Study Questions for George Reisman's *Capitalism: A Treatise on Economics*

CHAPTER 12. MONEY AND SPENDING

The Quantity Theory of Money

1. What does the quantity theory of money claim?

2. State the quantity theory of money in terms of an algebraic formula. Explain the meaning of each of the terms of the formula.

3. Illustrate the quantity theory formula in terms of specific assumptions about the size of its various terms.

4. How large is the M_1 money supply currently? How much of it represents currency and coin and how much of it represents checking deposits?

5. Estimate the current size of the M_1 money supply after allowing for additions resulting from the existence of "sweep accounts" and from the fact that a growing proportion of money market mutual funds has become indistinguishable from checking accounts. (The Federal Reserve Bank of St. Louis provides estimates on the size and growth of sweep accounts since they became significant after the end of 1993. The *Federal Reserve Bulletin* regularly reports the size of money market mutual funds. Varying assumptions may be made about the extent to which these funds have become the full equivalent of checking deposits since the end of 1993. Attempt to form an estimate on the basis of the best further information you can obtain about this subject.)

6. How large is gross domestic product (GDP), formly gross national product, (GNP) at the present time?

7. To what extent does GDP represent consumer spending?

8. Why should government spending be counted as consumer spending?

9. Why should expenditures for owner-occupied housing be counted as consumer spending?

10. How large is income velocity (or approximately, consumption velocity) at the present time?

11. Describe two other measures of velocity.

12. Describe how an increase in the quantity of money operates to increase the volume of spending in the economic system.

13. Explain the essential difference between the factors determining the increase in the quantity of a gold money and that of an irredeemable (i.e., fiat) paper money.

14. Explain rising prices on the basis of an increasing quantity of money.

15. Present the preceding explanation in terms of formulas both for the volume of consumer demand (spending) and the general consumer price level.

16. Explain the meaning of demand and supply as used in the price level formula.

17. Assume that over a decade the quantity of money and volume of spending double, while production and supply increase by 50 percent. How great is the percentage rise in the general consumer price level?

18. The price level formula shows demand as a numerator and supply as a denominator. In the light of this formula can you think of any way in which the average price at which goods are sold could rise without the demand rising or the supply falling?

19. Explain why it is far more likely for prices to rise under a system of fiat paper money than under a system of commodity (i.e. gold or gold and silver) money.

20. Explain why gold and silver moneys were often accompanied by long periods of *falling* prices, as in the generation preceding the discovery of the California gold fields and the generation from 1873-1896.

Origin and Evolution of Money and the Contemporary Monetary System

1. Describe the essential condition that must be present for a barter exchange to take place and how in the absence of this condition some of our more intelligent ancestors began to resort to indirect exchanges.

2. What goods have served as media of exchange in the course of history?

3. Describe how a medium of exchange evolves into money.

4. Describe how for a time cigarettes developed into a kind of quasi-money in some parts of Europe after World War II. Explain how this phenomenon led non-smokers to become eager to accept cigarettes in exchange for their goods and smokers not to smoke.

5. Explain why, historically, gold and silver in particular came to be money as civilization developed.

6. Describe how the process of a medium of exchange developing into money is cumulative and self-reinforcing.

7. "The precious metals came to be money because they are the most suitable commodities for most people to save." Discuss.

8. Explain how the growing use of gold and silver as media of exchange favored their use as a medium in which to write contracts and state debts and how this further encouraged their use as media of exchange and thus promoted their development into money.

9. Over what period of time did gold and silver coin serve as money in the Western world?

10. Describe the process by which paper currency and checkbook money came into existence.

11. Could paper money have come into existence without a preexisting commodity money to which it was considered a secure claim payable on demand?

12. Describe the critical role played by the National Bank Act of 1863 in fostering the use of paper money in the United States in place of gold coin.

13. The great bulk of the American people's gold came into the government's hands (a) in World War I, as the result of a wartime amendment to the Federal Reserve Act of 1913, (b) in 1933, when the New Deal ordered all privately held monetary gold to be turned into the Federal government. Explain.

14. What did the Federal Reserve's possession of the gold previously held by the private banking system make possible?

15. Why did virtually everyone continue to accept dollars after 1933, even though they were no longer redeemable in gold?

16. Explain why even though the law required the Federal Reserve to hold substantial gold reserves against the dollars it created, for many years this requirement did not impose an effective limit on the Fed's ability to increase the supply of dollars.

17. Describe the process by which the excess gold reserves of the Fed were gradually eliminated and what happened as their exhaustion threatened.

18. Explain why abandonment of external convertibility of the dollar at the rate of $35 per ounce was inevitable, given the rate at which the U.S. government wanted to increase the supply of dollars.

19. Describe what has happened to the price of gold since 1971, when the U.S. government abandoned the last vestige of the policy of redeeming dollars at the rate of $35 per ounce.

20. Describe the legal status of gold ownership by American citizens from 1933 to the present.

21. Explain the potential that is created for a spontaneous remonetization of gold under conditions of substantial inflation. Explain how this potential would be greatly increased if it were legal for businessmen to discriminate between precious metal coins and paper currency of the same face value.

22. What is meant by "fiduciary media"?

23. What, in contrast, is meant by standard money?

24. What is standard money under a gold standard? What is standard money today?

25. What is meant by the "monetary base"?

26. What is the relationship of standard money to the monetary base?

27. "Fiduciary media" represent claims to debt that circulate as money." Disuss.

28. What is the present magnitude of fiduciary media in the United States? What portion of the present money supply is this?

29. Describe the process by which fiduciary media come into existence.

30. "An alternative way of viewing fiduciary media is that of the fractional-reserve principle." Explain.

31. Explain why the opposite system to fiduciary media is the 100-percent-reserve system.

32. Describe the relative roles of standard money and debt as backing for paper currency and checking deposits under the 100-percent and fractional-reserve systems.

33. "The 100-percent-reserve principle applies only to checking deposits and banknotes, not to savings deposits or time deposits." Explain.

34. Describe how fractional reserve banking possesses a *deflationary* potential that, once unleashed, tends to be self-reinforcing and cumulative, ultimately capable of wiping out all fiduciary media.

35. Explain the applicability of the forces described in answer to the preceding question to the 1929 depression.

36. What prevents the deflationary potential of fractional reserve banking from being unleashed today? What does this portend for inflation?

37. Explain how a 100-percent-reserve monetary system would make the money supply absolutely independent of the failure of any debtors and thus make sudden, drastic reductions in the money supply virtually impossible.

38. Describe the factors that would greatly limit the creation of fiduciary media in a banking system that was free of government interference.

39. Describe, in contrast, the various ways in which government policy has promoted fractional reserve banking over the course of many years.

40. Short of prohibiting fiduciary media, what policy could the government follow that would entail simply removing all support it gives to their existence? Is there anything of relevance to such a policy to be found in President Jackson's specie circular?

41. What is meant by the Federal Reserve's "open-market operation"?

42. What is the role of the open-market operation in increasing the quantity of money?

43. What is the connection between the open-market operation and government budget deficits?

The Quantity of Money and the Demand for Money

1. Explain what is meant by "the demand for money" and its relationship to the velocity of circulation of money.

2. Explain the relationship between the demand for money and the security of property and why this relationship is very different under a commodity money system (i.e., a gold money) and fiat paper money.

3. Explain the relationship between the demand for money (velocity) and the development of financial markets and financial institutions.

4. Explain the effect on the demand for money (velocity) of improvements in transportation and the development of clearing houses.

5. "In the context of an economic system with developed financial institutions and financial markets, saving operates to *raise* the velocity of circulation of money." Present two reasons for this conclusion and describe how it contrasts with the view that saving is hoarding.

6. "In the conditions in which the velocity of circulation of a gold money rises, there is unlikely to be any

fall in the purchasing power of gold as a result." Explain why not. (Is the velocity that rises in connection with economic development likely to be mainly income velocity.)

7. Describe each of the four reasons why the more rapidly the quantity of money increases, the less is the demand for money likely to be and thus the greater is the (income or consumption) velocity of circulation likely to be.

8. Explain the connection between increases in the quantity of money and the rate of interest, both in the short run and in the long run.

9. "To avoid rapid destruction of the monetary system, there is no practical alternative but to allow the rate of interest to follow the rate of profit on up as the quantity of money increases." Discuss.

10. "Interest is the price of money. Thus, the larger the money supply, the lower must be the rate of interest." Discuss.

11. What is a more precise description of interest than the "price of money," and which is consistent with the rate of interest being higher as the result of more rapid increases in the quantity of money?

12. Explain how higher interest rates make it worthwhile to lend out smaller sums of money for shorter periods of time, sums which it otherwise would not have paid to lend out.

13. Explain why, despite the relationship referred to in the preceding question, a reduction in the rate of profit and interest that might result from a higher rate of saving should *not* be presumed to increase the demand for money and thus reduce the velocity of money.

14. Explain the changes in the velocity of circulation of money in the period 1929-1945 in the light of the relationship between velocity and changes in the quantity of money.

15. Explain the changes in the velocity of circulation of money in the period 1946-1981 in the light of the relationship between velocity and changes in the quantity of money.

16. Explain the changes in the velocity of circulation of money in the period 1981 to the present in the light of the relationship between velocity and changes in the quantity of money.

17. "The present monetary situation is highly unstable, possessing as it does the potential both for major inflation and for major deflation." Discuss.

18. Explain why the deadly alternative referred to in the preceding question would not exist if the policy of inflation had not been resorted to in the first place.

The Demand for Money: A Critique of the "Balance of Payments" Doctrine

1. Explain what is meant by the "balance of trade."

2. Explain what is meant by the "balance of payments."

3. Explain how these doctrines imply international economic conflict.

4. Which school of economists first propounded these doctrines?

5. Explain why from the perspective of economic history and the history of economic thought, the

concepts of the balance of trade and the balance of payments can be taken as interchangeable.

6. Describe the historical context in which the doctrines originated and the original, essentially military objective which a "favorable" balance was supposed to achieve.

7. Describe the wider, economic objectives that a "favorable" balance was supposed to achieve.

8. "On the Mercantilist view of things, in the absence of government intervention to secure a favorable balance, the balance of trade (payments) was determined on an essentially accidental basis." Discuss.

9. "On the mercantilist view of things, imports had the potential of completely draining a country of its money supply." Discuss.

10. "Mercantilism has a very contemporary ring to it in terms of the economic objectives it is thought necessary for governments to promote." Elaborate.

11. "Mercantilism's treatment of the balance of trade (payments) as being the fortuitous outcome of the unrelated actions of individuals is also shared by most contemporary writers and commentators on the subject." Illustrate.

12. "Concern with an unfavorable balance of trade or payments under a gold standard may have some plausibility, but under the conditions of a fiat paper money it makes no sense whatever." Discuss.

13. "To some extent the position of the dollar as an international money entails some actual loss of dollars to abroad each year, but such loss, for from being a proper source of worry, simply represents a modest lessening of the degree of domestic inflation of the money supply." Discuss.

14. "The far greater part of what is recorded as an unfavorable balance of payments does not in fact represent an actual outflow of money, but an increase in short-term foreign lending to the citizens of the country, or to its government. These are developments which are actually favorable from the point of view of economic well-being." Explain.

15. "The various items in the accounts are not independent, but rather are mutually interconnected. For example, the so-called unfavorable balance of trade (the excess of imports over exports) that the United States has experienced in recent years is precisely the result of the excess of receipts by the United States over outlays in the vital area of lending and investing." Explain why it is in the very nature of foreign investment that it be accompanied by a so-called unfavorable balance of trade in the country receiving the investment.

16. "The purchase of imports does not represent any significant carrying out of money from the United States or any reduction in total, overall spending for goods and services in the United States. On the contrary, the imports represent new and additional wealth brought into the United States, where they are added to the supply of domestically produced goods and made available for purchase by the same total expenditure of money that would otherwise take place." Discuss.

17. "The rise in the foreign exchange value of a country's money that foreign investment in the country causes not only does not cause unemployment in that country, but actually tends to be accompanied by *less* unemployment." Explain.

18. "The prohibition or forced reduction of auto and steel imports would reduce unemployment in those

industries but, in the absence of wage rate reductions, increase unemployment in the rest of the economic system." Explain.

19. Describe the unfavorable results likely to accompany the reduction or elimination of foreign investment and the excess of imports over exports that is the accompaniment of net foreign investment.

20. "What is called a favorable balance of trade can in fact be fully as much unfavorable as an allegedly unfavorable one is favorable." Explain.

21. Explain how foreign investment brings about an excess of imports over exports in the country receiving the investment under the conditions of an international gold standard.

22. Explain the principle governing the distribution of the world's money supply among the various individual countries under an international gold standard.

23. What is the implication of the principle cited in answer to the preceding question for the balance of payments of a country whose economic system grows (declines) relative to that of the rest of the world?

24. Explain the effect of the presence or absence of gold mines on a country's balance of payments under an international gold standard, namely, why a country with extensive gold mines would most likely experience an "unfavorable" balance of payments, while a country without them would most likely experience a "favorable" balance of payments.

25. "Other things being equal, under an international gold standard, *the balance of trade and payments of all countries always tends toward balance.*" Explain why.

26. Explain how under an international gold standard, labor union activities operate to reduce a country's share of the world's money supply in comparison with what it would otherwise be.

27. Explain the effect of labor union activities on the height of money wage rates that can accompany full employment in a country that operates under an international gold standard.

28. Explain how the growth rate of a country's economy relative to that of the rest of the world operates to determine that country's share of the world's money supply under a system of fiat moneys.

29. Explain how under an international gold standard, the creation of fiduciary media in any one country operates to cause a drain of gold from that country.

30. "What explains an `unfavorable' balance of payments in the sense of an actual outflow of money from a country is that the citizens of the country have an insufficient demand for that money to keep it in the country. In such circumstances it is futile to try to do so by blocking this or that category of imports or encouraging this or that category of exports." Explain.

31. "When the citizens of a country do have a demand for its existing quantity of money, no amount of outlays to abroad will for very long deprive them of any part of that quantity of money." Explain.

32. "Imagine that a new foreign aid bill is passed [in the U.S.] and, as part of it, an army of tax collectors is dispatched into the streets to seize money from every passerby and from every shopkeeper and businessman. The money, we can imagine, is then loaded into armored cars, rushed to nearby airports, and then flown to various foreign capitals." Will this foreign aid be at the expense of the cash holdings of the American people? Or will its effect very soon be a combination of decreased American imports and

increased American exports and borrowings from abroad until American cash holdings are restored to approximately their former level?

33. In the light of your answer to the preceding question, discuss the observation of Adam Smith that "the attention of government never was so unnecessarily employed, as when directed to watch over the preservation or increase of the quantity of money in any country."

34. "What needs to be understood in connection with the balance of trade and payments viewed as source of changes in the quantity of money in a country is that the change in the stock of money in people's pockets, like the change in the stock of food in their refrigerators, is fully within their control and that their decisions about changes in the stock determine the relationship between the receipts and outlays, not that the relationship between the receipts and outlays determines the change in the stock." Discuss.

35. In the light of the analysis of the balance of trade/payments doctrine, explain how in a free market unilateral tariff reduction by one country and a resulting surge in its imports would soon be followed by a diminution of the increase in its imports and an increase in its exports.

36. Explain what the lasting advantage of the tariff reduction would be.

37. Explain why an essential requirement of being able to adapt to the consequences of a temporary outflow of money is the absence of labor legislation.

38. In the light of the analysis of the balance of trade/payments doctrine, explain what would happen if one country pursued a policy of free trade, while all other countries absolutely prohibited the importation of its goods.

Invariable Money

1. "Changes in prices can reflect changes taking place on the side of money as well as changes taking place on the side of goods. This is certainly the case whenever there is inflation or deflation." Discuss.

2. "The variability of the value of money coming from the side of money applies even to a pure gold or silver standard--that is, to a 100-percent-reserve gold or silver standard." Explain.

3. "In order for a money to serve as an *invariable standard of value*, it would have to be such that changes in prices would reflect exclusively changes operating on the side of goods, not money." Explain.

4. What did Ricardo believe would be necessary in order for gold to serve as an invariable standard of value?

5. What would be necessary for gold to be an invariable standard of value according to *Capitalism?*

6. Under such an invariable standard of value, explain what all changes in the general price level would reflect.

7. What would be the relationship between supply changes and price level changes under such an invariable standard of value?

8. What would be the elasticity of aggregate demand under such an invariable standard of value?

9. At what level would price changes reflect demand changes under such an invariable standard of value?

10. What is Hazlitt's attitude, at least implicitly, toward an invariable money?

11. Does the concept of invariable money imply that every measure of velocity must remain unchanged, or only velocity in relation to the demand for products?

12. In what way does use of the concept of invariable money as a tool of analysis represent the adoption of a procedure analogous to that of mechanics? Explain.

13. In what way is the assumption of an invariable money necessarily made, at least implicitly, by everyone who thinks about economic phenomena?

14. Explain how the concept of invariable money and recognition of the fact that money is not of invariable value sheds light on the respective roles of a system of fiat paper money and the businessman's profit motive in the causation of the rising prices we see almost all around us.

15. Describe the uses that will be made of the concept of invariable money in the chapters to follow.