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Book Reviews

ROGER SANDILANDS

Reviews

Monopoly in Money and Inflation: The Case for a Constitution to Discipline Government

H. G. Brennan and J. M. Buchanan, *Monopoly in Money and Inflation: The Case for a Constitution to Discipline Government*, Hobart Paper 88, Institute of Economic Affairs, London, 1981. pp. 68. £1.50.

The primary purpose of this Hobart Paper is to demonstrate the necessity for imposing constitutional constraints on the government's monopoly franchise to create money. Brennan and Buchanan claim that economists have been too inclined to perceive governments as 'benevolent despots', in contrast to the 'malevolent despot' model normally presented of monopolists. They insist that even if it is accepted that the money-supply industry is a 'natural' monopoly, it does not follow that the government should be allowed to excise this monopoly power without any restraints. Other natural monopolies have their power circumscribed by potential or actual competition from other suppliers or by official regulation.

It is naive to believe that, as a rule, governments that are controlled by human politicians will not use monopoly power to further particular interests at the expense of the general public unless subject to some constitutional constraint. The fact that free markets also have inherent weaknesses is not an argument in favour of granting governments an *unrestrained* monopoly.

By invoking a revenue-maximizing monopoly model, the authors explain how politicians are likely to secure real resources from a partly willing, but often unwilling or unwary, public. Since money balances have a real transactions value, the public are willing to sacrifice a certain volume of real goods and services to obtain it. Thereafter, however, further issues of fiat money confiscate further real resources from the public by causing inflation and reducing the real value of existing cash balances and outstanding public debt. This is particularly true when inflation is unanticipated so the public is not given a prior opportunity to reduce its demand for real cash balances. When inflation is anticipated, the public spends a part of its real cash balances, causing prices and nominal incomes to rise before the government gets in on the act. In these circumstances, the government is obliged to inflate the money supply even more in order to achieve a given level of confiscation. This is the road to hyper-inflation and the eventual collapse of

the official currency. Since this is not even in the long run interests of the government monopolist, the basis for a social contract, in the form of constitutional constraints on money issue, is established.

Four possible types of constitutional constraints are discussed briefly, including the private issue or use of competing monies (including foreign currency) for transactions, the use of commodity money and the establishment of various 'money rules' to abolish or at least limit the discretionary powers of the monetary authorities. The authors appear to favour some kind of money rule but are more concerned to establish the case for some form of constitutional constraint than to argue the case in favour of any particular regime. Reliance on the continuing advice of economists is not enough: politicians have always been able to find tame economists willing to justify any new spending programme.

The authors thus make a powerful case against unrestrained monopoly power for governments, though one is left with the uneasy feeling that they would prefer almost no scope for discretionary action by the monetary authorities in any circumstances. Most economists, even those most strongly favouring first priority to the control of inflation, would want the authorities to retain discretionary powers to offset variations in the velocity of circulation during the business cycle. Irving Fisher's price index rule (to keep the value of the monetary unit stable) comes nearest to meeting this objection, but Brennan and Buchanan are sceptical of the ability of the authorities to fine-tune in this way.

This reviewer would feel happier about a money rule if there were clearer agreement on what constitutes the money supply that is to be subject to such constraints. Recent experience in the UK and elsewhere suggest that, contrary to Brennan and Buchanan's conclusion, agreement on this issue needs to *precede* agreement on a monetary constitution. The discrepancy between M1 and M3 in the UK in 1979–1981 has been extremely wide. A monetary rule limiting the growth of the officially favoured measure, sterling M3, to say 5% per annum would probably have had catastrophic results. This is because £M3 includes interest-bearing time deposits whose increase has been largely a reflection of a marked increase in the personal savings rate while the *means of payment* (M1) have been growing much more slowly.

It is means of payment that are used to make payments, not time deposits, no matter how liquid these latter are. Brennan and Buchanan themselves confuse this point (p. 48) by stating that the growth of interest-bearing deposits increases the power of the government to extract revenue from the public through new money issues, since these interest-bearing 'money' balances encourage people to 'hold more value in cash than they would in a pure

currency system'. This is untrue. Cash holdings, at least as normally understood, will fall as a proportion of income in bank deposits exist. And the greater the opportunity to place money in interest-bearing liquid assets, of which bank time deposits are only one possibility, the smaller the proportion of income that will be held in cash plus demand deposits, or means of payment (M1).

If the government makes purchases worth £1 million with new money, it acquires the same real resources regardless of whether the recipients hold the money as cash, place it in demand deposits, or put it in a time deposit for someone else to borrow and spend. However, in the latter case M3 would rise relative to M1 and, because reserves are required against time deposits as well as demand deposits, total spending would be smaller than if the £1 million had been put in demand deposits and spent by the original recipients.

This leads us to question whether Brennan and Buchanan are correct to insist that their analysis is unaffected by the existence of fractional-reserve banking. The 'inflation tax' extracted by the government consists of two main elements as we have seen: the government's ability to issue paper money (either currency or the creation of new bank reserves or 'high-powered money') and the reduction in the real value of outstanding public debt that is issued in nominal rather than index-linked form.

Leaving aside the latter type of gain, the existence of 'low-powered money' issued by the commercial banks means that the total money supply increases much more than the increase issued initially by the government in exchange for real goods and services. This means that the potential inflation arising from a given issue of new money by the government is much greater than if a 100% reserve banking system existed. It also means that a much larger part of the gains from inflation are captured by some part of the private sector (at the expense of the other parts) than Brennan and Buchanan recognize. No one granted these seigniorage rights to private banks; they acquired them almost by accident, as a by-product of the circulation of goldsmiths' receipts as money. As a result, government-issued fiat money declined in real terms as the public found it far more convenient to substitute privately-issued claims as their main means of payment.

None of this is recognized by Brennan and Buchanan and so the focus of their argument is on the need for constitutional constraints on government rather than the banks. However, in practice of course we now do have constitutional (legal) constraints on the money-creating potential of the private banks, through legally enforceable, minimum reserve requirements. However, since the banks are not required to hold a *maximum* amount of reserves they can, if they are not already 'full loaned-up' or if they can easily rely on lender-of-last-resort facilities, still take some of the initiative in creating

new money by making new loans, even in the absence of a prior expansion of the money supply through direct government spending.

In conclusion, while we would not wish to dispute that Brennan and Buchanan have made a powerful case for some kind of constitutional constraint on the monetary authorities' power to print money, this should not obscure the need for equally tight controls on the power of the private sector to create the most important form of money, bank demand deposits; nor the need for a clearer understanding of the distinction between money and interest-bearing liquid assets so that when we come to establish monetary rules we know exactly what it is we want to control.

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R. ROTHSCHILD AND H. W. ARMSTRONG

Review

Industrial Location and Regional Systems

J. Rees, G. J. D. Hewings and H. A. Stafford (Editors), *Industrial Location and Regional Systems*, Croom-Helm, 1981. pp. vi+264. £15.95.

This book consists of a number of papers presented to Symposia on Industrial Systems held in Philadelphia in 1979. According to the Editors, the contributions are representative of the type of work currently being undertaken by industrial geographers in North America. An important feature of much of the material is the fact that it presents 'partial findings of larger on-going projects'. It is undoubtedly the case that some of the results reported here are new, or at least suggest new ways of looking at familiar theoretical and empirical issues.

The collection is divided into two parts. Part A contains papers of a largely theoretical nature, while part B is concerned with empirical matters. It is possible to group the papers within each section. In part A, the papers by Storper (2) and Thomas (3) complement each other quite naturally. Storper discusses the question of the spatial organization of industry from both the 'systems theoretic' and 'structuralist' points of view. He argues that systems theory is too deterministic, too dependent upon the idea of 'functional spatial reality', while structuralist theories provide greater insight into the role of capital-labour relations in the evolution of spatial systems. Thomas, on the other hand, adopts a more traditional (less radical?) approach, arguing that it is product and industry life-cycle hypotheses which provide insight into the growth and changing nature of industries. Pack (4) examines the relationship