AN EXPLORATION OF MONEY & INTEREST IN THE
THEORY OF VALUE

THESIS SUMMARY OF

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About the Thesis:

The aim of the thesis is to achieve a formal unification of the monetary and the value theories using non-neoclassical approach. The broad objectives of the thesis are outlined as under:

- Literature survey to assess and explore developments in the field of monetary theory of value
- Providing a concise monetary theory of value
- A monetary theory of interest, output and employment
- Exploring the causes of disequilibrium in a monetary economy
- Exploring the role of Central bank and monetary policy
- Exploring the role of government and fiscal policy
- Ascertaining the optimal policy mix in a monetary economy
The context: Present State of Monetary Theory

Money buys goods, good buy money but goods do not buy goods\(^1\).

A general rise in prices is therefore only conceivable on the supposition that the general demand has for some reason become, or is expected to become, greater than supply. This may seem paradoxical, because we have accustomed ourselves, with J.B. Say, to regard goods themselves as reciprocally constituting and limiting the demand for each other. And indeed ultimately they do so; here, however, we are concerned with precisely what occurs, in the first place, with the middle link. Any theory of money worthy of the name must be able to show how and why the monetary or pecuniary demand for goods exceeds or falls short of the supply of goods in given conditions\(^2\).

How to make money appear without making standard theory disappear?\(^3\)

The most serious challenge the existence of money poses to the theorist is this— even the best developed models of the economy cannot find room for it\(^4\).

Finally, a monetary economy is also a one in which Say’s law need not hold because of the existence of a non-produced sink-hole of purchasing power\(^5\).

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\(^2\) Wicksell, Knut. 1906. Lectures on Political Economy, Vol.2, *pp.159-60*

\(^3\) Ostroy, 1973. Money, Interest & capital: a study in the foundations of monetary theory


In salvaging one feature of classical economics - the automatic tendency of the system to approach a state of full employment - Pigou and Haberler have destroyed another feature, namely, the real theory of the interest rate\textsuperscript{6}.

This is necessary because Patinkin's analysis is incomplete and leaves many important points obscure. We find that, while the price level is of course determined by the desire to hold balances together with the stock of money, the role of the real-balance effect is only to provide an explanation of how the system behaves in disequilibrium. Thus the real-balance effect is irrelevant to those famous propositions of the quantity theory which are the result of comparative static analysis\textsuperscript{7}.

It can be shown, indeed, that an increase in unsold stocks of any commodity the price of which is fixed, in a Patinkinesque world, generate an increase in the general price level and so, indirectly rise in the sales of the goods whose price is fixed. Again, therefore, we arrive at a conclusion that is offensive to our intuitive conception of the working of a money economy, a conclusion that indicates that money plays no distinctive role in economic activity\textsuperscript{8}.

Monetary theorists have been criticized (see e.g. F. H. Hahn [9]) for having neglected the "existence problem" that is the problem of the existence of an equilibrium where money has positive value in exchange. On the other hand, we are reminded by R. W. Clower [4, 5] that one of the weaknesses of contemporary monetary theory is that it primarily considers money as a

\textsuperscript{6} Meltzer Lloyd, 1951, Wealth, Saving and rate of interest, in his \textit{Collected Papers}, Cambridge 1973
store of value but does not pay enough attention to its function as an exchange intermediary.

One can reasonably expect that the two problems are closely related\(^9\).

Recent work on the existence of an equilibrium has been concerned with a world without money while all work in monetary theory has ignored the ‘existence’ question\(^\text{10}\).

**Approach & Methodology**

- A standard neoclassical approach may be incoherent with the monetary theory. Therefore, a non-neoclassical approach is proposed.
- Sraffa’s *Production of Commodities by Means of Commodities*, 1960, is used as a base theory to develop the real side of the economy.
- The monetary side is built by reconstructing the existing interest rate theory. The macro-economic equilibrium is sought for simultaneously in both, the real and money markets.
- Finally, policy implications are studied and evaluated.

**Main Conclusions & Limitations**

1. An important conclusion of this work to be noted is it may not necessary to have an explicit relationship between money and prices- like the quantity theory one.

2. Wages are not assumed to be rigid. The assumption of a perfectly mobile labour (that fits in with the theory with perfect markets) does not fit in with the assumption of rigid wages.

3. A one line conclusion that this exploration leads to is this: Output grows, money does not constrain labour (it cannot) and prices do not constrain distribution; in effect, they all

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\(^{10}\) F. H. Hahn, On some problems of proving the existence of an equilibrium in a monetary economy, *The theory of interest rates*, Ed. Hahn and Brechling
determine level of new money, new outputs, new interest, new employment, new prices and new income distribution.

4. In a monetary economy, a valid question is – does the interest rate get a liquidity trap? The answer could be “it may”.

5. A monetary economy will always face a disequilibrium if let loose. A regulator is required to manage the entire economic activity.

**Limitations of the proposed theory:**

Finally, as we conclude, it would only be imperative to present certain limitations of the presented model/ theory.

a. The ever predominant real balance effect plays no role in this system described so far. This empiricism leads one to search for an empirical relationship for the consumption functions that involves real money balances. Such an empirical relationship is absent from the present economic literature.

b. Almost all the markets are explicitly states, except the labour market. By explicit statement, we mean the famous Marshallian cross here, where labour demand and labour supply interact to determine the price of labour. Such a formulation is absent from the theory. However, we have presented the labour market in a fairly subtle manner. The famous \( N_d = f \left( \frac{w}{p} \right), N_s = f \left( \frac{w}{p} \right) \) & \( N_d = N_s \) is a macroeconomic formulation and applies where there is one good; however in a general equilibrium system \( N_d \), i.e. labour demand would come from various sources.

c. The role of uncertainty and expectations is absent in the theory.

d. Real balance and wealth effects are not considered in the theory.
e. Finally, Graham had proposed a model of commodity reserve currency during the later stages of the American depression. However, owing to high transaction cost and supply conditions, such a model was not adopted.

f. However, certain contradicting results are discovered. The principle of effective demand and the resulting under-full employment as observed in the Keynesian synthesis are not discovered in the analysis. Instead, it is discovered that in a monetary model, (any) one market will always be in disequilibrium.