Keynes's Approach to Money: An Assessment After Seventy Years

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Abstract

This paper first examines two approaches to money adopted by Keynes in the General Theory. The first is the more familiar supply and demand equilibrium approach of Chapter 13 incorporated within conventional macroeconomics textbooks. Indeed, even Post Keynesians utilizing Keynes's finance motive or the horizontal money supply curve adopt similar methodology. The second approach of the General Theory is presented in Chapter 17, where Keynes drops money supply and demand in favor of a liquidity preference approach to asset prices that offers a more satisfactory treatment of money's role in constraining effective demand. In the penultimate section, I return to Keynes's earlier work in the Treatise on Money as well as the early drafts of the General Theory to obtain a better understanding of the nature of money. I conclude with policy implications. (JEL E12, E41, E43, E51)

Keynes's Money Supply and Money Demand Approach

Chapter 13 of Keynes's The General Theory of Employment Interest and Money [Keynes, 1964] is devoted to answering the question: What determines the rate of interest? First, he narrows the scope by defining the rate of interest as “the inverse proportion between a sum of money and what can be obtained for parting with control over the money in exchange for a debt for a stated period of time” [Keynes, 1964, p. 167]. It is, thus, “the reward for parting with liquidity” [Keynes, 1964, p. 167]. This leads rather inexorably to the conclusion that the interest rate is “the ‘price’ which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash” [Keynes, 1964, p. 167]. This desire is “liquidity preference,” which is “substantially the same thing” as “propensity to hoard”—so long as that is not confused with “hoarding” [Keynes, 1964, p. 174]. As he cautions, an increase in liquidity preference cannot increase the quantity of hoards, “[f]or the amount of hoarding must be equal to the quantity of money...and the quantity of money is not determined by the public” [Keynes, 1964, p. 174].

All that is left is to work out determinants of the quantity of money and liquidity preference. Regarding the latter, Keynes outlines the “three divisions of liquidity preference,” the “transactions-motive,” the “precautionary-motive,” and the “speculative-motive” [Keynes, 1964, p. 170]. These are discussed in more detail in Chapter 15, where Keynes distinguishes between “two liquidity functions L1 and L2,” the first “mainly depends on the level of income, whilst L2 mainly depends on the relation between the current rate of interest and the state of expectation” [Keynes, 1964,
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p. 199]. This became the standard approach to money demand. Post Keynesians have put more emphasis on the link Keynes made between L2 and uncertainty, rejecting the mainstream conflation of uncertainty and risk [Chick, 1983; Tobin, 1958]. According to Keynes “[w]e have seen in Chapter 13 that uncertainty as to the future course of the rate of interest is the sole intelligible explanation of the type of liquidity-preference L2 which leads to the holding of cash M2” [Keynes, 1964, p. 201, emphasis in original], and he was careful to distinguish between probability and uncertainty, most clearly in his defense of the General Theory in 1937: “By ‘uncertain’ knowledge, let me explain, I do not mean merely to distinguish what is known from what is only probable”—i.e., insurable risk [Keynes, 1973b, p. 113]. Aside from this caveat, there is little in Keynes’s exposition to distinguish it from the presentation in textbooks.

What about money supply? Here Keynes is less clear, although the usual interpretation is that the General Theory assumes a given quantity of money. There are, indeed, statements that the money supply is determined by policy, for example; “The quantity of money as determined by the action of the central bank” [Keynes, 1964, p. 247]; “the quantity of money created by the monetary authority” [Keynes, 1964, p. 205]; and similar arguments are made elsewhere [Keynes, 1964, pp. 84, 167, 174, 230, and 267].

On the other hand, in one of the few detailed discussions of the “way in which changes in M [money supply] come about,” he discusses three possibilities. The first concerns use of gold coins, expanded by mining operations, while the second supposes government creation of money to finance spending [Keynes, 1964, p. 200]. Both of these can be reconciled with “exogenous” money. However, he discusses a third case in which money is created by banks, “where the new money can only be issued in the first instance by a relaxation of the conditions of credit by the banking system, so as to induce someone to sell the banks a debt or a bond in exchange for the new cash” [Keynes, 1964, p. 200]. Further, elsewhere Keynes allowed for “endogenous” variation of the money supply. In A Tract on Monetary Reform [Keynes, 1971a, p. 153]. In A Treatise on Money [Keynes, 1971b; 1971c Vols. V and VI], he recognized that a bank “may itself purchase assets, i.e., add to its investments, and pay for them, in the first instance at least, by establishing a claim against itself” [Keynes, 1971b, p. 21]. He asserts, “It is evident that there is no limit to the amount of bank money which the banks can safely create provided that they move forward in step” so clearing losses are compensated by gains [Keynes, 1971b, p. 23]. Finally, in his defence of the General Theory, he argued, “my analysis is not based...on the assumption that the quantity of money is constant” [Keynes, 1973b, p. 232].

This would seem to be a rejection of the textbook vertical money supply, and interdependence of supply and demand would leave interest rate determination up in the air. For example, he rejects a ‘supply and demand’ interpretation when he argues that “[the] short-term rate of interest is easily controlled by the monetary authority...” [Keynes, 1964, p. 203]. While he goes on to note that it is more difficult for central banks to determine the whole term structure, this ability “varies in different systems” [Keynes, 1964, p. 206]. In perhaps his most complete statement he argues:

The complex of rates of interest would simply be an expression of the terms on which the banking system is prepared to acquire or part with debts; and the quantity of money would be the amount which can find a home in the possession of individuals who—after taking account of all relevant circumstances—prefer the control of liquid cash to parting with it in exchange for a

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debt on the terms indicated by the market rate of interest. [Keynes, 1964, pp. 205–206].

Here, central bank policy operates through impacts on expectations of future interest rates and ‘willingness’ of banks to ‘acquire’ debts, rather than through control over money supply. Keynes also claims “the rate of interest is a highly conventional” phenomenon, and argues that “[any] level of interest which is accepted with sufficient convention as likely to be durable will be durable...,” further undercutting the equilibrium methodology of these chapters [Keynes, 1964, p. 203].

Chapter 17 and the Liquidity Preference Approach to Asset Prices

In Chapter 17, Keynes restates and generalizes the definition of the interest rate as “a definite quantity of (e.g.) wheat to be delivered a year hence which has the same exchange value to-day as 100 quarters of wheat for ‘spot’ delivery” [Keynes, 1964, p. 222]. “Thus for every durable commodity we have a rate of interest in terms of itself, a wheat-rate of interest, a copper-rate of interest, a house-rate of interest, even a steel-plant-rate of interest” [Keynes, 1964, pp. 222–223]. Each of these own rates can be stated in terms of money, which typically carries the ‘greatest of the own-rates of interest,’ hence, ‘rules the roost’ because money has special, peculiar properties [Keynes, 1964, p. 223; Kregel, 1997].

The expected nominal return to holding any asset is \( q - c + l + a \), where \( q \) is the asset’s expected yield, \( c \) is carrying costs, \( l \) is liquidity, and \( a \) is expected price appreciation. This total return can be used to calculate a marginal efficiency for each asset, including money. The composition of returns varies by asset, with most of the return to illiquid assets such as capital consisting of \( q - c \); while most of the return to liquid assets consists of the \( l \). If a producible asset’s return exceeds that on money, it is produced up to the point that its marginal efficiency falls back into line with money’s return that rules the roost. If an asset that is not producible has a higher marginal efficiency, its price is pushed up until its return falls back in line. Finally, changing expectations about the future have differential impacts on the marginal efficiencies of different kinds of assets. Increased confidence about future economic performance will raise the \( q \) on capital while lowering the subjective values assigned to liquid positions (hence, the \( l \) falls), so that the marginal efficiency of capital rises relative to that of assets that get much of their return from \( l \). In that case, capital assets will be produced (investment rises, inducing the ‘multiplier’ impact) and the full range of asset prices adjusts. Thus, expectations about the future go into determining the equilibrium level of output and employment—where that is defined as a position in which firms hire just the amount of labor required to produce the amount of output they expect to sell.

Expectations are given a bigger role to play in Chapter 17 in determining the own rates on all assets rather than simply giving rise to a speculative demand for money. The return to ‘cash’ is subjectively determined by the value imputed to a liquid position; a premium is required to induce one to ‘give up’ a liquid position. As he put it in 1937, “The possession of actual money lulls our disquietude; and the premium which we require to make us part with money is a measure of the degree of our disquietude” [Keynes, 1973b, p. 116]. But this ‘disquietude’ affects the demand for the full range of assets, differentially according to each asset’s composition of expected returns. Asset price equilibrium occurs where the marginal efficiencies are equalized—not simply where money supply equals demand. Finally, the impact of a change in the degree of ‘disquietude’ on employment is direct—through its impact on marginal efficiencies.
Keynes insists that “[there] is, clearly, no absolute standard of ‘liquidity’ but merely a scale of liquidity,” indeed, “the conception of what contributes to ‘liquidity’ is a partly vague one, changing from time to time and depending on social practices and institutions” [Keynes, 1964, p. 240]. While it might seem that an increase of ‘liquidity’ would reduce the value placed on \( i \), raising relative marginal efficiencies of illiquid assets and increasing employment, this might not be so simple. Keynes argues that part of money’s peculiarity arises from the fact that it has a very small “elasticity of production,” meaning that “the response of the quantity of labor applied to producing it to a rise in the quantity of labour which a unit of it will command” is miniscule [Keynes, 1964, p. 230]. This should not be interpreted as a fixed quantity of money in the face of rising demand for money, but rather means that an increase of liquidity preference cannot keep labor employed by shifting it to production of money. This is why Keynes argues that “[unemployment] develops, that is to say, because people want the moon; men cannot be employed when the object of desire (i.e. money) is something which cannot be produced and the demand for which cannot be readily choked off” [Keynes, 1964, p. 235].

Kregel [1976] argues that Keynes rejected interpretations that rely on disappointed expectations, or a distinction between ex ante expectations and ex post results, as the cause of ‘temporary’ unemployment equilibrium. Rather, Keynes could assume that long-period expectations are constant and that short-period expectations are always realised in order to put expectations into the back seat, giving all emphasis to effective demand. It was this purely static model, divorced from disappointment and shifts in expectations that Keynes finally preferred to use for demonstrating that unemployment was not a short-run disequilibrium phenomenon... [Kregel, 1976 p. 213].

The static model adopts one of the three different methodologies used by Keynes in the General Theory. His second, stationary equilibrium, allows disappointment of short-period expectations without affecting long-period expectations. In his dynamic model of shifting equilibrium, “current disappointment may affect the state of general expectations,” but disappointment or shifting expectations is not required to explain unemployment [Kregel, 1976, p. 215].

Keynes argued the existence of money is the cause of unemployment, because “in the absence of money...the rates of interest would only reach equilibrium when there is full employment” [Keynes, 1964, p. 235]. Here he is referring to the spectrum of own rates, equalized in the absence of money only at full employment. However, money (or another commodity with similar properties) sets a standard that is often too high for full employment. Further, he cautioned that an “increase of the money supply” is not necessarily a solution, as “there may be several slips between the cup and the lip” [Keynes, 1964, p. 173]. If liquidity preference is rising faster (or, the marginal efficiencies of producibles are falling faster) than the money supply, it will not be possible to stimulate employment. To analyze the impacts of monetary policy forces Keynes to move beyond the static equilibrium model, to consider how policy affects short-period and long-period expectations—which he examines in several places in the General Theory and concludes that the effects are unpredictable and could be counterproductive. He is thus “somewhat skeptical of the success of a merely monetary policy directed towards influencing the rate of interest....since it seems likely that the fluctuations in the market estimation of the marginal efficiency of different types of capital...will be too great to be offset by any practicable changes in the rate of interest” [Keynes, 1964, p. 164].
The Finance Motive: An Addendum or a Diversion?

In his *General Theory* defense, Keynes proposed a fourth reason to hold money, the finance motive. This addendum served two purposes, first to feature a prominent role for expectations in the L1 demand for money; second, to explain why an increased scale of production *might*, but *need not*, pressure interest rates. The first was in response to critiques by Ohlin and Robertson, while the second was to criticize Hicks's exposition that became the ISLM analysis. It is also used by some Post Keynesians to resolve Keynes's apparently contradictory exposition of the determinants of the quantity of money, and as a foundation for an endogenous money supply. I will argue that this is mostly a diversion.

In his December 1937 response, Keynes suggests a fourth motive for holding money as a function of expected expenditure:

> I should not have previously overlooked this point, since it is the coping-stone of the liquidity theory of the rate of interest.... Just as an increase in actual activity must (as I have always explained) raise the rate of interest unless either the banks or the rest of the public become more willing to release cash, so (as I now add) an increase in planned activity must have a similar, superimposed influence. [Keynes, 1973b, pp. 220–221].

The caveat that an increased demand for money *need not* raise interest rates so long as banks accommodate was stressed in his March 31, 1937 letter to Hicks: “From my point of view it is important to insist that my remark is to the effect that an increase in the inducement to invest *need not* raise the rate of interest. I should agree that, unless the monetary policy is appropriate, it is quite likely to” [Keynes, 1973b, p. 80]. Thus, an increase of planned spending—as well greater actual spending—raises money demand, which raises interest rates unless money supply increases.

After the *General Theory*, Keynes detailed his objections to the loanable funds approach, as well as to Robertson’s attempts to marry saving plus bank loans, as a hybrid source of finance. Keynes argued that saving is not equivalent to finance, indeed, “Saving has no special efficacy, as compared with consumption in releasing cash and restoring liquidity...There is, therefore, just as much reason for adding current consumption to the rate of increase of new bank money in reckoning the flow of cash becoming available to provide new ‘finance,’ as there is for adding current saving” [Keynes, 1973b, p. 233]. The supply and demand of ‘loanable funds’ are necessarily identical, with no adjustment of the interest rate required: “Increased investment will always be accompanied by increased saving, but it can never be preceded by it. Dishoarding and credit expansion provides not an *alternative* to increased saving, but a necessary preparation for it. It is the parent, not the twin, of increased saving” [Keynes, 1973b, p. 281].

Investment, itself, cannot pressure interest rates because it returns to the “revolving fund of finance,” creating equivalent saving [Keynes, 1973b, p. 209]. Thus, planned investment can never be constrained by lack of saving, but it can be limited by lack of finance during the interim, as money is hoarded to satisfy the finance motive on the prospect of increasing spending: “Unless the banking system is prepared to augment the supply of money, lack of finance may prove an important obstacle to more than a certain amount of investment decisions being on the tapis at the same time. But ‘finance’ has nothing to do with saving” [Keynes, 1973b, p. 209]. If banks do relax to satisfy the finance motive, interest rates will not rise as the scale of activity increases. Finally, he notes, “to the extent that the overdraft system is employed and unused overdrafts ignored by the banking system, there is no superimposed pressure resulting from planned activity over and above the pressure resulting from actual activity” [Keynes, 1973b, pp. 222–223].
This is an effective critique of both ISLM and loanable funds approaches to the interest rate. Further, Davidson [1965] argued that the interdependence of money demand and planned spending implies that we cannot dichotomize the real and monetary sectors, so money cannot be neutral. If, however, ‘money supply’ responds to ‘money demand,’ the two functions cannot be independent and Keynes is again left with no convincing explanation of the determination of interest rates along the lines of Chapter 13.

Indeed, Post Keynesians have argued that Keynes’s theory is fundamentally flawed for precisely this reason [Lavoie, 1985]. Further, they have sought an alternative in his discussion surrounding the finance motive, which is interpreted to formulate money demand as a function of the flow of planned spending—not as a desire to hold money but rather as a desire to spend it. Adding Keynes’s statement about overdrafts, it is presumed that “money supply” accommodates “money demand,” thus, rising spending has no impact on interest rates. Moore [1988] has proposed a horizontal money supply curve at a loan rate of interest that is a mark-up over the administered central bank target. Money supply is endogenous, while the interest rate is exogenous. Not only is ISLM vanquished, but there is no role left for liquidity preference, said to rely on a fixed money supply or—even worse—on loanable funds theory [Lavoie, 1985].

However, such arguments are mostly orthogonal to Keynes’s Chapter 17 approach. Recall from above the model of static equilibrium. At the point when one takes a decision to invest, the marginal efficiency of a particular capital asset is weighed against the marginal efficiency of money. Whether a higher scale of activity will affect interest rates is neither known (in practice) nor considered (by assumption) by the individual taking the ex ante decision to invest. He will consider his finance costs (and these could be upward sloping, rising as one increases the amount of external financing as in Minsky’s theory of investment), but it would be illegitimate to presume that effects on interest rates resulting from greater aggregate spending matter in this decision.

Similarly, the forces that equalize marginal efficiencies do not depend on any particular money supply function—all that matters is the way in which financing terms affect forward-looking marginal efficiencies at the time individual decisions are taken. Certainly, in discussing movement through time, we must abandon the static equilibrium method so that “realization of error alters the state of expectations and shifts the independent behavioural functions,” thus, “Keynes’s model of shifting equilibrium will describe an actual path of an economy over time chasing an ever changing equilibrium—it need never catch it” [Kregel, 1976, p. 217; Kregel, 1997]. By contrast, in using the method of static equilibrium, Keynes is able to simplify sufficiently to highlight the role played by liquidity preference in establishing an equilibrium level of effective demand that need not be consistent with full employment. Whether money supply is exogenous or endogenous is not relevant to this analysis. Neither is the finance motive nor the manner in which an increased scale of activity is financed; all that is necessary is that money has ‘peculiar characteristics’ that cause its marginal efficiency to ‘rule the roost’. This is not to deny that it is important to extend Keynes’s theory to incorporate endogenous money. Indeed, even orthodoxy has rejected central bank control of the money supply, and some orthodox approaches explicitly assume that the money supply—broadly defined to include bank deposits—expands as spending grows, implicitly rejecting the money supply and demand approach to interest rates. However, this rejection does not mean that Keynes’s liquidity preference—as presented in Chapter 17—should be discarded.

How do we reconcile liquidity preference theory with the reality that central banks today operate with a short-term rate target? First, it should be recognized that Keynes...
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accepted substantial control over short-term interest rates by central banks even while promoting the liquidity preference approach. More importantly, even if we accept complete discretionary control over the overnight rate, as well as substantial influence over other longer-term interest rates on instruments such as government bonds, this still leaves a role for liquidity preference in determining all other own rates. Keynes never argued for mono-causality, rather, he singled out the role played by liquidity preference because he believed that to be the ultimate barrier to operation of the economy at full employment. Money can be created, but if marginal efficiencies of producibles are too low, even enlightened policy would not successfully generate full employment.

I have previously distinguished between liquidity preference (desire to hold liquid assets) and the demand for money, conceived as demand for new loans [Wray, 1990]. Rising money demand will normally lead to an increase of the money supply (defined as an increase of bank liabilities as banks make loans). Whether the loan interest rate rises depends on numerous factors, including expected policy and liquidity preference of banks—but a completely elastic (horizontal) supply of loans is unlikely. On the other hand, rising liquidity preference is associated with a reduction of planned spending as marginal efficiencies of producible assets fall relatively to the return to liquid assets. For this reason, money demand (as defined) could fall when liquidity preference rises. Money supply will not normally meet rising liquidity preference, instead, asset prices adjust until wealth holders are satisfied to hold the existing set of assets. Hence, endogenous money is reconciled with liquidity preference, clarifying the finance motive not as a desire for a hoard of money but as a flow demand for finance. The finance motive should then be kept separate from the original three motives to hoard.

The Nature of Money

If money causes unemployment, why are economies organized around its use? Orthodoxy presumes that money originated to reduce transaction costs, a position that is at odds with Keynes's proposition that money prevents the economy from operating at its efficient, full capacity, level. Keynes clearly thought that money serves a more fundamental purpose than to ‘lubricate’ the market mechanism. In the General Theory, he explicitly advanced “the Theory of the Monetary Economy,” which is one “in which changing views about the future are capable of influencing the quantity of employment and not merely its direction” [Keynes, 1964, p. 7]. In his preparation of the General Theory, Keynes spoke of the “monetary theory of production,” that would deal with an economy in which money plays a part of its own and affects motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted, either in the long period or in the short, without a knowledge of the behaviour of money between the first state and the last. And it is this which we ought to mean when we speak of a monetary economy. [Keynes, 1973a, pp. 408–409].

He distinguishes this from a “real-exchange economy” that might use money but “does not allow it to enter into motives or decisions” [Keynes, 1973a, pp. 408–409]. By contrast, in Keynes’s approach, money cannot be neutral, whether in the long run or the short run.

Many attribute Keynes’s concern with money to the uncertainty of the future. As he said, “partly on reasonable and partly on instinctive grounds, our desire to hold money as
a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future” [Keynes, 1973b, pp. 116–117]. Some Post Keynesians argue that the existence of uncertainty leads to the use of money contracts and, indeed, argue as if money exists because the future is uncertain. According to Davidson, Keynesians recognize “The existence of particular market institutions, organizations, and constraints (for example, money contracts, the legal system, money, and sticky money-wage rates) which exist only because uncertainty is present” [Davidson, 1974, p. 91]. Dow argues that “[the] fact that almost every society employs some form of money is in itself a response to uncertainty” [Dow, 1993, p. 19]. Further, “[t]he uncertainties associated with taking action with respect to an unknown future (actions which cannot be reversed) have historically encouraged the widespread use of money contracts...” [Davidson, 1974, p. 20]. However, this can be taken too far if interpreted to mean that money exists because of uncertainty. Keynes takes the existence of money for granted while arguing no one outside a lunatic asylum would store wealth in money form in a neoclassical world without uncertainty [Keynes, 1973b, p. 116]. But this does not mean that use of money requires uncertainty, or that origins of money, or even clues to money’s nature, lie in uncertainty.

In the Treatise, Keynes argued the “money of account comes into existence along with debts, which are contracts for deferred payment, and price lists, which are offers of contracts for sale or purchase... [and] can only be expressed in terms of a money of account” [Keynes, 1971b, p. 3]. He distinguished between money and money of account by saying that the money of account is the description or title and the money is the thing which answers to the description” [Keynes, 1971b, p. 3]. Further, the state “claims the right to determine what thing corresponds to the name, and to vary its declaration from time to time—when, that is to say, it claims the right to re-edit the dictionary. This right is claimed by all modern States and has been so claimed for some four thousand years at least” [Keynes, 1971b, p. 4]. Finally, “the age of chartalist or State money was reached when the State claimed the right to declare what thing should answer as money to the current money of account—when it claimed the right not only to enforce the dictionary but also to write the dictionary. To-day all civilised money is, beyond possibility of dispute, chartalist” [Keynes, 1971b, p. 4].

These views can be traced to Keynes’s earlier unpublished work on ancient monies as well as to his 1914 review of an article by A. Mitchell Innes [Innes, 1913, 1914]. As Keynes argued that “the fundamental weight standards of Western civilization have never been altered from the earliest beginnings up to the introduction of the metric system” [Keynes, 1982, p. 239]. These were taken over for the monetary units, whether the livre, mina, shekel, or the pound [Keynes, 1982, p. 239; Innes, 1913, p. 386; Wray, 1998, p. 48; Gardiner, 2004].

Hudson explains that monetary units, developed in temples and palaces of Sumer in the third millennium BC, were created initially for internal administrative purposes: “The public institutions established their key monetary pivot by making the shekel-weight of silver (240 barley grains) equal in value to the monthly consumption unit, a ’bushel’ of barley...” [Hudson, 2004, p. 111]. Hence, rather than intrinsic value (or even the exchange value) of metal giving rise to a numéraire, authorities set the monetary value of metal equal to the numéraire that was itself derived from the weight of the monthly grain consumption unit.

Along these lines, Keynes approvingly noted Innes’s rejection of the story of the evolution of money from early commodity moneys to credit and fiat money. The value of coins was never determined by embodied metals; rather, they were “all token coins, their
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exchange value as money differing in varying degrees from their intrinsic value” [Keynes, 1914, p. 420]. Like Knapp [1924], Innes argued the state “enforces the dictionary” by imposing a tax liability, ensuring the money it issues—denominated in that unit—is generally accepted by agreeing to accept it in tax payments. In his review, Keynes concluded, “Mr. Innes’s development of this thesis is of unquestionable interest.... [The] main historical conclusions which he seeks to drive home have, I think, much foundation...” [Keynes 1914, p. 421].

This position points toward a conception of money inseparably tied to the notion of debt. In the Treatise, Keynes explains how moneys are “derived categories” based on the unit of account. The two types are “offers of contracts, contracts and acknowledgments of debt, which are in terms of it, and money proper, answering to it, delivery of which will discharge the contract or the debt” [Keynes, 1971b, p. 5]. Individuals discover “that for many purposes the acknowledgments of debt are themselves a serviceable substitute for money proper in the settlement of transactions” [Keynes, 1971b, p. 5]. In modern economies, bank money is the most important, “We thus have side by side State money or money proper and bank money or acknowledgments of debt” [Keynes, 1971b, p. 5]. The state can “use its chartalist prerogative to declare that the [bank] debt itself is an acceptable discharge of a liability” [Keynes, 1971b, p. 5]. Bank money becomes money proper, changing “its character” so that it “should no longer be reckoned as a debt, since it is of the essence of a debt to be enforceable in terms of something other than itself” [Keynes, 1971b, p. 5].

However, Innes insisted that even “money proper” is debt, albeit a peculiar kind. While it is true that ‘fiat’ money is not ‘enforceable’ in terms of anything else, it shares with all debt the promise that it must be accepted by its issuer. According to Innes, this is the “very nature of credit throughout the world,” which is “the right of the holder of the credit (the creditor) to hand back to the issuer of the debt (the debtor) the latter’s acknowledgment or obligation” [Innes, 1914, p. 161]. Government money—like any liability—must ‘reflux’ in this manner back to the issuer. Still, government money is different, because it is “redeemable by the mechanism of taxation” [Innes, 1914, p. 152]: “[I]t is the tax which imparts to the obligation its ‘value’.... A dollar of money is a dollar, not because of the material of which it is made, but because of the dollar of tax which is imposed to redeem it” [Innes, 1914, p. 165]. In other words, what ‘stands behind’ the state’s currency is the state’s obligation to accept it in payment of taxes. This is sovereign power—ability to impose taxes and issue what is accepted in payment of taxes.

The significance is that the state is able to spend by emitting its own IOUs, required by the population to pay taxes. Complex coordinating procedures among the central bank, treasury, and private banks simultaneously obscure this reality and ensure it operates smoothly [Wray, 1998]. The important thing is that use of a state money makes it possible to implement Keynes’s fiscal policies to raise aggregate demand (Keynes Chapter 24). Neither ‘money’ nor ‘finance’ can be a barrier to adopting full employment policy because sovereign government can also spend on the necessary scale.

Conclusions

Keynes’s money supply-money demand determination of interest rates offered an alternative to the loanable funds approach and to the quantity theory’s use of money supply to determine the price level. However, the Chapter 13 treatment suffered from interdependence of the two functions. Keynes’s addition of a finance motive, as well as his introduction of overdrafts and revolving funds of finance only emphasized the
weaknesses of the equilibrium approach. Chapter 17 offered a better treatment of asset price determination, singling out the ‘peculiar’ role played by money, when liquidity matters, in setting a standard return that is usually too high to allow for the full employment level of effective demand. In earlier work, Keynes had provided insights into the nature of money and of a monetary production economy. Rather than highlighting the ‘lubricating’ role played by money in exchange, Keynes had emphasized the unit of account, as well as the role played by the state in ‘writing the dictionary.’ By imposing tax liabilities in the state’s unit of account, payable in its own ‘money proper,’ the state establishes not only the conditions required for private creation of monetary contracts, but also for using government spending to raise effective demand. It is not monetary but fiscal policy that can resolve the unemployment problem.

References


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