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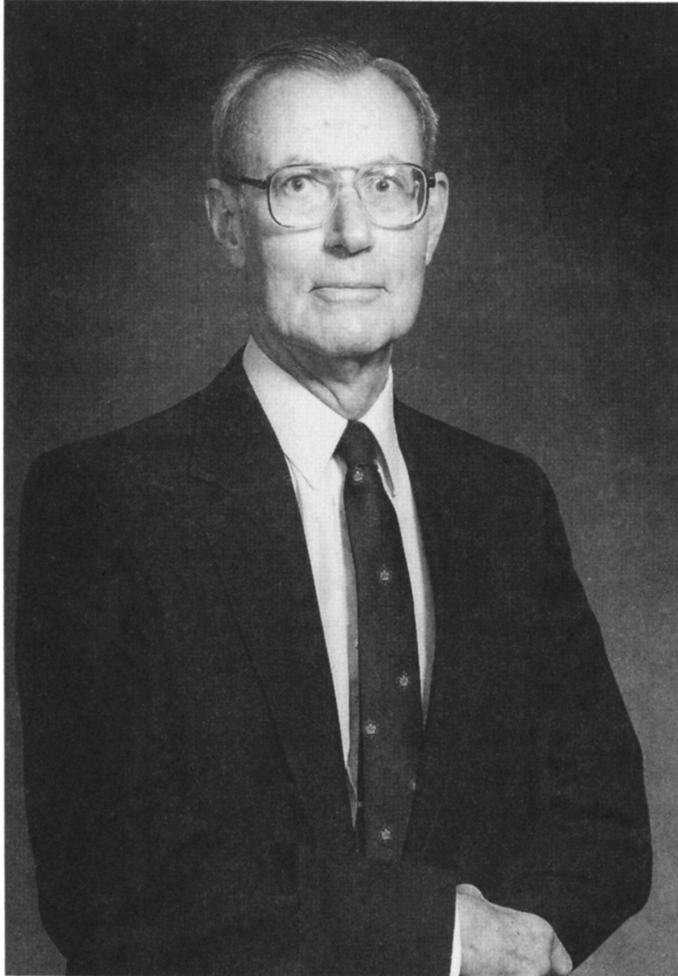

LELAND B. YEAGER

The Fluttering Veil

Essays on Monetary Disequilibrium

Leland B. Yeager

Edited and with an Introduction by George Selgin

LIBERTY FUND
INDIANAPOLIS
1997

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The cuneiform inscription that serves as our logo and as the design motif for our endpapers is the earliest-known written appearance of the word "freedom" (*amagi*), or "liberty." It is taken from a clay document written about 2300 B.C. in the Sumerian city-state of Lagash.

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Printed in the United States of America

97 98 99 00 01 H 5 4 3 2 1

97 98 99 00 01 P 5 4 3 2 1

Library of Congress Cataloging-in-Publication Data

Yeager, Leland B.
The fluttering veil : essays on monetary disequilibrium / by Leland B. Yeager ; edited and with an introduction by George Selgin.
p. cm.
Includes bibliographical references and index.
ISBN 0-86597-145-5. —ISBN 0-86597-146-3 (pbk.)
1. Monetary policy. 2. Inflation (Finance) 3. Equilibrium (Economics) I. Selgin, George A., 1957– . II. Title.
HG230.3.Y43 1997
332.4—dc20 96-20654

Liberty Fund, Inc.
8335 Allison Pointe Trail, Suite 300
Indianapolis, Indiana 46250-1687
(317) 842-0880

CONTENTS

Editor's Note
xi

Introduction: The Significance of Leland Yeager's Monetary Writings
xiii

Note on the Author
xxi

PART ONE

MONETARY DISEQUILIBRIUM AND ITS CONSEQUENCES

A Cash-Balance Interpretation of Depression (1956)
3

Monetarism (1971)
19

The Costs, Sources, and Control of Inflation (1981)
33

PART TWO

MONETARY MISCONCEPTIONS

Essential Properties of the Medium of Exchange (1968)
87

What Are Banks? (1978)
111

Individual and Overall Viewpoints in Monetary Theory (1982)
137

Inflation, Output, and Employment:
Some Clarifications (1982)
163

Money and Credit Confused:
An Appraisal of Economic Doctrine
and Federal Reserve Procedure (1986)
179

PART THREE

KEYNESIANISM AND OTHER DIVERSIONS

The Keynesian Diversion (1973)
199

The Significance of
Monetary Disequilibrium (1986)
217

Injection Effects and
Monetary Intermediation (1990)
253

New Keynesians and Old Monetarists (1991)
281

PART FOUR

AVOIDING MONETARY DISEQUILIBRIUM

Monetary Policy:
Before and After the Freeze (1971)
305

Stable Money and
Free-Market Currencies (1983)
337

A Laissez-Faire Approach
to Monetary Stability (1983)
363

Deregulation and Monetary Reform (1985)
383

A Real-GNP Dollar (1989)
393

Can Monetary Disequilibrium
Be Eliminated? (1989)
407

Index
427

Editor's Note

In preparing this collection, I have made a few minor changes to Professor Yeager's previously published writings. Most of the changes, including the relegation of citations in the text to footnotes, were undertaken to satisfy Liberty Fund's style guidelines. Other changes include the addition of first names of authors mentioned in the text, the spelling out of an acronym or two, the deletion of references to conferences, and the correction of various typographical errors that found their way past earlier editors. In a few very rare instances, with Professor Yeager's permission, I have altered a word or phrase for the sake of clarity. Finally, I have included a new introduction to the chapter "The Costs, Sources, and Control of Inflation," prepared especially for this volume by Professor Yeager.

INTRODUCTION

The Significance of Leland Yeager's Monetary Writings

Does the success of a capitalist economy depend on the nature of its monetary arrangements? It may surprise readers who are not also economists to learn that, at least according to two influential twentieth-century schools of economic thought, it does not.

The two schools of thought are the Keynesian and the New Classical.[1] Despite their generally disparate views on the proper role of government, economists of both schools share the belief that the quantity and quality of *money* in a capitalist economy is relatively unimportant. On one hand, the post–World War II Keynesian orthodoxy insisted that monetary policy is impotent: changes in the money stock would, by inducing opposite movements in interest rates, promote corresponding changes in the demand for money and therefore leave little scope for monetary policy to influence levels of spending, output, or employment. On the other hand, New Classical theorists reject the Keynesian view that changes in the interest rate serve mainly to clear the money market, and believe that changes in the money stock are direct sources of changes in total spending. However, New Classical theorists also believe that changes in total spending will be mirrored almost perfectly in uniform changes in money prices that leave output and employment unaltered except for occasional random effects. In this view, as in Keynesian caricatures of the "old" classical theory, money is merely a "veil" that ob-

1. The term "Keynesian" refers to beliefs of certain followers of John Maynard Keynes (1883–1946), whose thinking dominated macroeconomic thought and policy making in the decades following World War II. According to Keynesians, an economy's rate of employment depends primarily on its level of spending, including government spending. In contrast, New Classical theorists argue that increased private or government spending generally leads to higher prices without stimulating employment. New Classical theorists differ from "old" classical theorists in insisting that random (and hence entirely unpredictable) changes in government spending are the only ones that can possibly influence employment, and then only temporarily.

scures but does not otherwise influence the shape of real economic activity. Consequently, monetary policy "matters" only in the relatively unimportant sense that it determines the path of the "price level."

For more than three decades Leland Yeager, who describes himself as an old-fashioned monetarist and an admirer of Clark Warburton and Milton Friedman, has been engaged in a relentless and often lonely battle against these and related doctrines that deny the importance of money. His efforts have helped to preserve a tradition in monetary theory that goes back at least to David Hume but which also goes in and out (and currently is out) of fashion. Beginning in the 1950s, when (old-style) Keynesian thinking dominated the discourse on economics, Yeager held forth on the preeminent importance of money as a source of economic fluctuations—of booms and depressions—whose influence went far beyond mere changes in interest rates (with consequent changes in money demand, investment, or both) or the price level. Contrary views, according to Yeager, were based on the false assumption that the market for money holdings must always be in equilibrium, an assumption that in turn rested on the failure of many theorists to grapple with and understand the painful, roundabout manner by which any monetary imbalance, or "disequilibrium," must be resolved in real economies.

The reality of monetary disequilibrium, which Yeager sees as the root cause of the business cycle, is especially troublesome to those theorists, including the New Classical theorists, who regard any state of disequilibrium (in which the supply of and demand for one or more goods are unequal) as contradicting the voluntary nature of exchange in a free-market economy. Because no one in a free market is ever *forced* to accept money in trade, all units of money in existence at any moment are held voluntarily. How, then, can a discrepancy between money's supply and demand ever occur? The answer, according to Yeager, arises from money's unique and essential role in a free market, namely, its role as a generally accepted medium of exchange. The medium of exchange is accepted routinely not only by those who intend to hold it as an asset but also by those who *do not*

wish to augment their average holdings of money but intend, rather, to exchange it almost immediately for other assets and goods.

A case in point is the borrower from a bank. Though the borrower gladly accepts the proceeds of the loan in the form of money, he or she typically pays interest not to have the money itself but to acquire certain real goods—for example, a house, a car, or working capital. Money is routinely accepted by borrowers only because of the ease with which it can be exchanged for other things that are the real objects of the borrowers' desires. In short, the demand for bank loans or credit is *not* a demand for money per se but is primarily a demand for real goods. Nevertheless, changes in the (nominal) supply of bank loans do typically involve changes in the supply of money. It follows that, at least in the bank loan market, changes in the stock of money can occur independently of prior, equal changes in the public's demand for money holdings, and can give rise to monetary disequilibrium.

Of course, the suggestion that changes in the money supply occur independently of changes in the demand for money does not, by itself, imply any *long-lasting* disequilibrium. Can't price adjustments quickly eliminate temporary imbalances of supply and demand in the market for money holdings, as they do in markets for other assets? Yeager's answer again refers to one of money's special attributes, this one deriving from its conventional role as the unit of account in which prices of other goods are expressed. This attribute of money makes it the one good in a free economy that lacks its own (adjustable) price. The absolute price of money being fixed, its price relative to other goods or assets can be adjusted only by means of adjustments in the money prices of all the other goods. Consequently, a shortage of money requires (in the absence of an appropriate change in the nominal quantity of money) a reduction in prices of goods in general; conversely, a surplus of money requires an increase in prices of goods in general. Insofar as *general* price adjustments are harder to achieve than similar adjustments in any single price, a disequilibrium in the market for money balances is much more likely to persist than a disequilibrium in any other single market.

But why should general price adjustments be particularly hard to achieve? Part of the answer, according to Yeager, is a special coordination problem that is implicit in such adjustments —the fact that they involve what theorists today might call a "network externality." This externality exists because the private benefits to be gained by any one seller from adjusting the prices of his or her products in response to a monetary disequilibrium depend positively on the extent to which other sellers have already adjusted their own prices. Each seller therefore has an incentive to wait for others to go first in making desirable adjustments. As a result, the economy must grope its way slowly toward a new price-level equilibrium. In the meantime, both the price level and *relative* prices continue to be displaced from their ideal, full-equilibrium values—the values they must attain if they are to be accurate guides to entrepreneurial activity.

Episodes of monetary disequilibrium, and long-lasting episodes especially, cannot fail to have serious repercussions. According to the elementary logic of the so-called equation of exchange, any change in either the supply of or the demand for money, to the extent that the change is not immediately and fully reflected in an (equilibrating) change in the price level, will imply changed values of real output and employment. To quote economist John Gurley, "Money is a veil, but when the veil flutters, real output sputters."[2] Moreover, because monetary disequilibrium also involves a distortion of relative prices, its real effects are not limited to mere alterations in *total* quantities of output and employment but also involve qualitative changes in the composition of each, to the detriment of all-around well-being.

All of this suggests that well-designed monetary arrangements and policies are important to the success of any free-market economic system.[3] This point is not, of course, unique to Yeager; indeed, it is a crucial component of the Marxian critique of capitalism. Unlike the Marxists, however, Yeager insists that the defects of exist-

2. John G. Gurley, Review of *A Program for Monetary Stability*, by Milton Friedman, *Review of Economics and Statistics* 43 (August 1961): 308.

3. This does not, by the way, mean that a socialist economy could prosper regardless of its monetary system. On the contrary, I would say (and I think Professor Yeager would agree) that a sound monetary system would be wasted on a largely socialized economy.

ing monetary arrangements in "capitalist" nations are not inherent in capitalism but are alterable consequences of the misguided or mischievous interventions of government.

How, then, can the government of a free capitalistic society responsibly discharge its monetary duties? Yeager's answers to this question have changed considerably over the last twenty years. For example, in the early 1970s he rejected the call of certain "extreme libertarians" to abolish "all government responsibility for money," and argued that the avoidance of monetary disequilibrium by means of a wholly free-market monetary system could occur "only by unbelievable good luck." Part of Yeager's pessimism stemmed, no doubt, from his view that a free-market monetary system would perpetuate the "preposterous" linkage of the medium of exchange and unit of account that has characterized both paper- and commodity-based monetary standards. The separation of monetary functions—that is, the establishment of a unit of account defined independently of any particular medium of exchange, so that some media of exchange might have flexible prices in terms of the unit—has long been and still remains, in Yeager's view, an ultimate desideratum of monetary reform. In his more recent writings, however, Yeager has come to conclude that such a separation of monetary functions can most likely be accomplished in a free-market monetary system in which the sole role of government would be to propose and encourage the use of a particular unit of account. Yeager's change of mind undoubtedly reflects in part the influence of F. A. Hayek and other recent proponents of free choice in currency, whose writings have led him to abandon his earlier belief that money is among the small set of things the government can manage "less badly than unregulated private enterprise."

The writings gathered here are a generous sample—but only a sample—of Yeager's contributions to monetary economics. Only the writings that deal with matters of domestic monetary theory and policy are included. Readers interested in Yeager's views on international monetary affairs will find most of them already gathered in two of his earlier books.[4]

4. See *The International Monetary Mechanism* (New York: Holt, Rinehart & Winston, 1968) and *International Monetary Relations: Theory, History, and Policy*, 2d ed.

The writings are arranged in four parts. Part 1 presents Yeager's "positive" elaborations of the monetary disequilibrium hypothesis in which the real (detrimental) consequences of both deficient and excessive money growth are described. "A Cash-Balance Interpretation of Depression" offers an early monetarist analysis of the consequences of inadequate money growth in an environment of "sticky" prices. The article therefore makes for an interesting comparison with later developments in "disequilibrium" macroeconomics, including recent contributions by self-styled "New Keynesians." "Monetarism" surveys empirical evidence supporting this analysis. Finally, "The Costs, Sources, and Control of Inflation," excerpted from the American Enterprise Institute book *Experiences With Stopping Inflation*, demonstrates Yeager's appreciation of the distorting consequences of *excessive* monetary growth. Yeager's two-sided awareness of the dangers of monetary disequilibrium stands in refreshing contrast to the one-sided awareness of earlier Keynesians (who worried only about deflation) and Austrians (who worried only about inflation).

Part 2 is devoted to what Yeager regards as fundamental misconceptions in modern monetary writings. For example, in "Essential Properties of the Medium of Exchange" Yeager responds to the British Radcliffe Committee Report of 1959, which denied the relevance of conventional monetary aggregates as objects of monetary policy. (Ironically, by the 1980s Yeager felt compelled to admit that "recent and ongoing financial innovations [might have rendered] the very concept of money hopelessly fuzzy," and to confess grave doubts about the practicability of "the familiar monetarist quantity rule" as a basis for monetary policy. He hastened to add, though, that the financial innovations themselves were a response to controls interacting with high and variable rates of inflation that could have been avoided had a money growth rate rule been adopted in the late 1960s.) "What Are Banks?" criticizes the "New View" of James Tobin and others who see banks as pure intermediaries that are

(New York: Harper & Row, 1976). Some of Yeager's additional thoughts on the proper relation between domestic and international monetary policy are offered in "Domestic Stability Versus Exchange-Rate Stability," *Cato Journal* 8 (Fall 1988): 261–77.

incapable of lending to borrowers more than what savers lend to them, and hence incapable of being a source of excessive money in the economy. The remaining essays in part 2 confront errors ranging from monetary fallacies of composition, to the confusion of the "demand for money" with the demand for credit, to the view (attributed to Austrian school economists) that *any* increase in the quantity of money involves distorting "injection effects" and should therefore be avoided.

Part 3 is devoted to Yeager's critical writings on nonmonetarist monetary theories, including Keynesian, New Classical ("Rational Expectations"), and Austrian. What usually is called the Keynesian "revolution" was in Yeager's judgment only a diversion from other, more fruitful avenues of monetary thought. Moreover, the New Classical response to Keynesianism is described as a poor substitute for "old-fashioned" monetarism: the New Classical theorists, unlike the earlier generation of Chicago school writers, rely on the unrealistic Walrasian *tatonnement* view of how prices are determined and thereby rule out the very possibility of monetary disequilibrium. In consequence, they are forced to turn a blind eye to overwhelming evidence of money's role in the business cycle, and instead offer alternative "real" business cycle theories. As for writers of the Austrian school, most, Yeager suggests, have been too quick to downplay the harmful side effects of deflation by focusing almost exclusively on the dangers of excessive money creation, which they exaggerate. Next, Yeager insists that the currently fashionable ideas of so-called New Keynesian economics are neither new nor Keynesian but have been the stock-in-trade of many an old-fashioned monetarist.

Part 4 presents Yeager's still-developing observations on how monetary disequilibrium might be avoided. "Monetary Policy: Before and After the Freeze" spells out Yeager's circa 1971 views on how monetary policy ought to be conducted. In contrast to these early views are Yeager's later, much more radical recommendations calling for a complete withdrawal of government from money and banking. These later recommendations appear in essays, including several written with Robert Greenfield, that have provoked many a critical response, not only from critics of laissez-faire but also from writers who, while agreeing with the desirability of getting govern-

ment out of the money business, doubt that doing so would lead to the sort of "separated" monetary system envisioned by Yeager and Greenfield.[5] The debate these essays precipitated is still in progress, and its outcome is uncertain. What is certain, though, is that the debate will enhance our understanding of the monetary foundations of a free society—an understanding that already owes a great deal to the writings of Leland Yeager.

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5. See George Selgin and Lawrence H. White, "How Would the Invisible Hand Handle Money?" *Journal of Economic Literature* 32 (December 1994): 1718–49; and Selgin and White, "Money and the Invisible Hand: A Correction," *Journal of Economic Literature* 34 (March 1996): 124–25.