Controversies in Monetary Economics: Ideas, Issues, and Policy
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Moral values may enter at a number of levels when economic decisions are made. Consider the issue of aid to temporarily unemployed workers. Social policies must be formulated, legislated, and administered. What are the values held by voters and their representatives? What are the values and expected behavior of the benefit recipients? How will values and behavior interact over time as economic and social conditions change?

If neoclassical economics is ill-equipped to address important social issues, it does not follow that its teleological theory (Utilitarianism) must be replaced. Amitai Etzioni, and most contributors to this book, would argue for a deontological theory of ethics, with greater attention paid to the interplay of institutions and moral values. However, we need to be reminded that within neoclassical economics Utilitarianism has been severely truncated. Moreover, the assumption of narrow self-interests is of recent vintage. Indeed, the Utilitarian credo "the greatest good for the greatest number" is almost absurdly egalitarian. Can we really expect individuals to sacrifice their own narrow self-interests to increase the community's total welfare? John Stuart Mill recognized that such a high level of social action could only be attained after years of education about Utilitarian social values. While neoclassical theory may have lost its way, the search for a more humane economics should not overlook the arguments of the original Utilitarians.

I highly recommend this book to economists seeking to improve their methodology; hence this book is recommended to all economists. Criticisms of neoclassical methodology have been made previously in other contexts, but the interdisciplinary perspectives offered in this volume provide a wealth of new insights for addressing social issues.

Controversies in Monetary Economics: Ideas, Issues, and Policy. By John Smithin. Aldershot, England: Edward Elgar Publishing, 1994. pp. ix, 211, $59.95. ISBN 1-85278-399-0.

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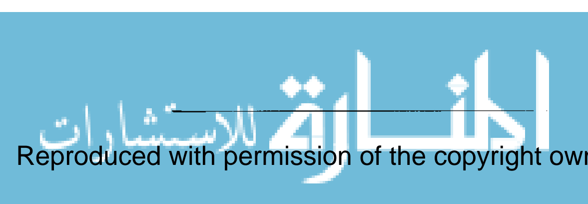
As its title suggests, this book surveys major controversies in monetary economics, from early formulations of the quantity theory to current debates. The author nicely organizes this huge topic around three major themes: (1) does money enter the economy *exogenously* or *endogenously*?; (2) do *real* or *monetary* forces determine the rate of interest?; and (3) does money *permanently* impact real variables? Regardless of their theoretical perspective, most monetary economists agree that these are the fundamental questions driving research and policy recommendations. While Smithin vigorously defends his own position on each question, he mostly provides a balanced presentation of the different answers provided by major (and some obscure) theoretical approaches over the past several centuries. Thus, his book is highly recom-



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mended as a reference work for economists and as a general survey for advanced students. In addition, Smithin offers an appealing alternative to the orthodox approaches dominating the field since Keynes' *General Theory* was bastardized.

The book covers too much material to allow more than a brief summary. Chapter 1 argues that most work in monetary economics assumes money is not important; however, there have always been dissenters who viewed capitalism as "pre-eminently a monetary system." Smithin falls into that camp, along with the Banking School, Keynes, the Post Keynesians, and the French/Italian Circuitistes. Chapter 2 examines the nature and functions of money, distinguishing the traditional focus on money as a medium of exchange from the nonorthodox emphasis on money as a standard of value. Smithin identifies the "dual role of money" (the terms in which debts are written and the means of payment used to discharge debt) with the view that capitalism is a monetary production system rather than a barter system using money to lubricate exchange. Chapter 3 traces the evolution of the quantity theory of money through a number of variants, including Friedmanian and New Classical versions of Monetarism. Chapter 4 examines alternatives to the quantity theory.

In Chapter 5 Smithin argues central banks would arise naturally, even in the absence of state intervention, since powerful forces generate concentration in the financial sector. Because credit money is issued on the basis of trust, prestige, and reputation, one institution with the ability to issue the final means of payment will emerge. This institution then sets the interest rate on its own liabilities, which becomes the base interest rate. Thus, central banks are "natural," their liabilities become the ultimate reserve, and they gain the power to implement monetary policy (defined as setting interest rates).

Chapter 6 examines and rejects the popular view that central banks primarily impact prices, arguing that monetary policy directly determines short-term interest rates. According to Smithin, this is the key difference between those who view money as neutral (at least in the long run) and those who argue that money is never neutral. In addition to rejecting the view that the interest rate is determined by "real" variables (such as productivity and thrift), Smithin rejects Keynes' liquidity preference approach (although he does allow for *temporary* effects of liquidity preference on the term structure). He adopts instead the "horizontalist" approach, in which the central bank sets the discount rate, short-term market rates are set as a mark-up over this rate, long-term rates primarily represent the expected value of future short-term rates, and the money supply is horizontal (supplied on demand) at the short-term market rate.

Chapter 7 offers a spirited defense of flexible exchange rates. Chapter 8 argues that economists have not been able to identify substantial costs of inflation (particularly when inflation is stable), nor have they paid sufficient attention to the costs of fighting inflation. In Chapter 9, Smithin offers a model to summarize his approach to theory and policy, showing that within the constraints of this model, a *real* interest rate target will generate the greatest economic stability at high employment.

Obviously, no author can examine every prior contribution; yet Smithin has neglected two major and relevant figures — Keynes and Minsky. While both are

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mentioned in passing, their major contributions receive little attention. Many agree that Chapter 17 of the *General Theory* is a seminal contribution to monetary theory; yet Smithin refers only once to "the complex arguments of Keynes' Chapter 17" [106]. He describes Keynes' liquidity preference theory as a theory of "the" interest rate, determined by the relation between the demands for money and bonds; and then rejects it with citations to Basil Moore and Marc Lavoie (among others), who interpret Keynes as being inconsistent with the endogenous money approach. However, Keynes' approach to monetary theory concerns *own rates* rather than *the rate* and provides a *general* theory of the link between own rates and the levels of effective demand and *monetary* production.

In Minsky's extensions, own-rate analysis leads to a two-pronged approach. Liquidity preference, financial market conditions, and expected yields determine the demand prices of assets; while production costs and aggregate demand determine current output prices. The interplay between these two price systems determines the level of monetary production.

Failure to recognize such insights leads Smithin to an apparent inconsistency. While presenting a monetary theory of production, Smithin discusses *real* interest rates and advocates a *real* interest rate target. However, he makes no argument to support the use of real variables in a model where *money* and nominal values are of utmost importance. If he had recognized that Keynes' use of *own rates* offered a coherent alternative to *real rates*, and if he had used Minsky's distinction between the two price systems, he would have realized that no logical defense can be made for deflating nominal interest rates by some measure of the *price level for current output*.

Ironically, Alan Greenspan, an avowed Monetarist, recently adopted a *real* interest rate target, exactly as Smithin advocates! (Admittedly, Smithin would target real interest rates to stabilize output and employment while Greenspan would do it to stabilize prices.) Greenspan's plan was immediately met with derision as misguided, unworkable, and inadequately grounded in theory. Smithin does not offer a convincing argument that the central bank can hit a real interest rate target that must be a residual — the difference between nominal rates and ephemeral expectations of inflation. Nor does he explain why the economic effects of a 2 percent *real* interest rate would be the same regardless of whether the *nominal* rate is 20 percent or 4 percent. If money really matters, the results should be quite different.

One also wonders whether rejecting fixed exchange rates is consistent with the view that money is a standard of value and with the argument that a dominant institution will naturally emerge whose liabilities function as the ultimate reserve. As Smithin recognizes, *within* countries a single unit of account is adopted in which the liabilities of the central bank are denominated; as lender of last resort, the central bank imparts stability to the economy because it can provide reserves without limit. Because he fears tight policy imposed by a monolithic international institution, or imposed by domestic central banks in order to maintain fixed exchange rates, he opts for flexible exchange rates and national independence. However, the logic of his argument concerning the nature of money and banking seems to lead to fixed exchange rates, an international reserve, and something like an international clear-

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ing union. This, of course, was precisely Keynes' prescription, but is only briefly analyzed and rejected by Smithin as politically infeasible. Further, Smithin's argument that flexible exchange rates provide greater national autonomy for monetary policy is disputed by the worldwide movement to Monetarism with abandonment of the Bretton Woods system. However, he may be correct in arguing that flexible rates are superior to fixed rates in a system dominated by central banks and international monetary bodies that follow Friedmanian dictates in lockstep fashion.

Despite these reservations, Smithin must be commended for his breadth of coverage, for his reasoned and fair analysis, and for attempting to synthesize and extend previous work in this area. In particular, his model should provide the basis for further attempts to develop a coherent approach to monetary theory and policy.

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