MONEY AS A CREATURE OF THE STATE

By ABBA P. LERNER
New School for Social Research

A favorite pastime at the London School of Economics, where I was first introduced to the subject of economics, was the cruel baiting and tearing to pieces of Professor Knapp's *State Theory of Money*. The chief performer in this sport was Professor Gregory who spent several lectures at the beginning of his course on money in ridiculing Knapp's notions that the value of money derives in some metaphysical manner from the sovereign authority of the state. Gregory held with the classics that the value of money derives from the scarcity of gold and that this scarcity is impervious to declarations by government officials.

Later in the course the state managed to creep back quietly and unobtrusively through its power, via the banking system which it could control, to mitigate the scarcity of gold by economizing in the monetary demand for it. This was done by the substitution of currency and bank credit for gold thus reducing the demand for gold in relation to the supply. There was considerable development of the devices for such economies. Fiduciary issues of currency in addition to that which was backed 100 per cent by gold; fractional backing of currency which stretched gold further; the development of the banking system with the pyramiding of bank money on fractional currency reserves which were in turn backed less than 100 per cent by gold; the use of foreign exchange standards which permitted currency to be used instead of gold as reserves for central banks; and so on through a long list culminating with the temporary issue of "fiat" money, without proper backing, to deal with crises involving an urgent need for liquidity.

But the lesson of the first lectures on Knapp was never entirely forgotten. The money created or expanded by state action was made to recognize its inferiority to gold. It was merely a substitute for gold. Its value depended in the last resort on the gold backing or at least on the ability of the authorities to keep their promises to redeem the notes in good solid gold.

Since then we have been emancipated theoretically from the fetishism of gold. Nearly everybody who defends the use of gold in modern currency systems guards himself by saying that he is doing so only in order to be kind to somebody else's unreasonable prejudices. It is no longer a paradox to declare that the value of gold depends on the possibility of getting dollars for it rather than the other way round. And it is only from inferior textbooks that students are still getting the impression of some mysterious influence that gold exercises at a distance on the value of the currency backed by it. Even for those who have got no further from gold than to rest their emphasis on the quantity of money, it seems hardly more essential to explain the value of currency in terms of gold backing than to explain the value of gold in terms of its being backed by some still more primitive form of money, such as cattle or fish.

Money, as I have said in an article of that name in the *Encyclopaedia Brittanica,* is what we use to pay for things. The basic condition for its effectiveness is that it should be generally acceptable. Its transformability into gold and the guarantee of this possibility of gold backing (or any other kind of backing) are nothing but historical accounts of how acceptability came to be established in certain cases. These were possibly the only ways in which general acceptability could be established prior to the development of the well-organized sovereign national states of modern times. General acceptability had to be transferred in some such way from something which had already acquired it in the course of history. But if general acceptability could be established in any other way these historical methods would no longer be necessary or relevant.

This is just what has happened. The modern state can make anything it chooses generally acceptable as money and thus establish its value quite apart from any connection, even of the most formal kind, with gold or with backing of any kind. It is true that a simple declaration that such and such is money will not do, even if backed by the most convincing constitutional evidence of the state's absolute sovereignty. But if the state is willing to accept the proposed money in payment of taxes and other obligations to itself the trick is done. Everyone who has obligations to the state will be willing to accept the pieces of paper with which he can settle the obligations, and all other people will be willing to accept these pieces of paper because they know that the taxpayers, etc., will accept them in turn. On the other hand if the state should decline to accept some kind of money in payment of obligations to itself, it is difficult to believe that it would retain much of its general acceptability. Cigarette money and foreign money can come into wide use only when the normal money and the economy in general is in a state of chaos. What this means is that whatever may have been the history of gold, at the present time, in a normally well-working economy, money is a creature of the state. Its general acceptability, which is its all-important attribute, stands or falls by its acceptability by the state.

But there is another and much more serious sense in which the state is the responsible creator of money. The second most important problem that modern civilization has to solve if it is to survive the totalitarian threats to its existence is the prevention of severe inflations and depressions. (The first problem is, of course, the establishment of world peace before we slip into an atomic war by way of appeasement and/or preparedness.)

Depression occurs only if the amount of money spent is insufficient. Inflation occurs only if the amount of money spent is excessive. The government—which is what the state means in practice—by virtue of its power to create or destroy money by fiat and its power to take money away from people by taxation, is in a position to keep the rate of spending in the economy at the level required to fill its two great responsibilities, the prevention of depression, and the maintenance of the value of money.

Up till now governments have shirked these responsibilities, seeking refuge in an alibi of helplessness. The extraordinary complacency both of the government and of its critics in the face of the recent rise in prices can be appreciated only if one imagines what would have been the reaction to a government declaration that it was going to default on say 30 per cent of its interest and repayments to holders of war bonds and other government obligations. An equal despoiling of patriotic subscribers to war loans through the price increases does not prevent the treasury from still advertising government bonds as giving back $4.00 for $3.00. Nobody seems to find this dishonest. And even this denial of responsibility is as nothing compared with the way in which nearly all states have nearly all the time permitted depressions to begin, to grow, and to establish themselves without calling into play their power to create the money demand which would have made the depression impossible.

Before the tax collectors were strong enough to earn for the state the title of creator of the money, the best the state could do was to tie its currency to gold or silver which had a stability of their own that antedated the appearance of the state. By that policy extreme inflations were made impossible, and in a small country even small inflations (relatively to other countries) would be checked by the disappearance of the money in an outward flow of gold. By the same policy a limit was set to depressions. For the world as a whole they could not go below the point at which the available and fairly steady supply of gold-money became so redundant on account of the small volume of business (or possibly because of lower prices) that it spilled out into increased spending by somebody who was supersatiated with liquidity. For individual countries special conditions of foreign trading and lending might lead to much worse depressions, but on the other hand any further depression beyond that determined by these special conditions would be quickly corrected by an inflow of gold-money from the rest of the world.

The return to such methods now can only be proposed by exuberant Republicans who have not yet given a second thought to their meaning. The "margin of adjustment" involved in so crude a mechanism—which stretches from the limits of price rises within a gold standard to the level of depression that corresponds to zero net investment—have become wider still. The United States can carry much more inflation than we have so far had without running out of gold, while the level of unemployment that would be possible before a redundance in the supply of hard money came to the rescue grows greater with our growing productive competence and is now far beyond the limit set by the political conditions for the maintenance of a free society.

No government will be able to sit back and wait for the degree of unemployment which will result in the degree of price fall that will create enough idle money to induce sufficient private investment to start a movement back to prosperity. The New Deal and the war prosperity will have shown enough people that serious depression is dispensable. Some form of functional finance will in fact be practiced by whatever government we have. The only danger is that it will be too little and too late.

Less well worked out is a technique of dealing with the other responsibility of the creator of money—the responsibility for maintaining its value. The key points here are not in the direct supply of money, or even in the regulation of the level of spending. The key points are in the determination of wage rates and in the determination of rates of markup of selling prices over costs.

Wage determination by collective bargaining brought an improvement over the condition of the unorganized worker bargaining with a large employer in time of depression. With the abandonment of severe depression as part of the technique of influencing the determination of wage rates, and with the growth of trade unions to national and international size, the power of the trade unions has become too great for the purpose of determining wages by collective bargaining. Each union is forced to use its power to try to increase the share going to its members even though its more intelligent leaders know that what it gains is not from the employer, who can and will pass any wage increase on in higher prices, but from the population as a whole—which means in the main from other workers and their families. They also know that the other trade unions will have to do the same so that there is nothing left but a general inflation. For any particular trade union to restrain itself in the scramble may merely mean that it is left behind while the inflation continues. So that unless some alternative mechanism of wage determination is developed, a full employment policy will mean inflation. The acceptance by the government of its responsibility for preventing depression would seem to make it impossible for it to carry out its second responsibility for maintaining the value of money.

On the other hand it seems to be very likely that the Nathan report is right in believing that after the restocking boom the maintenance of adequate spending will be impossible without an increase in real wages; that is, in the ratio of money wages to the prices of finished goods. This is the same dilemma in a different form. Higher wages relatively to prices are necessary for long-run prosperity but raising wages will do no good because they will only lead to higher prices and inflation.

The dilemma can be resolved only by the government going to work on both money wage determination and on markup rates. Both are problems of monopoly and as such are inevitably destructive of a free economy. Markup rates must be reduced by antimonopoly measures of the kind that the government was working on when interrupted by the war. The most important help to the government in this will be the policy of maintaining full employment which will make it profitable for business to work with smaller markups. The effects can be speeded up by the government making the benefits of the full employment more immediately evident to producers by costlessly guaranteeing adequate (or even unlimited) sales of standard goods at moderate prices, releasing the energies and initiative of businessmen from the worries of selling to the concentration on efficiency in production.

The trade union monopolies must be tackled by establishing an artificial free market with compulsory arbitration for wage determination in which both the worker and the employer get a fair deal. Starting from some initial set of wage rates, such as the prevailing rates, wages in general can be raised by 1 per cent about every four months (on account of the secular growth in labor productivity) without the general level of cost and prices having to rise. This would be the basic money wage movement. In areas and industries where the level of unemployment is more than twice the national average the wage increase would not take place. Where the level of unemployment is less than half the national average the wage would be increased 2 per cent instead of 1 per cent.

This would have to be accompanied by measures to maximize the mobility of labor, removing all restrictions on entry to any occupations. The appearance of twice the national average of unemployment would then be evidence that workers consider the existing conditions in the area of industry more attractive than elsewhere, so that it would be fair for the increase to be forgone. Workers who insisted on the increase would in effect be claiming the retention of an advantage over workers in general.

Less than half the average of unemployment would be evidence that workers in general considered the conditions less attractive than elsewhere. A refusal of employers to raise wages by the required 2 per cent would then be seen as an attempt to maintain substandard conditions. In the end there would emerge a set of wage rates which would correspond to the workers' own estimates of the necessary compensation for differences in net advantages.

I have no time to defend these proposals. They are only intended as an indication of the direction in which solutions to these most pressing problems might be found. I will only make two remarks.

The side-stepping of collective bargaining will undoubtedly be denounced as an attack on labor. It is important to note that it will appear so only to those who in their thinking have completely substituted the labor unions for the workers, raising these instruments for improving the economic welfare of labor to the status of ends in themselves. We should remember that an end in itself is nearly always a means for some end which one does not like to mention aloud, such as the maintenance of the position, prestige, and salary of a union bureaucrat.

The second remark is addressed to another professional group—monetary theorists. I have gone quite a way from the traditional field of monetary theory. I find that this is inevitable if we are to begin to take seriously a slogan which we have been repeating for quite a while now. The problem of money cannot be separated from the problems of economics generally just as the problems of economics cannot be separated from the larger problems of human prosperity, peace, and survival.