty because it gives them an interpretation of the current situation, a mode of behavior to adopt, and an objective that reduces the darkness of the future* (a projection of the future that they would like to create).

B. Banking Convention, Financial Convention, and Financial Market

By putting together the financial convention and the banking convention and by explaining their origins and mode of formation, one obtains a general explanation of the framework in which asset-prices are determined. As it has been argued above, the formation of a convention is based on the beauty-contest principle (autoreferential rationality) and is “the outcome of the mass psychology of a large number of ignorant individuals” [Keynes 1936, 154]. The convention also results from the influence of media and experts that homogenize the thought of investors [Shiller 2000]. Let us now examine how all the different elements are linked. All of the following refers to Figure 1.
If uncertainty about the success of investment projects were nonexistent, it would be unnecessary for capitalists to demand market liquidity because everything would be expected: they would invest knowing the (expected) profitability of each project and having planned their financial needs for the future. Thus, a financial architecture constructed to promote liquidity would be unnecessary because capitalists would face no uncertainty. Market liquidity is artificially created to face uncertainty of the future. This liquidity is conventional and depends on the financial convention: *There is an interaction between uncertainty and the interpretation of market liquidity.*

In addition, if everything were easily predictable, the central bank would not have the necessity to act as lender of last resort unilaterally because it would be able to distinguish between illiquid and insolvable banks and could know all the consequences of a refusal to grant a loan.

In a situation of uncertainty, capitalists and banks cannot individually take the responsibility to evaluate a firm, an economic sector, or a country. Indeed, they do not possess all the available information and are not necessarily able to interpret it. *Therefore, they look at their own community to confirm or disconfirm their judgment and banking and financial communities interact with each other.* They also follow the opinion of experts and media.

Putting together the institutional factors such as, not only market liquidity and the central bank’s attitude but also the mode of remuneration of fund managers and the competition between banks, the behavior that consists in looking at each other is rational. This behavior is reinforced by the existence of psychological and sociological factors. The first takes the form of the conservatism principle, representativeness, anchoring, the unpacking effect, etc. The second is social pressure, herding, mimetism, fashion, etc. These two factors lead to giving importance to the financial experts who are a focal point. To continue the picture presented by Keynes, one could say that some judges in the beauty contest are estheticians. These judges have more weight in the formation of the main opinion.

Thus, from one side, we have capitalists that look at the opinion of the financial community and, from the other side, we have banks that look at the interpretation of the economic and financial reality via the bank sector. It seems likely that an interaction between both communities occurs.
Figure 1: Asset-price formation in a context of uncertainty
The financial convention determines the speculative sentiment — that is to say, whether capitalists are more prone to sell, or to buy assets. The banking convention determines the state of credit — *i.e.* the confidence of the banking sector and thus the possibility of indebtedness making possible for investors to benefit from a leverage effect on financial markets. Both conventions work together to fix the market price *via their influence on the behaviors of capitalists and bankers*.

Here there is one major positive feedback loop. The market price, by confirming or disconfirming the convention in place, will influence uncertainty or, more precisely the *perception of uncertainty*. There are two sources of uncertainty. The first is that price does not conform to what is judged normal by the convention. The second is that conventions evolve with the evolution of institutional and socio-psychological factors or of the economic situation.

### III. Conclusion

Figure 1 gives us a global explanation of the way asset-prices are fixed and evolve. *A priori*, this figure seems not to take account of the autojustification process, because conventions determine asset-price. In fact, this simply shows that the convention appears before price fixation. The convention appears from the very beginning with the determination of the marginal efficiency of capital. Then, abnormal evolution in the market price can induce an evolution in conventions. The following figure is at work:

Institutional factors are supposed to vary progressively over years. Uncertainty is basically purely exogenous but becomes endogenous via the interaction between price and conventions. Psychological factors are those that react the most rapidly to the evolution of uncertainty. Finally, what should be put forward is that *conventions do not determine asset-price, it is the “law of supply and demand” that does so, conventions “only” influence the behaviors of financial actors*. Moreover, a convention does not imply homogeneity of behaviors; it only constrains them.

### Conclusion

One of the essential conclusions of this paper is to show that monetary regulation is not sufficient to regulate financial inflation; an internal regulation of the market and external institutional evolutions are necessary. As Galbraith says: “Far more important than rate of interest and the supply of credit is the mood. Speculation on a large scale requires a pervasive sense of confidence and optimism and the conviction that ordinary people were meant to be rich” [Galbraith 1954, 174]. The analysis also shows that to put
the blame on investors and their irrationality is not a good way to understand the problem. Financial actors adapt themselves to their environment (so they are rational), and if one wants to change this behavior, it is necessary to change the conditions in which financial investors evolve. It is also possible to put controls on behaviors, but this way of proceeding is less effective because financial actors always innovate to bypass constraints that are imposed on them.

As Figure 1 shows, one essential solution to regulating financial inflation goes through an evolution of external institutions. For example, a control of the yield offered by the mutual and pension funds would help to regulate financial inflation. Indeed:

$$p^*_{t+1} = R_t - \frac{d}{p_t}$$

This would need to be coupled with a monetary regulation to limit indebtedness of enterprises to face a demand for increasing dividends. As Aglietta (2000) showed, dividend policy puts a lower limit on indebtedness. Thus, an extension of the income policy to the funds would help to regulate financial inflation. The regulation of financial inflation can also result from a reduction of competition when the latter leads to dangerous behaviors. One good example is the behavior of mutual funds on the NASDAQ. The bubble is mainly explained by the fact that mutual funds are judged on their quarterly performance so they all copied each other to limit the differences in their yields. A competition based on quarterly analyses is clearly unreasonable for funds that are normally oriented toward long-term purposes.

Globally, therefore, it is necessary to develop a true financial policy that deals with the specificity of this sector. A monetary regulation via the fed fund rate can only be partially effective because financial actors can protect themselves against the variations of interest rates. Moreover high variations of interest rate are needed to control this kind of inflation (leading to instability in other sectors of the economy) [Toporowski 2000]. Some solutions can be provided, but it is necessary to look behind what we can see in the market and to ask ourselves why people act as they do. To complain about their behavior is like making more powerful cars and complaining that there are more accidents.

**Notes**

1. Campbell (2000) reviews the works of the last twenty years.
2. Graber (1990) argues that what is commonly known as the tulip bubble was actually not a bubble but the integration by the market of exceptional characteristics of some bulbs.
3. In the rational bubble explanation, a bubble can appear only if it exists at the issue of the financial asset.
4. Irrationality is defined in the following manner: “Noise trader falsely believe that they have special information about the future price of the risky asset. They may get their pseudosignals from the technical analysts, stockbrokers, or economic consultants and irrationally believe that theses signals carry information” [De Long et al. 1990, 707]. Thus, an irrational investor does not look only at its own information to make a decision. However, it will be shown further that this kind of behavior can be considered as perfectly rational.
5. The macroeconomic approach to overconfidence is an exception.
6. The stabilization of the financial market implies that investors have a mimetic behavior
7. It is possible to add a deposit insurer and other institutions of supervision but this is not important for the present topic.

8. This general behavior is, however, very rare and occurs mainly in periods of crisis, when the structure of banks is very degraded. The lender of last resort, moreover, prevents this from happening by buying at a better price or taking as collateral the assets of banks. Thus, as soon as banks know the central bank will be behind them, they continue to loan even if they become more restrictive after a crisis. There are, however, situations, like in Japan, where the situation is so degraded that banks refuse to lend even when the central bank buys and discounts a huge amount of assets.

9. One has to note that Keynes was already clearly aware of the different between an accomodationist and structuralist approach.

10. One important element is missing: the entrepreneurial convention. This one plays a role on the new emission of shares, the leverage buy-out, and the buy back of shares to sustain the market price.

References


Eric Tymoigne


The Future *United* European Community:  
A Discussion of the Past, Present, and Future*

By Jonathan L. Watkins

The Euro is the new single European currency for participating European Union (EU) member countries. The participating countries have adopted the new single currency to simplify cross-border trade, employment and travel. Through the single currency, most European travelers (or businesses), for example, will no longer have to pay the currency exchange rate fee (i.e., transaction costs). In addition, there will be no need for speculation on the value of European currencies against one another as risk related to such valuation changes.

The intent of this paper is to briefly discuss the historical reasons for the creation of the European Union. The current state of the European Union will be presented by stating the economic significance of this pact for the European Community. This paper will culminate with a weak-form hypothesis concerning what will happen to the European Community and the Euro in the future.

A Brief European History Lesson

European countries have a long history of war from the times of the Roman Empire invading, controlling and influencing much of Europe before 400 AD. Around 800 AD, Charlemagne tried to unify Europe. In France, Spain, Portugal, Italy and Great Britain, Catholic Church influence and control lasted beyond the 1530’s. The Catholic Church’s influence and control lasted in Great Britain until King Henry VIII was excommunicated from the Catholic Church and helped Britain break free of Catholic control. Since the ‘early days,’ the most important military actions occurred during the 20th century.

In 1834, the first logical attempt to unify Europe was proposed by the Young Europe Organization. This proposal was never accepted or given much thought. Both World War I and II “caused immense damage to the European economy,” since both wars were fought in Europe during the 20th Century [Schnetzer 2000, 339]. While World War II was initiated with the intent to “unify the European Continent under a single ruler through force,” World War II was not able to accomplish its intent [Schnetzer 2000, 339]. This is mainly because these wars tried to force the people of Europe to live under a single dictatorship, imperialistic rule. The most noteworthy is when Adolf Hitler tried to unify Europe under his control during World War II.

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*I would like to thank Professor W. Robert Brazelton for all the valuable information and suggestions he shared with me while writing this paper. Professor Brazelton should not be held responsible for errors and opinions in this paper.*
Post-World War II European History

Since the end of World War II, European Countries began making economic trade pacts and first became known as the European Coal and Steel Community. The economic trade pacts began moving European Countries closer together to create a European Union and to create a single common European market. The first such treaty to pursue this goal was the Treaty of Rome signed by six European countries. The 1957 Treaty of Rome became the “basis for trade among members” [Angressano 1996, 333].

The treaties signed in Rome “led to the establishment of the European Economic Community (EEC) and of the European Atomic Energy Commission (EAC) in 1958” [Kondonassis 1989, 129]. The following are the basic purposes for the European Economic Community, as outlined in Article 3 of the Treaty of Rome and summarized by A.J. Kondanassis [1987, 125-126].

1. The elimination of customs duties and of quantitative restrictions on the import and export of goods;
2. the establishment of a common customs tariff and of a common commercial policy toward third countries;
3. the abolition, among member states, of obstacles to freedom of movement for persons, services and capital;
4. the adoption of a common agriculture policy;
5. the adoption of a common transport policy;
6. the creation of a European Social Fund in order to improve employment opportunities;
7. the establishment of a European Investment Bank to facilitate the economic expansion of the Community;
8. the association of the overseas countries and territories in order to increase trade with them, and to promote jointly economic and social development.

In order for the EEC to pursue its basic purposes, it created a number of institutions to help achieve its goals of greater economic equality and freedom within the European Community. The institutions that were created are as follows: Council of Ministers, European Commission, European Council, Court of Justice, European Parliament, Court of Auditors, and the Economic and Social Committee. No parallels can easily be drawn between the European Community’s institutions to those of Great Britain or the United States.1

The EEC promoted economic integration through the use of four goals:

first, the elimination of internal barriers to trade through removing customs barriers; second, the achievement of a customs union through applying a common external tariff toward nonmember nations; third, the establishment of a common market by permitting the free flow of factors of production plus goods and services; fourth, the attainment of further integration by adopting common policies (e.g., agriculture, competition, social, transport), which would contribute to the establishment of a single market” [Angresano 1996, 333].
Since the Treaty of Rome, two positive events have greatly affected the current state of the European Union. First, enlargement of the EU to include 15 nations “has increased the potential for trade creation considerably” [Angresano 1996, 333]. This has greatly increased the size of the EU to challenge the United States economically and to exceed the United States’ size population-wise. “The second series of events started in the late 1960s, when global monetary stability had ended, Japan had emerged as an economic power, and EU leaders recognized they were experiencing a ‘loss of sovereignty in macroeconomic and monetary policies’” [Angresano 1996, 333].

In 1986, the Single European Act (hereafter SEA) amended the Treaty of Rome, reforming many of its institutions. This act primarily deals with improving the EEC’s institutions, while removing “all of the barriers to the free movement of goods, persons, services and capital, with cooperation in economic and monetary policy” [Kondonassis 1989, 132]. Also, SEA improves “cooperation in the areas of social cohesion, research and development, the environment, foreign policy and defense” [Kondonassis 1989, 132]. A single unified European Economy has the ability to be very significant, both micro- and macro-economically.

SEA achieved the “introduction of a clear program for the creation of the single market, internal decision making reform and the formalization of the earlier biannual meetings between the heads of state of the member states” [Kreppel 2001, 79]. To continue the momentum created since the end of World War II through the 1986 SEA, it started to become obvious that a single currency would need to be implemented under the control of a true monetary union. In order to achieve a true monetary union, the European member states would need to agree to relinquish their monetary power to a supranational power.

Not only did the Single European Act assist in the future development of a single currency and a single economic and monetary authority: it also was aimed at achieving a more expansive European Community. This momentum helped carry forward the idea of a unified European economy, thus creating the European Monetary Union and the idea for the implementation of a single currency (i.e., the Euro) in the 1992 Maastricht Treaty.

The European Union since 1992

The history of Europe this century (twentieth) is not just a history of wars – as it has been for several generations who lived through them as victors or vanquished – nor of division and outside dominance, the last vestiges of which are now being dismantled. For Europe has always been a place of peaceful encounter and mutual exchange between peoples too, and this shared experience lies as much at the root of European integration as the realization that a community is more than the sum of its members. Many of the things we now take for granted in the Community – peace, open borders, relative prosperity – have never been part of the natural order of things before [The European Community 1992 And Beyond 1991, 1]

According to Amie Kreppel the creation of the European Monetary Union with a “single currency (the Euro) and a European Central Bank (ECB)” was “perhaps the most important aspect of the Maastricht Treaty” [Kreppel 2001, 80]. The EU currently consists of the following 15 member states with their entrance years: Austria (1995),

The Maastricht Treaty put forth a “strict set of economic performance criteria that would be required before any country could join the new ‘Euroland’, including limiting inflation, budget deficits and low long-term interest rates” [Kreppel 2001, 80]. Twelve of those member states wanted to join and agreed to use the Euro at the beginning of 1999, with three countries (Britain, Denmark, and Sweden) deciding to opt out for the time being. Eleven of the twelve member states that wanted to join met the strict criteria set forth by the Maastricht Treaty as of early 1999. Greece was the only country that didn’t meet the criteria, but it “has since met the criteria and became a member of Euroland” in early 2001 [Kreppel 2001, 80].

In agreeing to join the single currency and monetary authority, the eleven initial states had their currency permanently fixed to the European single currency. The Euro’s start date was midnight on January 1, 2002.

The European Community and the Euro in the next 100 years:

The rapid and extensive development of the EU is unparalleled. At no time in history have so many countries willingly given up so much of their national sovereignty to a supranational authority [Amie Kreppel in her article European integration: past, present and future 2001, 77].

The Euro is bringing about an economic unification of the EU member countries. Through this economic unification, I argue that these member countries will begin to lose a part of their national (self-) identity by replacing their own currency and economic plan with one single currency and one single economic plan. The end result will culminate in a single Unified European nation during the next 100–200 years and probably within 50 years. The economic unification’s impact is still in its infancy, but the political side effects can already be seen.

The new single currency will have many positive ramifications for the European Community. As a result of the successful implementation of the Euro, I expect that the number of languages spoken in Europe will be reduced to three, English, German and Spanish, unless Britain never decides to join ‘Euroland,’ and then the main languages will be German and Spanish. In order for the European economies to be successfully integrated, greater interaction between governments will be required to ensure future peacetime in Europe. Europe will face the challenge of truly becoming united economically while diminishing the possibility of having another inter-European war.

In order to achieve this, European nations will need to adopt a unified military defense program for all nations to cooperate and participate in. Many changes have already occurred, and the only logical conclusion is for the nations to come together and create a single United Europe nation. There are many possibilities to achieve this end result of the Euro. Each current nation could become a nation-state of a United Europe, much like the states in the U.S. By doing this, each nation could maintain a major piece of its history and culture: its name. Furthermore, each nation could retain its current flag just as each state in the U.S. has its own flag.
The main argument for a *United* Europe is that the greatest economic booms have occurred during peacetime, and in order for the Euro to succeed, all the current nations will have to trust each other like never before. In the current state of the Euro, we do not know what will happen if one economy is in a deep recession while the rest of the EMU countries are experiencing an economic boom. We do know that a country cannot necessarily stimulate its economy through fiscal policy, since the member countries have a budget requirement to not carry a deficit greater than three percent. Will that single country get the economic aid it needs? Will that country try to break away from the Euro and begin to issue its own currency and economic policy? In the worst case, will economic inequality result in one EMU country declaring war on another or on the EMU as a whole?

Those are the main questions that remain to be answered and, until 15, 25, 50, or 100 years from now, we can only philosophize about the answers. In a *United* Europe, the nation-states would need to be fiscally responsible, much like the states in the USA, to carry little or no budget deficit. Where there is a strong need for boosting the economy, there would be a federal government that could take on a bigger deficit to help the economy recover and to help increase equality through federal grants to “states.”

The most important policy initiatives that ‘Euroland’ can promote are to reduce unemployment, maintain a low rate of interest, and keep inequality low among member nations. The first policy should be trying to achieve full employment, which is more plausible with the assistance of a federal government initiative. A policy such as the one that the Center for Full Employment and Price Stability promotes would be a good place to start discussing the benefits of achieving full employment.

In “The Employer of Last Resort Approach to Full Employment,” Professor L. Randall Wray discusses both the benefits of this type of program and addresses the pessimistic questions about how such a program could exist. The key point, at least for my purposes here, is that a program such as having the government be the employer of last resort will lead to full employment. There would not be any involuntary unemployment in this type of system because all those people unemployed would have done so voluntarily.

The ELR will eliminate the need for a minimum wage, as the ELR wage will become an effective minimum wage. It could also establish the base package of benefits that private employers would have to supply. It could replace unemployment compensation, although it could be simply added on to give workers who have lost their jobs more choices. In the US well under half of the officially unemployed even qualify for unemployment compensation. The point is that no matter what social safety net exists, ELR can be added to allow people to choose to work over whatever package of benefits might be made available to those who choose not to work. Obviously, generous benefits to those who do not work can affect willingness to work. The ELR benefit and wage package should be set higher than the benefit package given to similar individuals who do not work, but even this is not absolutely necessary. If ELR enhances one’s access to desirable private and public sector (non-ELR) jobs, then some individuals will choose to work in the ELR program even if this means taking a benefit cut. However, if society values work, it seems far more reasonable to reward ELR workers with a better
compensation package than they would receive if they did not work [Wray 2000, 4].

This program would not be effective if it required deficits above 3% of GDP, in the current state of the EU, because each country is restricted to maintaining a deficit no larger than 3% of GDP. Supporting a program to achieve full employment should also indicate the importance of having a federal government to hire everyone who is willing and ready to work. Why is a federal government needed in the EU to help promote and achieve full employment? I believe it is fair to use Professor Wray’s answer to why the ELR is needed when states already have ‘welfare to work’ programs implemented:

State governments cannot run continuous deficits and would find that precisely when ELR is most needed, tax revenues would fall. Further, the price stabilizing features of ELR requires creation of a national labor buffer stock pool. For these reasons, the program should be nationally funded and should be subject to national standards regarding wages and benefits [Wray 2000, 4].

Maintaining a low rate of interest is the second policy that the European Central Bank should advocate trying to keep the economy in a ‘quasi-boom.’ John Maynard Keynes argues, in his General Theory chapter on the trade cycle, that “the remedy for the boom is not a higher rate of interest but a lower rate of interest!” [Keynes 1964, 322]. Keynes argues this because a lower rate of interest “may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom” [Keynes 1964, 322].

In the concluding notes to Keynes’ General Theory, he states that unemployment and inequality of wealth are the two main faults of capitalism. He believes that some inequality of wealth is good and does not want to promote savings, but wants to promote investment. Inequality impedes growth because it lowers the marginal propensity to consume and increases the demand gap. A reason for allowing some inequality in the capitalist society, Keynes states that “It is better that a man should tyrannise over his bank balance than over his fellow-citizens” [Keynes 1964, 374].

I believe that John Maynard Keynes would agree with this type of program. Keynes writes that he would defend the “enlargement of the functions of government ... both as the only practicable means of avoiding the destruction of existing economic forms in their entirety and as the condition of the successful functioning of individual initiative” [Keynes 1964, 380]. By having a single constitution for ‘Euroland’ countries, it would become possible for the government to take on debt at the federal level while the nation-states would remain fiscally responsible. This seems to be the best way to achieve peace and economic integration throughout Europe.

Notes
1. For purposes of this paper it would be much too drawn out to try and discuss the great intricacies of the European Community’s. In order to gain a greater understanding of how the European Communities Institutions are integrated and work, I suggest reading through Part II of Alun Jones’ The European Community – A Guide through the Maze. Part II (pg. 26-43) is
titled “The Way the European Community Works” and discusses the basic responsibilities for each institution. Part IV (pg. 53-62) “Decision-Making and how it is Influenced” should also be read.

2. This argument assumes that the Euro is strong with little or no economic downfall in the short run and that member countries do not begin using their own currency due to little or no control of their economic policy.


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The Power Elite by C. Wright Mills, Oxford University Press, Inc. 1956.

Reviewed By Jennifer Norton

“The powers of ordinary men are circumscribed by the everyday worlds in which they live, yet even in these rounds of job, family, and neighborhood they often seem driven by forces they can neither understand nor govern.” – C. Wright Mills, 1956.

The Power Elite by C. Wright Mills rings true in today’s society even after fifty years. This review highlights some of the main points of Mills’ classic work and suggests some contemporary examples of how these points apply. The chapters focused on are “The Higher Circles,” “The Chief Executive,” and “The Higher Immorality.” In these chapters, Mills discusses an interlocking triangle among the powers that be – corporate, political, and military power – and the power of money.

In “The Higher Circles,” Mills states that people cannot control (and only sometimes understand) the outside forces that drive everyday events. There are many ‘natural’ powers over which we have no control, but when influence our actions and conduct, e.g., weather, luck, and the unknown. The biggest, most powerful company in California may have its power stripped due to a major disaster such as an earthquake. There is also the lottery winner who was once middle class but is now wealthy and perhaps powerful. “The power elite are not solitary rulers,” says Mills, and this is seemingly a very accurate statement. No one person or thing has absolute power. Even the President of the United States has advisors to aid in his decision making as well as voters to answer to. The biggest, most powerful CEO’s of the corporate world rely heavily on their managers and consultants. The President or a CEO may have the ultimate authority, but they do not have absolute power.

Another point Mills discusses in the “Higher Circles” is the triangle of power in America among the economy, politics, and the military. For example, some say the most powerful man in the U.S. is not the President but the chairman of the Federal Reserve Board of Governors, Alan Greenspan. But they are almost surely incorrect. He may make decisions to stimulate (or hurt) the economy, but those decisions are influenced by the big corporations, politics, and the military. The economy does not rely solely on Greenspan’s decisions (which are made not solely by him but with the aid of the other board members) but also heavily on corporations. These corporations are regulated and sometimes controlled by politics or the government. Many companies also rely on the military. During wartime, the economy has been helped due to military spending. War can be linked to all three powers. For example, politicians make the ‘decision’ to go to war, which is influenced by the military. The economy is boosted because of the military’s additional spending, which resulted from the political decision to engage in war. Therefore, no one elite or individual has unilateral power. Rather, it is the interaction of those in important institutions that results in power, and these are the power elites.
In the chapter on “The Chief Executive,” Mills examines in detail the power of the corporation or the chief executive of the corporation. During the twentieth century America witnessed the consolidation and merger of many small companies to create conglomerates. Some individuals in government feared that these companies would become monopolies and would take advantage of that position to the detriment of the larger population. Directors on some of these large corporations would serve on several boards of directors for other companies (i.e. industrial organizations can serve on bank and insurance boards, and the bank and insurance boards can serve on the industrial organizations’ boards). Hence, the pro-competition theory of the government is no longer maintained. This then raises the question of whether those who run large, powerful corporations are the power elite or is it the corporation itself? A corollary question is whether corporations make people powerful or whether they are powerful without the corporation.

Mills’ “Higher Immorality” chapter is very interesting. He argues that there is a general acceptance on the part of the larger population of the higher immorality of the American elite. Mills also asks why the power elite’s immorality is more acceptable than that of an average person. The American way is the pursuit of the dollar, and for many, money runs their life and is everything. Money is the main criterion for success in America. If one were to ask Americans who is more successful, Bill Gates or Mother Teresa, most would say Bill Gates because he is extremely wealthy. Usually, people pursuing power need money. While in this pursuit, they place less value on their moral values and more on getting to the top. Mills gives a comparison of the ‘self-made man’ versus the ‘family-made man’ that seems very accurate. Americans view the ‘self-made man’ as superior but only if he is not a family man too. The reason for this is that people know that the self-made man loses his moral values in the pursuit of the power of money. This is not a valued quality for a family man.

Mills goes on to argue that there is “no such thing as a self-made man.” This too is true. People often shape themselves to fit into a society in order to excel and become powerful. For example, many refer to Bill Gates or Donald Trump as self-made billionaires. Yet, both came from wealthy families. They were molded to go to the elite colleges. They had the help of their past – they did not do it entirely on their own. For them, as for many others, who they knew was the key to their success.

Today, as in 1951, one can agree with Mills: the American elite is not composed of ‘representatives’ that reflect the mass society. The power elite in America cannot be representative of the middle-class population. The last paragraph of “The Higher Immorality” exemplifies these thoughts:

The men of the higher circles are not representative men; their high position is not a result of moral virtue; their fabulous success is not firmly connected with meritorious ability. Those who sit in the seats of the high and the mighty are selected and formed by the means of power, the sources of wealth, the mechanics of celebrity, which prevail in their society. They are not men selected and formed by civil service that is linked with the world of knowledge and sensibility [Mills 1956, 361].
The Power Elite was written nearly fifty years ago, but it still addresses very relevant issues in today’s society. The power elite does exist in America. However, we do not know exactly who or what really possesses the most power. A very important triangle exists in America, consisting of a powerful economy, politics, and military. Some argue that the real power is in the government and the military. But others argue that the corporate world really is in charge. Yet, as Mills states, all are the power elite, all are in charge, and all are interlocking powers.

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http://www.thirdworldtravelor.com/Book_Excerpts/HigherCircles_PE.html

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Reviewed by Benton Wolverton

Patten’s work had never been well received by economists other than his students. His mastery in the classroom had not translated into mastery in print. This was to change with the publication of his beautiful polemic The New Basis of Civilization. It was Patten’s most popular book, which went through eight editions in sixteen years. The reason this book came to be is that one of his former students, Samuel McCune Lindsey, asked Patten to give a series of lectures before the New York School of Philanthropy. The result of the 1905 lectures was the publication of the The New Basis of Civilization in 1907.

Writing a review of a book that is almost a century old has to be done with caution. Especially a book that predicts that poverty can be abolished with the advances of technology. “The economic revolution is here, but the intellectual revolution that will rouse men to its stupendous meaning has not done its work” [Patten 1907, 11]. The intellectual revolution that Patten was talking about concerned a transformation from a ‘deficit’ to a ‘surplus’ economy. In this transformation, our social institutions must evolve; otherwise, the industrial revolution would remain incomplete. “It was in such a world [a ‘deficit’ economy], where a man’s death was his neighbor’s gain, that our social institutions were grounded” [Patten 1907, 67]. There are two types of institutions social and economic. The social institution “establishes status and the rights of possession and of exploitations; the other [economic institution] increases the mobility of men and goods, promotes industry, and gives each generation renewed power to establish itself closer relations with nature” [Patten 1907, 68]. Instead of quoting the book over and over go to your local library and pick it up.

The economic profession lacks the passion that is contained in this short book written 97 years ago. It is time that we look towards the window and not towards the chalkboard for solutions to society’s problems. The book stands the test of time, and for that it should be considered a classic.
Books Received


Congratulations to UMKC’s Economics Students for their Publications, Conference Presentations, Interviews, and other professional and academic activities! Keep up the good work!

Steven A. Waller

**Book Publication:**

**Book Overview:**
Is the economy new? It really depends upon your education and perspective. Steve’s book goes beyond the static analysis of Orthodox economics and gives readers a dynamic approach. In other words, the economy is not necessarily “new,” it is always new. The book is intended for undergraduate business and economics students as well as business managers.

Claudia Maya Lopez

**Book Chapter Publication:**

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Presentations:

“Production and Consumption under Vested Interests: Sabotage of Production and Pecuniary Emulation,” Annual Meeting of the Association for Institutional Thought (AFIT) – Albuquerque, New Mexico – April 10-13, 2002.


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Presentations:

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