## insight into the quantity theory of money: a historical perspective

The quantity theory of money is not an abstract theory that only applies to modern times and to few countries. Actually, to fully appreciate what this theory says (and what money really is for an economy) it may be useful to go back to our introductory brief history of money (text at the beginning of this section) and see how the quantity theory of money applies to different contexts.

Let us start by considering how the quantity theory of money works for a simple economy of a small little island where a rare type of seashell is used as commodity money. Let us suppose that there is a certain stock of this type of seashell in this economy, which is enough to support the economic transactions that take place within the island over a certain period of time and which is enough to support the savings that certain people are able to make. As sea shells are fairly rare, the total stock of money has remained stable for a very long time.

Let us now suppose that one day a fisherman discovers a huge stockpile of the precious sea shells down the seabed. Without revealing the discovery to the community, this person starts, day after day, digging some shells, and going the local market to buy something. Initially, as demand for goods increases, more is being produced. As more is being produced other members of the community feel richer, and they also start purchasing more. Overall production increases and so does overall income. Eventually, the community hits a technological barrier and cannot further increase production. However, the fisherman keeps introducing shells to the economy. After some time something unprecedented happens: producers, who cannot stretch production further, start asking more shells for what they sell and prices start increasing. As prices increase those who saved will see that the value of their shells declines in real terms, that is, in terms of goods and services. Fearing that the value of their savings will erode even further, they start bringing their shells to the market to purchase goods. Prices will increase until the fisherman has exhausted his treasury. At that point, prices will stop increasing but shells will be worth less than before the increase in prices began.

This simple example is actually not very far from reality. Medieval Western Europe suffered for centuries from a chronic lack of gold and silver. There were not enough coins to support economic activity, to the point where many communities were functioning with barter. As there was not enough gold, prices used to remain constant for decades. Actually, as shocks to supply were common, Western Europe used to experience long periods of falling prices. With the discovery of America gold started to flood in. At first, the increase in gold stimulated demand, production increased (as more and more gold supported more and more transactions), and the economy prospered. At a certain point, around the beginning of the 16th century, the quantity of gold in circulation started to exceed the value of what the economy was able to produce. At that point prices started to increase and they kept increasing steadily for over a century, something that had been unseen before.

These two tales (one fictional, the other real) highlight the function of money for the economy and how the quantity theory of money works. Money makes economic transactions smoother. Too little money can hurt the economy and push production below potential (see module 1). However, once production reaches or is close to potential, too much money can be equally bad, as it generates inflation. In modern times, many countries experienced high level of inflation as their money was being created beyond what the economy needed to function, like the fisherman in the island of the first example.

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For more on the quantity theory of money and monetarism, check out this Back to Basics article from Finance & Development (F&D) Magazine: What is Monetarism?

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