CHAPTER 25. MONEY AND THE THEORY OF THE FIRM

INTRODUCTION TO MONEY AND THE THEORY OF THE FIRM

A $10 National Gold Bank Note — issued by the First National Gold Bank of Oakland, California (c. 1870s). (Wikimedia, Public Domain)

CHAPTER OBJECTIVES

In this chapter you will learn about:

- The Metallist and the Barter Myth
- Smith, Marx, Keynes, Chartalism and Modern Money Theory
- The Money Hierarchy and the False Duality of the State and Market
- Local Currency Systems: Social Money and Community Currencies

The standard approach, taken in neoclassical texts, to describe the firm's role in the economy is to ascribe a coordinating function: the firm optimally selects the inputs of labor and capital to efficiently produce output for the market. This functional interpretation (1) of the firm allows the neoclassical economist to maintain the same level of simplicity, or abstraction achieved in consumer theory. This approach limits the scope of value determination to commodity market exchanges, as seen in Chapter XX (The Role of Value(s) in the Economics Discipline). In this chapter, we investigate how this abstract methodology of modeling the economy influences our understanding of money.

$q = f(k, l)$

where

q is output,

k is capital,

l is labor,

f provides the functional description of technology.

Understanding the limitation of money in the neoclassical framework will be achieved in three steps. First, the story of money will be told from the neoclassical perspective. In telling this story, we will discover that the neoclassical economist relegates money to a secondary role in economic activity. The neoclassical presentation describes money as a commodity that facilitates the exchange of other commodities. This secondary role for money allows the neoclassical economist to continue to apply, what we will define as real analysis. After our neoclassical story is completed, a second story of money will be told. This story is guided, not by theory, but by history, and will help us to understand money's true origins. In applying a historical and institutional methodology, we will see that money is much more critical to economic activity than neoclassical economists suppose. Money is special, because of how it can be used, and who is able to produce it. In the next section, the historical understanding of money not as a commodity, but as a social relation will break down the traditional perspective of a strict duality between the state and the market. This is accomplished through an analysis of or economy not as a barter system, but as a monetary production economy that operates within the constraints of the legal and institutional framework of a money hierarchy.

The final section extends our understanding of the monetary production economy by examining local currency systems. Local currency systems are emerging across the world in communities that have been abandoned by mainstream economic policies. These local money systems are supporting single mothers, helping children go to school, cleaning up streets and neighborhoods, and reducing waste. By comparing the monopoly issuing authority of the United States and these micro currency systems, the coordinating function of money in economic activity will become clear. Geoffrey Ingham once argued that, money is our most powerful and underemployed social technology[1]. This chapter will help you to understand why.

[1] This insight is drawn from Geoffery Ingham's contribution to John Smithin's 2001 edited volume, *What is Money?.*

25.1 THE METALLIST AND THE BARTER MYTH

LEARNING OBJECTIVES

By the end of this section, you will be able to:

- Discuss the importance of barter in modern economic analysis

In what kind of an economy do we live and operate our daily lives? This is not a trivial question. As ideas about how human beings can best organize their resources developed into enlightenment philosophy, a prominent method for expressing what a society free of the feudal constraints would look like involved imaginary stories. Philosophers, such as John Locke, Thomas Hobbes, and Jean-Jacques Rousseau asked their audience to imagine a place called the state of nature to consider possible social outcomes, when this place is populated with free individuals. In the state of nature, will chaos, barbarism, or a harmonious stable society result?

In Locke's version, individuals needed to follow two constraints or simple rules in order for a harmonious and stable society to emerge. The first of these constraints is the spoilage constraint. In the state of nature, no individual should collect more food, nuts and berries than they can consume before they spoil. Second, the prejudice constraint cannot be violated. This constraint is "predicated on the right to subsistence: the privatization of land [can]not disadvantage non-property holders, violating their right to subsistence goods."[1] As long as all those in the state of nature follow these two simple moral constraints, then a harmonious and stable society is argued to emerge. Through the evolution of similar stories, political economist would add their own plot twists and establish the setting for neoclassical economics.

What these imaginary stories have in common is the collective illusion that capitalism or free market economics grows out of a state of nature. The basic plot and stage for this story remains the same in neoclassical economics. How many of you got dressed and ready for your classes today in the Cartesian plane? Like their enlightenment predecessors' use of the state of nature the neoclassical story also takes place in a space that is not inhabited by human beings. The mathematical universe of maximization and optimal decisions, like Locke's imagined individuals, aggregates to a harmonious and stable solution. This solution is known as equilibrium in the formalized mathematical models of neoclassical economics. While the technical names and the math provide the neoclassical story with a scientific veneer, the underlying plot remains generally the same as those told over the previous four hundred plus years. A strong characteristic of these stories is their staying power, but a significant cost of such longevity is a lack of analysis regarding the actual economy in which we live and conduct our daily lives.

The economy described by Jean Baptiste Say[2] and other classical political economists of his era, as well as by modern neoclassical economists, is a barter economy. In a barter economy, goods trade for other goods. If we were to open a barter market in class, students could trade their hats, backpacks, books, shoes, and whatever else they had in their possession with other students. In this scenario, would much trade occur? Generally the answer would be no. This is because it would be rare that the **double coincidence of wants** would be solved very often. This means that for trade to occur I must have what you want and you must have what I want. If and only if this is the case will trade occur, because trade must make us both better off than we were before the trade took place. To solve this problem and reduce the amount of time individuals would need to spend seeking out solutions to the double coincidence of wants, society spontaneously agrees to accept a commodity as the facilitator of exchange—or at least this is how the story is told from state of nature and Cartesian plane origins.

The magical device that solves the double coincidence of wants and sets the economy free is money. Commodity money in the form of gold or silver has an **intrinsic value** that can be measured and all parties understand its value. Intrinsic value is a key concept and can be defined as the value the object has in and of itself. This is why precious metals are central to this story, as it is believed gold has value in and of itself. Thus, through this agreement, the transaction costs for all the producers and consumers in this economy are reduced and are therefore better off. This is the story often told by a group of economists known as the **Metallists**, because of the use of precious metals to denote the value of money. We can model money as the facilitator of a barter transaction using the following notation of C for commodity and M for money.

This is likely the story you have heard before, and it is definitely the one told to your parents in their introductory economics courses. As mentioned above, it is an old story. Roots to its origins go as far back as Plato and Aristotle, but the more modern versions are linked to the 16th and 17th century enlightenment philosophers discussed above. The staying power and continued adherence to this story is heavily reliant upon metal's intrinsic value. If money's value is connected to the weight and quality of metal, then it, just like the gold, silver, or the other goods it trades for, is a commodity. As a commodity, money preserves the barter system. In a barter framework, economists are able to practice **real analysis**.

Real analysis is described by the 20th century economists Joseph Schumpeter as:

> [all] the essential phenomena of economic life are capable of being described in terms of goods and services, of decisions about them, and of relations between them. Money enters the picture only in the modest role of a technical device that has been adopted in order to facilitate transactions. This device can no doubt get out of order, and if it does it will indeed produce phenomena that are specifically attributable to its *modus operandi*. But so long as it functions normally, it does not affect the economic process, which behaves in the same way as it would in a barter economy.[3]

In other words, economists can study real changes to output, employment, distribution, and growth without addressing money as anything other than a facilitator of exchange, because in the long-run money is neutral. Money does not generate real changes only nominal changes that create short-run disturbances to the stability of economic equilibrium. In other words, it disrupts the *modus operandi* in Schumpeter's quote. By examining money, within the context of modern economic events, it will become clear that the commitment made by neoclassical economics to the Metallist's story is not intended to provide an accurate understanding of history, but is rather an effort to preserve their method of economic analysis and the continued application of optimization techniques and mathematical modeling.

While the barter story is intuitively appealing, especially when described as an economy at a time and place far, far away, difficult questions about value and the role of the state complicate the drama. For instance, when gold or silver was spontaneously accepted as the commodity money, did people just trade nuggets of the metal? Where did coins come from? Who made the coins, and how was their value determined? Then finally, as economies incorporate paper money, how is the value of the currency maintained, especially if it cannot be directly converted into gold or silver? These questions are examples of critical analysis. Rather than accepting the story as given, critical thinking and investigation will help economists' and policy makers to develop an understanding of money and its evolution in economic systems.

To address these critical inquiries, let us return to Schumpeter's description. Money's value is as a technical device used in the facilitation of exchanges. Its value is intrinsically derived through a precious metal. In this scenario, it is a commodity like all other commodities. Difficulty only emerges, if it gets out of order. If money's *modus operandi* extends beyond the facilitator role, then the economy is no longer functioning as a barter system. It is in this capacity, as something more than a technical device that the **Chartalist** school of thought is introduced here, in the second act.

The complications, regarding money's value, have become increasingly difficult for Metallists to assume away and maintain money's status as a commodity. The most significant of these changes to the global economy has been the development of fiat currency systems that have completely broken monetary systems from the gold standard. An example of a fiat money is the U.S. dollar. They are issued by fiat, because the issuer will not give us anything other than other dollars in return. It is an inconvertible paper money. The gold standard allowed for the commodity money story to survive the complications associated with the expansions of both credit money lending and paper money, because money remained **convertible** into gold. However, the elimination of the gold standard has ended the convertibility scene and requires a new dialogue. If money cannot be converted into gold, and value is not intrinsically determined, then where does its value come from?

[1] The academic journal *The Review of Social Economy* has published a number of works of by Modern Money Theorist including the co-authored piece by John F. Henry, Stephanie Kelton, and L. Randall Wray, "A Chartalist Critique of John Locke's Theory of Peoples Accumulation, and Money: or is it Moral Trade your Nuts for Gold?".

[2] Jean Baptist Say is an important character in the development of the ideas that support neoclassical economics. One of his most well known contributions is Say' Law, which is commonly paraphrased as "supply creates its own demand".

[3] Joseph A. Schumpeter is widely regarded as one of the most influential economists of the 20th Century. Students are encouraged to explore his ideas on money in his 1954 text *History of Economic Analysis*.