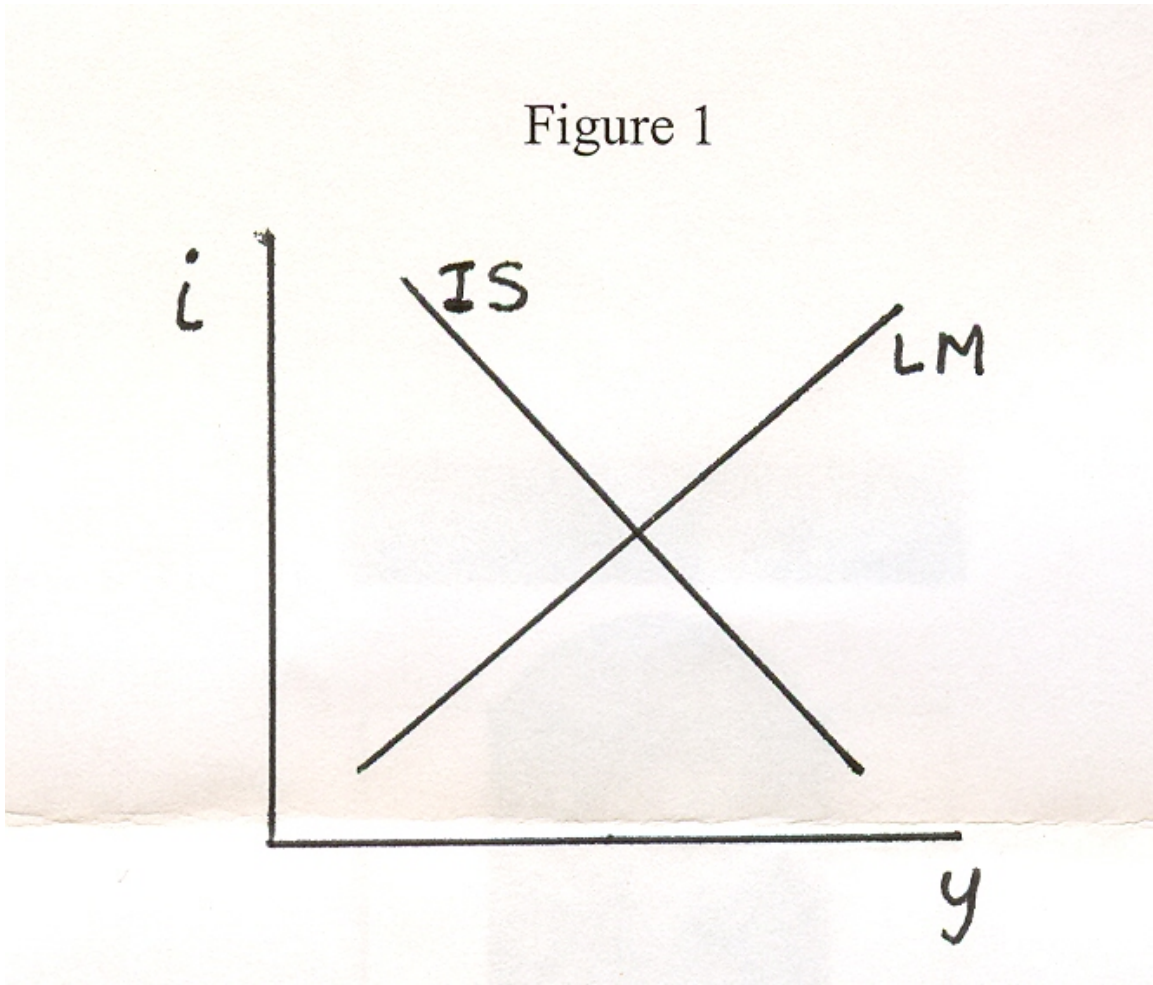


# The Continuing Muddles of Monetary Theory: A Steadfast Refusal to Face Facts

By C.A.E. Goodhart  
Financial Markets Group  
London School of Economics

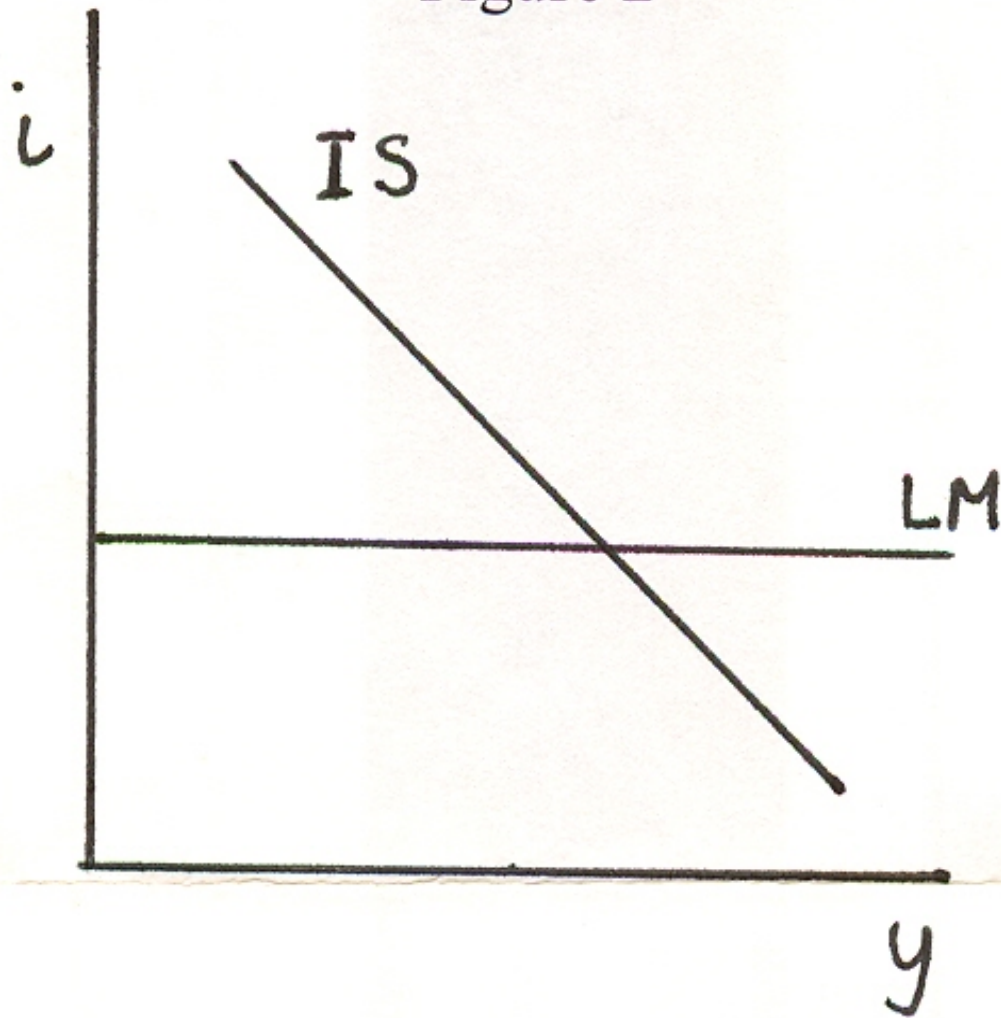
Lionel Robbins was much concerned about the methodology of economic science. When he discussed the desirable relationship between theory and 'reality', two of the three examples that he presented where the theoretical analysis was not sufficiently based on a knowledge of historical fact were taken from monetary economics. Indeed, monetary theory has remained prone to such shortcomings ever since.

Figure 1



This is probably the second most famous diagram in economics.

Figure 2



Analysis of the determination of the money stock is frequently undertaken via the base money multiplier, e.g. Friedman and Schwartz (1963).

$$M = H \frac{(1 + C/D)}{(R/D + C/D)} \quad (8)$$

Whereas this is frequently misinterpreted as a behavioural equation, it is in fact a definitional identity, derived from the two identities,

$$M = D + C \quad (9)$$

(the money stock is defined as deposits plus currency in the hands of the public), and

$$H = R + C \quad (10)$$

(the high powered money stock is defined as the reserves of the banking system and currency outstanding; to get from (9) and (10) to (8) divide throughout by D and then divide (9) by (10)).

$$y_t = E(y) + b_1(i_t - E(\pi)), b_1 < 0$$

$$\pi_t = E(\pi) + b_2(y), b_2 > 0$$

$$i_t = b_3(\pi - \pi^*) + b_4(y), b_3 > 1, b_4 > 0$$

## The Evolution of Money

### The Two Concepts of Money

- (1) A mechanism for reducing transactions costs in private sector markets. Menger (1892), Kiyotaki and Wright (1989, 1991).
- (2) A social mechanism for transferring value, backed by the power of government. (Cartalism).