

Charter House Essays in Political Economy

Why monetarism does not work

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Why monetarism does not work

The logic of monetary theory is represented by an identity known as the Quantity Theory of Money (QTM). This identity is used in discussions and explanations of policy actions where money volumes and interest rates are raised or reduced. It is alleged that the objective of policy is to manage the value of the currency by avoiding inflation, or at least, to keep inflation within acceptable limits. On the other hand, money volumes are equated with demand which, it is claimed, needs to be maintained in order to stabilize employment and economic growth.

This logic has been taught in economic schools over the last century and it provides the logic behind the mainstream theories and policies advocated by Keynesianism and monetarism, both of which are oriented to aggregate demand management of the economy.

The QTM

The QTM is a simple identity which purports to show the relationship between money volumes and prices.

$$M.V = P.C \quad \dots \quad (i)$$

Where M is the volume of money circulating in the economy; V is the velocity of money; P is the average price level and C is the total services and products consumed.

The logic of the QTM follows the following assumptions. Consumption, C, can be equated with the real income as the total physical quantities of goods and services that can be consumed for a given average nominal disposable income. So, if prices rise, while money volumes and money velocity remain the same, then C will fall and with this, real incomes will also fall. If prices rise, for some reason, then lowering the volume of money M will compensate and drive prices down. So, the QTM is being used as if it were a mathematical function or algorithm.

Complete and incomplete data sets

A fundamental due diligence procedure to be applied when building models or algorithms is to make sure that the variables in the formula are the same as the data set that explains the relationships between the variables that are used. In other words, is the data set in the formula complete¹.

A critical point about the QTM is that it refers to money circulating in the economy. However, money volumes injected into the economy can be applied in many ways. Experience over the last 50 years and in particular during the last 12 years of quantitative easing (QE) have demonstrated that money ends up in circulating and non-circulating encapsulated markets which make up sub-sectors of any economy.

These markets include:

- Non-circulating encapsulated markets
 - Land and real estate - r
 - Precious metals - p
 - Commodities - m
 - Art objects - a
 - Shares - h
 - Financial instruments - f
 - Crypto-currencies – c
 - Offshore investment - o

- Circulating open markets

¹ Complete and incomplete data sets is a basic distinction identified by Location-State Theory as part of due diligence procedure used to build models and algorithms that are able to simulate real conditions.

- Supply side production and consumption of goods, services and capital equipment in exchange for wages - w
- Savings - s

Except for offshore investment the encapsulated markets are all speculative asset markets with which less than 5% of the population participate in as asset holders.

When offshore investment generates offshore profits that are reinvested or held offshore, then offshore investment becomes a noncirculating encapsulated market in relation to the onshore economy.

The circulating open markets are where something like 95% of the populations work and earn their living.

Therefore, a more complete data set should feature as variables within the QTM the 10 markets indicated above as r, p, m, a, h, f, c, o, w and s.

As can be appreciated the simplistic QTM does not have any of these variables in the identity.

$$M.V=P.C$$

However, since consumption C is paid out of wages, “w” his can be used to substitute C as follows:

$$M.V=P(w) \quad \dots \quad (ii)$$

However, we have seen that that M does not only flow into w it also flows in the other encapsulated markets each of which is distinct. Therefore, apart from w the rest of M flows into these markets. Therefore, the QTM should be as follows:

$$MV = (r + p + m + a + h + f + c + o + s) + P(w) \quad \dots \quad (iii)$$

Readjusting this by placing the non-supply side money on the righthand side of this identity, what flows to the supply side and wages can be seen to be a very small proportion of M.

$$(M - (r + p + m + a + h + f + c + o + s)) V = P(w) \quad \dots \quad (iv)$$

For example, f (financial instruments) includes a vast array of derivatives and other devices whose total volume today exceeds the GNP of the country. In this case as well as most other asset markets there is no oversight of the flow of money into these markets.

The impact of money flows

The overall practical outcome of QE has been a major rise in the value of assets and an indirect reduction in the performance of the supply side production of goods, services and capital goods and also of the purchasing power of wages.

The steep rise in prices in the land, real estate and some commodities as a result of speculation has also led to an inflationary leakage in the form of raised prices and rentals for:

- Land
- Houses
- Retail units
- Office space
- Industrial units
- Warehouses
- Port facilities
- Some commodities

As a result, there is cost-push inflation causing supply side companies to have to raise unit prices or have their margins reduced. Margins, as observed by Schumpeter, are the guarantee of future operations and employment. As house rents and prices rise and goods and service prices rise the

purchasing power of wages declines. As a result, the demand derived from the spending of wage earners, the majority of the population, declines leading to rising overhead in companies due to lack of use of capacity leading to associated laying off of manpower.

Because of the declining prospects of the supply side banks raise interest rates on any loans on the basis of perceive risk.

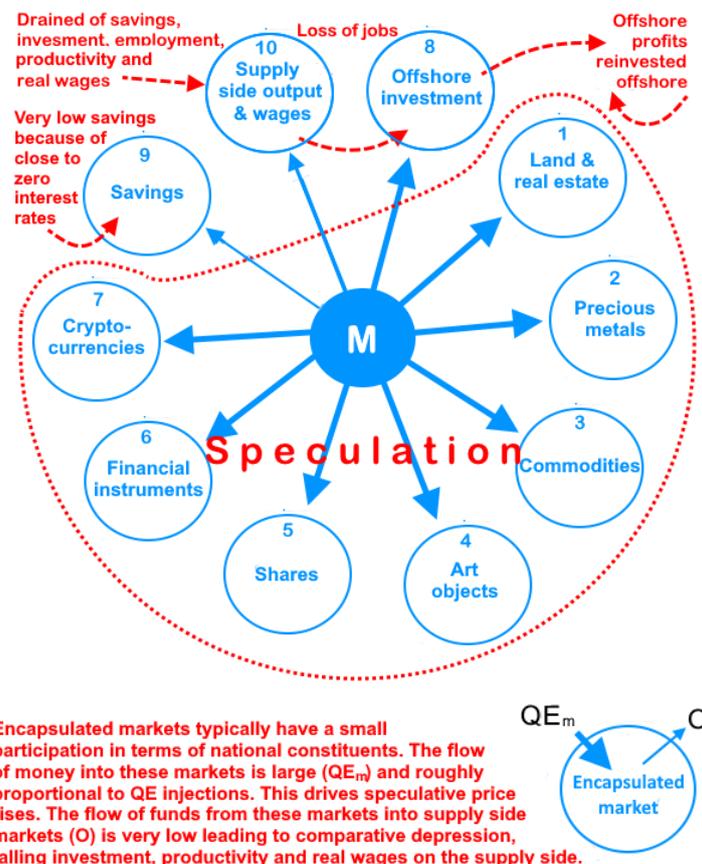
The outcome is continuing rises in the wealth of asset holders and a gradual decline in the purchasing power of the majority of the population.

Conclusion

No matter what is declared as being the beneficial intent of monetary policy, the track record of 12 years of QE demonstrates that:

- The models applied (e.g. QTM) by decision makers are flawed
- The general population is prejudiced
- The small higher income faction that deal in assets benefit directly from the boost in asset values as a direct function of monetary injections
- There is no effective oversight to control over where money flows
- There is no effective oversight to control over the encroaching prejudice for the majority
- No political parties in the United Kingdom have called into question the Bank of England's independence in being able to pursue this policy
- Because monetarism does not work as the government stated, the continuation of QE is corrosive to economic stability and divisive in terms of social conditions with the steep rise in pauperism amongst the working population

A summary of impacts of quantitative easing²



² McNeill, H. W., "Strategic Review - A summary of impacts of quantitative easing", DAI 2020-2030, RIO, SEEL-Systems Engineering Economics Lab, January, 2021.