"THEORY OF MONEY: COMPARE AND CONTRAST THE POST-KEYNESIAN WITH THE INSTITUTIONAL PERSPECTIVE"

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Abstract

The purpose of this paper is to compare and contrast the Post-Keynesian and the Institutional views on the theory of money. The paper starts with the various definitions of money, reviews the monetary theory of production and then delves into the two money theories represented by each camp's main representatives' such as Domar, Harrod and Sollow (Post-Keynesians) and Veblen and its cronies (Institutional). The paper concludes that there are both some convergent as well as divergent views regarding the theory of money, since each camp basically examines money from a different perspective and uses their own interpretation.

Key-Words
Post-Keynesian; Institutional Economics; Veblenian Dichotomy; orthodox econ theory; monetary theory of production; Marxian formula of capital (Das Kapital); Keynes' 'Treatise on Money' and "The General Theory of Employment, Interest and Money"; liquidity preference;

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I. Introduction

Money is a topic that is neither easily nor simply defined. The conventional/orthodox economics methodology summarizes money's functions and properties however it fails to explain money's ontology, encompass the institutional perspective and express money's essence of modern life. The purpose of this descriptive paper is to compare and contrast two different economic views on money --the Macroeconomic non-hyphenated Post-Keynesian[1] interpretation of the theory of money vis-a-vie the Institutional Economics perspective[2]. To this end, this paper will look at the different viewpoints on the theory of money, from selected representatives of both the post-Keynesian and the Institutional camps.

II. Money definition

The most widely accepted definition of money can be found in Webster's dictionary: "something generally accepted as a medium of exchange; a measure of value or a means of payment; officially coined or stamped metal currency; money of account; coinage or negotiable paper issued as a legal tender by a recognized authority; assets or monetary possessions; pecuniary gain; property valued in terms of money; capital dealt in as a commodity to be loaned or invested" (Webster's p. 1458).

1.Post-Keynesian Economics has two branches. One branch, involving complex growth analysis via the use of mathematical models, is represented by Domar, Harrod and Sollow, while the other, criticizing the accepted form of Keynesianism, is represented by Minsky, Davidson, Eichner and Weintraub. The Post-Keynesian perspective holds that 'modern' Keynesians no longer emphasize Keyne's theory of uncertainty and future expectations.

2. Institutional Economics is an alternative economic perspective derived from the works of Veblen and analyzes the economy and economic behavior via the evolution of social practices (institutional and technological) and their relationship to 'making a living'. Its main concepts are (a) the Veblenian Dichotomy, (b) the theory of Production, and (c) the theory of Consumption.

The mainstream orthodox economic theory considers money as a neutral agent used for barter exchanges, meaning that the 'real economy' model does not acknowledge any structural difference between barter and money exchange (Ingham, 2004).

The Keynesian Economics definition of money is "a generalized claim against all things or entities that possess economic value" (Peterson 1992, p.161), and performs four major functions, all essential for the continuance of any economic activity in a capitalist economy. Money acts as a medium of exchange, serves as a standard for the measurement of value, serves as a store of value, and functions as a standard of deferred payments. The property of money to act as a medium of exchange, is necessary for the efficient operation of today's societies, division of labor and the exchange of products and services; its function as a standard for the measurement of value enables the calculation of prices as well as the actual and potential costs and benefits, and profits and losses. The store of value attribute makes for the maintaining future purchasing power in spite of possible erosion due to inflation. When money is held for longer periods of time, decisions can be changed, revised or cancelled.

The institutional perspective on money is very different than that of the conventional economics. The institutional perspective is concerned with money as a special form of private property, as well as with its impact on employment and output in the economy as a whole.

Prior to taking a closer look at the Institutional perspective under Capitalism, the main feature of capitalism needs to be clarified, which not only makes money so special, but also is a necessary assumption for this examination. Capitalism's main feature is the tenet that owners of non-personal means of production--such as land, labor, raw materials, machinery, equipment, etc.--depend on free laborers to put those means into motion via various processes, since free laborers do not have legal access to the instruments of production required for self-employment. Under this feature, the Institutional perspective looks at money as a special form of private property and at its impact on the economy's employment and output (GDP).

Consequently, the terms in which real output can be converted into money in the future determines the availability of capital that can be transferred from private owners of production to wage earners. Additionally, business judgments about the realization of prospective money gains determine the purchase of factors of production (raw materials) and their utilization (Dillard, 1988).

III. Monetary theory of production

The theory of money was first integrated into economics by Marx who considered money as the logical and necessary outcome of a system that produces commodities and the universal equivalent of any commodities whose values can be expressed in monetary terms. He used his formula of capital to distinguish three stages in the transformation of capital: the purchase, the production, and the sale. Marx divided money into two categories: money capital and productive capital. Each consists of three parts: the variable capital (or wages); the constant capital (or depreciation) and raw materials; and surplus value (or net profits). He then went on to derive that the demand for output of one part depends on the income and expenditure generated from the other, which indicates a delicate condition for a balanced flow (Marx, 1933). Of course, under these conditions disequilibrium becomes very likely, and that is why he dismissed the notion of the market's self-correcting mechanism.

The monetary theory of production states that money plays a central and indispensable role in the determination of output, which may be represented as an institutional factor in the functional relationship between factors of production and output. Money is an institutional factor in the functional relationship between inputs and output. The Marxian formula of capital holds that output (factors of production) is a function of labor, capital and the institutional process for realizing the value of real output in monetary terms (O=L, K, M). The institutional process (M) refers to one of the three ways of increasing total output in a monetary economy, basically using demand more effectively via fiscal and monetary policies. So in this context, monetary production means producing and realizing money values or converting output into money by selling the product.

The reason the monetary theory of production is viewed from the institutional economic perspective, is because it examines as well as accounts for the way in which the institution of money capital affects the behavior of both businesses and the economy as a whole (Dillard, 1988).

IV. The post-keynesian versus the institutional perspective

The basic principles of Keynes's monetary theory were presented in his three major works in this field: '*A Tract on Monetary Reform* '(1923), '*Treatise on Money*' (1930), and '*The General Theory of Employment, Interest and Money*' (1936). He was a convinced quantity theorist Marshallian, and believed -in the full causal sense- that the price level is determined by the quantity of money. He also believed that the quantity function represents a connection between the money demand function and the level of nominal income. The connection is given by a velocity coefficient, which measures the convenience of holding money to bridge the time gap between receipts and expenditures. One of the main subjects of the '*Tract*' was the situation in which the economy is in disequilibrium due to deep inflation, a situation in which one cannot expect elements like velocity to remain constant. Money is not neutral, and the absence of neutrality is present only in the short run; in the long run everything returns to normality. Another subject of Keynes' analysis was the exchange rate theory, specifically the qualifications introduced into the purchasing power parity theory of exchange rates when considering the existence of forward exchange markets. Hyperinflations are circulatory disturbances of some importance, but there are no long-run consequences following from circulation problems. In the '*Treatise*', a fundamental change is presented, in that money, being a means of circulation to facilitate transactions, becomes a representation of wealth and an asset that can be held as a pure form of purchasing power. In addition, its consumption can be deferred until a future point in time. Keynes identified the fact that financial circulation breaks the linkage between money and the circulation of goods, what he called 'industrial circulation.' Financial circulation includes operations with assets, stocks of wealth that have no necessary relation to the turnover of goods, which breaks the connection between demand and the money supply. Keynes also examined the notion of money as a form of waiting and speculation, how the relation of positions in money affects the prices of assets and liabilities, and the allocation of wealth among its various forms, making money non-neutral (Carvalho, 1992). Money and the rate of interest in the Keynesian system are not only intimately related but also hold strategically important roles in market capitalism. Keynes' relative assets price theory holds that asset choices in a monetary economy are determined by the interest rate, which is based on the total yield, the income claims generated, the convenience of possession, and the capital gains one obtains from the sale. The competition among owners of wealth in an effort to obtain the highest-yield assets will determine the prices of these assets, which in turn will indicate which assets are scarce and which are in excess supply. This competition will further determine the composition of the total wealth that has accumulated in a community. In Keynes's liquidity preference theory, the fundamental question of monetary theory--with implications for interest, price, and activity levels--is to explain why individuals choose to retain money, which is an idle, non-interest-bearing stock in lieu of the available goods, services or interest-yielding securities. In Keynesian theory, the demand for money is actually a demand for liquidity, whose nature depends on how it is interpreted in light of the motives for holding money balances. The Keynesian liquidity preference theory of interest is based on the notion that that money functions as a store of value and as a medium of exchange. Keynes' primary consideration is the demand for money as an asset, as a means for holding wealth versus securities -and interest, rather than being a reward for saving, is a reward for parting with liquidity. What determines the interest rate is the demand for cash as an asset, a demand for liquidity due to uncertainty about the future. In his theory of interest, Keynes holds that it is the interaction between the demand for money as an asset (liquidity preference) and the money available to hold as an asset, what determines the interest rate, and not the demand for and supply of savings (Peterson, 1992). The importance of this theory is twofold. First, it makes clear that monetary equilibrium is the product of forces other than those which produce equilibrium in income and employment;

and second, it provides the necessary theoretical framework to demonstrate the neutrality of money.

In Keynes' theory of investment, investment spending varies inversely with the rate of interest, and what counts is the volatility of the investment demand schedule, which is a highly unstable function. This function is dependent on expectations of the yield to be derived from capital goods whose useful life may be extended into the uncertain future (Peterson, 1992). The prime determinants of investment spending in an economy are the rate of interest, the level of income, and the quantity of capital required to produce a certain level of output. Investment spending is undertaken in the expectation of profits, and such expectations tend always to be unknown and elusive. Keynes believed that the basis of the knowledge upon which businesspersons form their expectations of prospective yields is very precarious and subject to the sudden and unforeseen fluctuations of the business cycle. He achieved novel results because of his assumption that velocity was allowed to vary while prices and wages were to be rigid. His interpretation emphasizes the importance of time and uncertainty, especially as they relate to capital asset pricing, investment, and the liability asset structures of households, businesses, and financial institutions. The liquidity preference function is interpreted as a demand for money function. Given a set of long-run expectations, the supply and demand for money affects the price level of capital assets. A capitalist economy is characterized by two sets of relative prices, one for current output and another for capital assets. Prices of capital assets depend on current views of future profit as well as the current subjective value placed on the insurance against uncertainty embodied in money. These views depend on the expectations of the longer run development of the economy. The prices of current output are based on current views of near-term demand conditions and current knowledge of money wage rates. Thus the prices of current output and the employment offered in producing output depend on shorter-run expectations. Current output and capital asset prices are based on expectations over different time horizons, since capital asset prices reflect long-term expectations while output prices reflect short-term expectations. The combination of these two sets of prices, along with financial conditions, determine investment (Keynes, 1964).

Veblen's dichotomy refers to the differences between industrial employment (making goods) and pecuniary employment (making money). In his 'Business Enterprise', he states that the dominant factor in the industrial process is the businessperson's interest in making money. That statement makes it obvious that the purpose of production and the control of output is monetary gain; and that the sale of output (conversion into money) is the realization of real output value (Veblen, 1904). So the objective of industrial employment, which also acts as a motivational factor, is the realization of real output. Unemployment is a normal condition, which results from the application of business principles, and its concerns are limited within a particular industry. Therefore, business cycles are not attributed to industrial fluctuations but rather to fluctuation in economic activity. The rate of return on capital assets is responsive to the changing expectations of the convertibility of output into money, which means that expectations of future profits cause frequent changes in the capitalized values of the business firms, and in turn lead to financial crises or depressions (Minsky, 1992).

Mitchell was greatly influenced by Veblen's work, and he viewed the business cycles as a product of a money economy engaged in the pursuit of profit by manufacturing goods that can be converted into money (Dillard, 1988).

In his *Can 'It' Happen Again* reprise, Minsky questions whether 'It'--a Great Depression--can happen again and why it hasn't happened yet. Looking to answer these questions, he searched for a theory that would explain the economic differences responsible for the economic successes of the post-war era. The programs and policies put forth to change economic conditions, such as monetarism, supply-side economics, and fiscal orthodoxy, are alike in their basic claim, which constitutes the neoclassical synthesis. The major theorems of neoclassical synthesis are that a decentralized market system under capitalism is capable of yielding both a coherent and, in some cases, efficient result. The neoclassical theorems hold true only under certain assumptions--which have never been shown to hold--in an economy that consists of evolving financial institutions, evolving practices and privately owned capital. These conditions are conducive to financial instability, which is inherent in our economy, and the abstract model of the neoclassical theory does not provide for it. Therefore, we must examine economic processes that evolve over time and are of a dynamic rather than a static nature. Then, instability can be shown to be a normal result of the economic process. The economy we live in, consisting of borrowing, lending and changes in equity interests, determine investment.

For a theory to be useful, it must focus on the accumulation process. This is where the concept of money enters the picture. Money's importance in the accumulation process is indicated by the three functions of business cash flows: they act as a gauge or indicator of past investment decisions, provide the means for a business to meet its financial commitments as they come due, and determine investment and financing conditions. The financial instability hypothesis is better suited to our economy than the neoclassical synthesis, because it is an attempt to build a theory that is relevant to and reflects a financially sophisticated capitalist economy whose instability is inherent. According to the financial instability hypothesis, the troubles of capitalist economies are not anomalies; they have simply been behaving in ways capitalistic economies with sophisticated financial institutions are supposed to behave (Minsky, 1986).

Copeland considered the flow of funds a system of social accounting whose purpose is to trace the flow of money through the economy. This includes investment payments, payments of taxes, payments of debt, as well as income-generating payments (Dillard, 1988).

V. Conclusion

Keynes's monetary theory has a lot of similarities with the institutionalist camp. He argued against the idea that the quantity of money determines the price level of capital assets. In his view, the prices of capital assets are generated by the money supply, the liability structure preferences, the mix of available assets, and the supply of financial assets. Each capital and financial asset is a combination of quick cash and future income. Reciprocally, each liability is a dated demand or contingent commitment to pay cash; thus the quantity of money determines the amount of quick cash that will be held, as well as the subjective returns from holding money. He addressed Veblen's 'realization' problem--referring to the problem of selling real output for money--and used Marx's general formula for capital. His financial views are shown in his theory through the rate of interest. He considers the realization problem, as a purely monetary phenomenon (in agreement with Veblen), which brings equilibrium between the desire to hold wealth in cash and the available supply of money. Money is very important due to its high liquidity, its low carrying cost, and the zero or miniscule elasticities of production and substitution. In other words, money cannot be produced like any other asset when demand for it increases, so its price--the rate of interest--will rise. In '*The Essential Properties of Interest and Money*' Keynes indicated his concern about money by stating that the rate of interest is important, since a high rate of interest impedes new investment and leads to involuntary unemployment of labor. This concern is the main reason why he considered withholding the means of production from labor as a normal condition under capitalism. His industrial views influenced his theory through the marginal efficiency of capital, which he considered to be the expected rate of return on real capital assets. He also believed that interest depends on the marginal efficiency of capital and not the reverse. Both Keynes and Veblen shared the view that a monetary capitalistic economy is characterized by fluctuating levels of output as well as large-scale unemployment. However, their views of technology were different. Keynes did not consider technology and the change it brings the primary reason for either depression or unemployment. On the other hand, Veblen considered technology the primary reason for chronic depression, since it lowers expected profits on old capital assets. This in turn erodes profits, making full employment not profitable under the new market conditions following the technological change.

If we are to have an economic system of private production such as capitalism, where real output must be converted into money--if the producer is to realize a meaningful form of wealth--then money is a form of property that wealth holders use to limit losses and sets standards which create unemployment. Additionally, the monetary (pecuniary) theories of production, which dominate industrial employment, are of primary importance.

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