



An Introduction to
Monetary Theory

Rudolf Peto



Preface

This book is mainly a translation of the theoretical part of my German publication “Geldtheorie und Geldpolitik” provided with some updates. It reproduces in the main my lectures given in the University of Mannheim and in the University of Applied Sciences of Bielefeld.

This book is not at least influenced by the lectures of Émile James (Professor in the University of Paris) I visited with great interest during my studies in Paris.

With this publication I want to provide an introduction to monetary theory starting with an explanation of basic terms. The publication went on with detail analysis of money supply, the demand for money, monetary equilibrium, interest of rate formation and transmission. Last not least follows an analysis of the most central problem of monetary theory and policy, i.e. the changes in the value of money.

In my opinion the knowledge of monetary theory is essential to understand monetary policy.

I hope therefore that it will be possible someday to present a new and expanded edition with some chapters about monetary policy.

Rudolf Peto
Professor of Economics

Contents

| | | |
|----------|---|-----------|
| 1 | Fundamental Concepts..... | 7 |
| 1.1 | Money..... | 7 |
| 1.1.1 | Monetary Functions..... | 7 |
| 1.1.2 | Forms of money..... | 12 |
| 1.1.3 | Monetary Aggregates..... | 17 |
| 1.2 | Credit..... | 24 |
| 1.2.1 | Definition of credit..... | 24 |
| 1.2.2 | Forms of credit..... | 27 |
| 1.2.3 | The economic function of credit..... | 29 |
| 1.3 | Liquidity..... | 31 |
| | Comprehension questions on Chapter 1..... | 35 |
| | Bibliography for Chapter 1..... | 37 |
| | | |
| 2 | Money supply..... | 39 |
| 2.1 | The central bank's money supply and lending facilities..... | 39 |
| 2.2 | The commercial banking sector's supply of book money and credit facilities..... | 43 |
| 2.2.1 | Introduction..... | 43 |
| 2.2.2 | Fundamental static analysis..... | 45 |
| 2.2.3 | Dynamic analysis..... | 47 |
| 2.2.4 | Base money and other monetary aggregates..... | 51 |
| 2.2.5 | More recent aspects of the money supply..... | 56 |
| | Comprehension questions on chapter 2..... | 60 |
| | Bibliography for chapter 2..... | 61 |
| | | |
| 3 | Demand for money..... | 63 |
| 3.1 | Introduction..... | 63 |
| 3.2 | Classical/neoclassical money demand theory..... | 63 |

| | | |
|-----------|--|-----------|
| 3.2.1 | The velocity approach..... | 64 |
| 3.2.2 | The cash-balance approach..... | 67 |
| 3.3 | The Keynesian liquidity preference theory..... | 71 |
| 3.3.1 | Introduction..... | 71 |
| 3.3.2 | Transaction-cash balances..... | 72 |
| 3.3.3 | Speculative-cash balances..... | 75 |
| 3.3.4 | The general demand function according to Keynes..... | 78 |
| 3.4 | Post-keynesian demand theories..... | 80 |
| 3.4.1 | The inventory theory approach..... | 80 |
| 3.4.2 | Portfolio selection theory..... | 83 |
| 3.5 | M. Friedman's money demand theory..... | 85 |
| | Comprehension questions on chapter 3..... | 89 |
| | Bibliography for chapter 3..... | 90 |
| 4 | Monetary Equilibrium and Transmission..... | 91 |
| 4.1 | Interest Formation and Transmission in classical/neoclassical Theory..... | 91 |
| 4.2 | The Keynesian Monetary Equilibrium Model and the Transmission Mechanism..... | 95 |
| 4.2.1 | Monetary Equilibrium and Interest Formation according to Keynes..... | 96 |
| 4.2.2 | The Transmission Mechanism..... | 99 |
| 4.2.2.1 | The Curve of Equilibria in the Money Market (LM Curve)..... | 99 |
| 4.2.2.2 | The LM Curve and Changes in Price Level..... | 102 |
| 4.2.2.3 | The Curve of Equilibrium in the Goods Market (IS Curve)..... | 105 |
| 4.2.2.4 | The IS Curve and Changes in the Price Level..... | 108 |
| 4.2.2.5 | Equilibrium in the Goods and Money Markets at Constant Price Level..... | 109 |
| 4.2.2.5.1 | Monetary Measures to Achieve Equilibrium at a Constant Price Level..... | 110 |
| 4.2.2.5.2 | Goods Market Measures to Achieve Equilibrium at a | |

Contents

| | | |
|----------|--|------------|
| | Constant Price Level..... | 112 |
| 4.2.3 | Summery of the Hitherto Results and Their Consequence for .. Economic Policy..... | 113 |
| 4.3 | Further Developments of the Classical Theory..... | 115 |
| 4.3.1 | Wicksell's Processes..... | 115 |
| 4.3.2 | The Loanable Funds Theory..... | 116 |
| 4.4 | The Basic Concept of Monetarism and the Monetarist Transmission Process..... | 119 |
| 4.4.1 | The Basic Concept of Monetarism..... | 119 |
| 4.4.2 | The Monetarist Transmission Process..... | 122 |
| 4.4.3 | Some Comments on Monetarism..... | 125 |
| | Comprehension questions on chapter 4..... | 127 |
| | Bibliographie for Chapter 4..... | 128 |
| 5 | Changes in the Value of Money..... | 129 |
| 5.1 | Definitions..... | 129 |
| 5.2 | Measuring Changes in the Value of Money..... | 130 |
| 5.3 | Types of Inflation..... | 132 |
| 5.4 | The Monocausal Approach in the Theory of Inflation..... | 134 |
| 5.4.1 | The Classical/neo-classical Theory of Inflation..... | 134 |
| 5.4.2 | The Monetarist Theory of Inflation..... | 136 |
| 5.5 | The Multicausal Approach in the Theory of Inflation..... | 137 |
| 5.5.1 | Demand-pull Inflation..... | 137 |
| 5.5.2 | Supply-push Inflation..... | 140 |
| 5.5.2.1 | Cost-push Inflation..... | 140 |
| 5.5.2.2 | Profit-push Inflation..... | 143 |
| 5.6 | The Effects of Inflation..... | 143 |
| 5.6.1 | Effects on the Function of Money..... | 144 |
| 5.6.2 | Effects on International Competitiveness..... | 144 |
| 5.6.3 | Effects on Employment..... | 145 |
| 5.6.4 | Effects on Growth..... | 147 |

| | | |
|---|--|------------|
| 5.6.5 | Effects on Distribution..... | 148 |
| 5.7 | The Effects of Deflation..... | 149 |
| | Comprehensive question on chapter 5..... | 151 |
| | Bibliographie for Chapter 5..... | 152 |
| List of Symbols and Abbreviations..... | | 153 |