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To cite this article: Maria Cristina Marcuzzo (2017) The “Cambridge” critique of the quantity theory of money: A note on how quantitative easing vindicates it, Journal of Post Keynesian Economics, 40:2, 260-271, DOI: 10.1080/01603477.2017.1286939

To link to this article: http://dx.doi.org/10.1080/01603477.2017.1286939

Published online: 06 Jul 2017.

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The “Cambridge” critique of the quantity theory of money: A note on how quantitative easing vindicates it

Maria Cristina Marcuzzo

ABSTRACT
Through quantitative easing markets have been flooded with liquidity, but rather than inflation we have witnessed a general deflation because of the liquidity trap environment in which the banking system operated; this article revisits the arguments against the quantity theory in the “Cambridge” tradition of John Maynard Keynes, Richard Kahn, and Nicholas Kaldor, and defends their soundness and topicality.

KEYWORDS
Cambridge Monetary Theory; inflation; Quantitative easing

JEL CLASSIFICATIONS
B31; E31; E40

Economists’ understanding of the dynamics of inflation is far from perfect. Reflecting that limited understanding, the predictions of our models often err, sometimes significantly so.

—Yellen (2015, pp. 21–22)

Premise
In any standard macroeconomics textbooks (i.e., Mankiw and Blanchard to name the most widely adopted), the function of money as a medium of exchange is given prominence and the demand for it is mainly accounted for as a function of the level of income. This quickly establishes that the equation \( MV = PT \), or its modified form \( M = kPY \), is the key relationship allowing us to determine price levels, at least in the long run. This conclusion is based on the assumptions that:
1. The velocity of circulation is constant;
2. The supply of money is exogenous;
3. Variations in the quantity of money have only a short-term effect on output, which in the long run always reaches full employment level;
4. The function of store of value can be neglected.

In Keynes’s ([1936] 1973) *General Theory* we find an alternative approach to money and price-level determination, the seeds of which were already planted by Alfred Marshall, cultivated by his followers at Cambridge in the 1930s, and remained the consensus view well into the 1960s. But Milton
Friedman and the Monetarists of the 1970s managed to rehabilitate the approach based on the quantity theory and to win over the joint assault later launched by Richard Kahn and Nicholas Kaldor from the House of Lords, in the media and academic journals of the time. In the 1990s, New Classical economists joined forces in favor of restatement of the quantity theory, with Robert Lucas famously summarizing the implications of the theory, writing, “in the long run, money growth should be neutral in its effects on the growth rate of production and should affect the inflation rate on a one-for-one basis” (Lucas, 1995, p. 665).

The restatement of the quantity theory was part of an anti-Keynesian climate that was there to last. For almost forty years the quantity theory regained its hegemony in the academic and economic discourse (traces of it remaining in standard textbooks), whereby the central bank, which is responsible for the supply of money, is said to be able to manage the inflation rate.

Even in macroeconomics textbooks of the so-called neo-Keynesian orientation, we find that an increase in the quantity of money through its effect on spending causes only a short-run increase in output; any increase in output beyond the natural or NAIRU level, brought about by expansionary policies that entail an increase in the nominal stock of money, keeps pushing wages and prices up until the real quantity of money is back to its initial level. So, rather than an alternative approach to price-level determination, the Keynesian approach appears to complement the quantity theory, and is thus valid to explain short-term fluctuations in output and prices.

In the past few years, the quantitative easing (QE) experiment has given us exceptional data to test the validity of this argument. Unlike the influx of silver in sixteenth-century Europe—which is said to have induced belief in the validity of the theory—the unprecedented expansion of the monetary base by the Bank of Japan, Federal Reserve, and European Central Bank have hardly produced any effect on price levels, but only on asset prices. On the contrary the corresponding average annualized inflation rate over that same period, as measured by the personal consumption expenditures price index, not only did not rise, but in the case of Japan and the eurozone showed signs of declining.

Trying to estimate the effects of QE on the economy is said to be difficult because “a host of factors will have been affecting the economy during the crisis period, when most QE programmes are launched…most estimation methods require ‘heavy’ assumptions (e.g., about transmission mechanisms at work) that can dramatically affect the results” (Gros, Alcide, and De Groen, 2015, p. 20). However, the evidence of no link between monetary expansion and inflation is overwhelming, and most commentators have resorted to “financial frictions” together with “zero-interest rate lower nominal bound” to explain it. As a result, the quantity theory approach is not discarded but said just not to apply in these particular circumstances.
As Brad de Long put it:

At the zero-interest rate lower nominal bound, [the QT-based] Fisher–Friedman framework breaks down. With no opportunity cost to holding wealth in money rather than in other short-duration safe nominal assets, there is no reason for changes in the money stock to induce any changes in the flow of spending at all. Anybody seeking to model nominal and real income determination must then find another, alternative equilibrium condition to focus on. (De Long, 2015)

Furthermore, the vice president of the European Central Bank admitted that “No technical traditional monetarist channels were operating. They did not work either in other cases. This implies that QE is not about the traditional monetarist channels but about new ones, namely signalling and portfolio rebalancing due to financial frictions” (Costancio, 2015).

The evidence vindicates old and present critics of the quantity theory and points to the liquidity preference theory as better able to explain the facts: when money is being held as a store of value at the margin, the money banks receive from QE primarily pads out their cash reserves. The financial system has not reacted to the injections of liquidity by augmenting lending and thereby increasing the money supply, while the private sector has been deleveraging and not increasing its borrowing. From both supply and demand considerations, therefore, the link between $M$ (money supply) and $P$ (average price) of the quantity theory is severed. The relevant aspect of demand for money neglected by the quantity theory approach is what Keynes called the “speculative” motive, that is, the propensity to hold it in face of uncertainty or negative expectations on future interest rates, leading to possible capital losses. Money is not held for transaction purposes only, but also for its store of value property, as protection against uncertainty. This role of money derives from its liquidity, of which money has more than any alternative asset.

So we must turn to the notion of liquidity to find the appropriate theoretical framework to understand why reasoning based on the quantity theory leads us on a false track.

**Kahn and Keynes: Before the General Theory**

A good starting point is a passage from the Preface to the French edition of the *General Theory*, dated February 1939:

The following analysis registers my final escape from the confusions of the Quantity Theory, which once entangled me. I regard the price level as a whole as being determined in precisely the same way as individual prices; that is to say under the influence of supply and demand…. The quantity of money determines the supply of liquid resources and hence the rate of interest. (Keynes, [1936] 1973, pp. xxxiv–xxxv)
Kahn gave the reconstruction of the gradual abandonment of the quantity theory by Keynes in his Mattioli lectures.

Keynes' long struggle over a period of six years to produce a version of the *Treatise* worthy of publication was directed partly to an escape from the stranglehold of the Quantity Theory of Money in its crude form…. Nevertheless, Keynes seems to have been so much under the spell of the Quantity Theory that he could write about his Fundamental Equations as though they were “versions” of the Quantity Theory. (Kahn, 1984, p. 56)

However, in May 1940, the year after publication of the preface to the French edition, we find Keynes writing to Kahn: “I enclose as a specimen the letter I wrote on Christmas Eve, 1917, which is interesting for two reasons— ... (ii) the fact that even then I was thinking in terms of supply and demand and not of the quantity theory of money!” (RFK 13/57:460).¹

There were two steps in the process of Keynes’s abandonment of the quantity theory approach: the determination of the price level on the basis of aggregate demand and supply and that of the rate of interest on the basis of supply and demand for money. Kahn’s multiplier article (Kahn 1931) opened the route toward a price level determination based on aggregate supply and demand curves in providing the terms for analysis of the conditions that see an increase either in the level of prices or in the quantities (or a combination of the two) in aggregate given an increase in demand (in this case, public investments in road building). In fact, these were the appropriate conditions to evaluate the proposal made by Keynes in “Can Lloyd George Do It?” dating to 1929, to implement public works policy as a way out of economic depression. If the level of demand is high, then the productive capacity will already be made good use of, and greater use will entail an increase in costs and thus in prices. But if, on the other hand, the level of demand is low, then plant and equipment will be largely idle and production can therefore be stepped up without any appreciable increase in unit costs and prices.

Although its application was limited there to the consumption goods sector it was clearly a step forward from the *Treatise* framework to the *General Theory*. Kahn himself stated:

I regard the most important part of my article as being quite different from the view normally taken of it. I dealt with the effect of a higher level of demand on the price-level of consumption-goods by introducing the concepts of the supply curve, and demand curve, of consumption-goods as a whole. This is symptomatic of the new method, to be introduced by Keynes eventually in the early drafts of the *General Theory*, of determining price-levels of “output as a whole,” or rather consumption-goods and capital-goods as a whole, in terms of demand and supply. (quoted in Patinkin, 1993, p. 659n17; emphasis added)

¹Kahn Papers, King’s College Archives, Cambridge.
Extension of this analysis to output as a whole was accomplished in the discussion of the aggregate supply function as we find it in the lectures given by Kahn in Michaelmas Term 1932, as recorded in the notes taken by Lorie Tarshis. To derive the aggregate supply curve, Kahn starts from determination of the supply cost of each level of output for a single firm. Given marginal and average costs, associated with a given level of output, the supply curve tells us what the price must be in order for the firm that maximizes its profits to be willing to produce precisely that level of output. Unlike the multiplier article, the expected proceeds necessary to induce entrepreneurs to produce a given output are on the vertical axis, while the level of output on the horizontal axis. The aggregate supply curve, drawn in the expected proceeds-aggregate output space, allowed for a straightforward derivation of the level of prices as the ratio of expected proceeds to output. Thus the same forces determine the levels of price and output, with no room left for the quantity of money.

Keynes acknowledged Kahn’s contribution:

It was Mr. Kahn who first attacked the relation of the general level of prices to wages in the same way as that in which that of particular prices has always been handled, namely as a problem of demand and supply in the short period rather than as a result to be derived from monetary factors. (Keynes, [1936] 1973, Appendix, p. 400fn)

In fact, Kahn’s opposition to the quantity theory precedes Keynes’s and we have evidence of his disdain for it in his letters to Keynes from America (during Kahn’s visit from December 1932 to April 1933) where Kahn gives his opinion on the dominant influence of the quantity theory of money in the United States. For instance, he wrote: “I am thinking that the only way to save humanity is to lead a campaign against the Quantity Theory” (JMK L/K: 363). And in a paper he presented to the Political Economy Club when he returned, he added: “the scourge which goes by the name of the Quantity Theory of Money has swept the country” (RFK 3/18/3:15); “my visit to the United States inclines me to ascribe most of the ills of the world to the Quantity Theory of Money” (RFK/3/18/3:16).

By mid-1933 Keynes had grasped the concept of effective demand, although the “precise definition of what is meant by it,” was announced to

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2 An outline of Kahn’s lecture notes can be found in Kahn’s papers (RFK 4/15/4-14).
3 Keynes papers, King’s College Archives, Cambridge.
4 Kahn’s criticism of the quantity theory before the General Theory is illustrated by what Joan Robinson refers to as his “Quantity Equation for Hairpins.” It is worth quoting the relevant passage from her 1933 article: “Let P be the proportion of women with long hair, and T the total number of women. Let 1 / V be the daily loss of hairpins by earn women with long hair, and M the daily output of hairpins. Then M = PT / V and MV = PT. Now suppose that the Pope, regarding bobbed hair as contrary to good morals, wishes to increase the proportion of long-haired women in the population, and asks a student of economics what he had best do. The student sets out Mr. Kahn’s equation, and explains it to the Pope. ‘All you need do,’ he says, ‘is to increase M, the daily output of hairpins (for instance, you might give a subsidy to the factories) and the number of long-haired women is bound to increase.’ The Pope is not quite convinced. ‘Or, of course,’ the student adds, ‘if you could persuade the long-haired women to be less careless, V would increase, and the effect would be the same as though the output of hairpins had increased’” (Robinson, [1933] 1951, p. 55). See Marcuzzo (2002a).
Kahn only one year later, but what was still lacking was the framework in which the different elements of his new theory—the liquidity preference, the output-adjustment mechanism and the wage theory—fit logically together, and provide an alternative determination of the price level and the rate of interest. For this we have to turn to the General Theory.

**The General Theory**

In chapter 21 of the *General Theory*, Keynes presents his theory of the determinants of the price level and shows how it stands in relation to the quantity theory and the conditions under which the result of the strict quantity theory—a proportional increase in prices as a consequence of an increase in the quantity of money—actually holds. First, there is the effect of a change in the quantity of money on effective demand and then how the change in effective demand spends itself in increasing output and prices. In other words, the elasticity of changes in prices \( P \) with respect to a change in the quantity of money \( M \) is given by the elasticity of changes in effective demand with respect to changes in the quantity of money times the elasticity of changes in prices with respect to changes in effective demand.

Formally

\[
e = \frac{M}{P} \frac{dP}{dM} = e_d e_p
\]

It is immediately evident that if effective demand increases in the same proportion as the quantity of money, that is, if we assume a constant ratio between effective demand and the quantity of money, namely, if \( e_d \left( = \frac{M}{D} \frac{dD}{dM} \right) = 1 \), prices will increase in the same proportion as the increase in effective demand \( (D) \), whenever \( e_p \left( = \frac{D}{P} \frac{dP}{dD} \right) = 1 \). The derivation of \( e_p \) gives \( e_p = 1 - e_e e_o (1 - e_w) \), where \( e_o = \left( \frac{N}{D} \frac{dC}{dN} \right) \) is the elasticity of output in response to changes in employment, \( e_w = \left( \frac{D}{W} \frac{dW}{dD} \right) \) is the elasticity of money-wages in response to changes in effective demand, and \( e_e = \left( \frac{D}{N} \frac{dN}{dD} \right) \) is the elasticity of employment in response to a change in effective demand.

We then have:

\[
e = \frac{M}{P} \frac{dP}{dM} = e_d [1 - e_e e_o (1 - e_w)],
\]

\[
e = e_d (1 - e_e e_o + e_e e_o e_w).
\]

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\(^5\)The fundamental assumption of the classical theory, ‘supply creates its own demand,’ is that \( OW = OP \) \( (W = \text{marginal prime cost of production when output is } O; \ P = \text{expected selling price of this output}; \ \text{OP = effective demand}) \) whatever the level of \( O \), so that effective demand is incapable of setting a limit to employment which consequently depends on the relation between marginal product in wage-good industries and marginal disutility of employment. On my theory, \( OW \neq OP \) for all values of \( O \), and entrepreneurs have to choose a value of \( O \) for which it is equal;—otherwise the equality of price and marginal prime cost is infringed. This is the real starting point of everything” (Keynes, [1936] 1973, pp. 422–423). On these and other points addressed here, see Marcuzzo (2002b).
The above expression, according to Keynes can be regarded as “a
generalized statement of the Quantity Theory of Money” (Keynes, 1973,
p. 305). Thus the quantitative result is made dependent upon the values of
four critical elasticities:
\( e_d \) = liquidity factors that determine the demand for money in each situation;
\( e_w \) = labor factors that determine the extent to which money-wages are raised
as employment increases; and
\( e_e e_o \) = physical factors that determine the rate of decreasing returns as more
employment is applied to the existing equipment.

Thus, if the public holds a constant proportion of their income in money,
\[ e_d = 1 \]
if money wages are fixed \( e_w = 0 \);
if constant returns prevail \( e_e e_o = 1 \); and
if there is full employment either of labor or equipment, \( e_e e_o = 0 \).

In fact, there are many conditions under which \( \frac{M}{P} \frac{dP}{dM} = 1 \):
For instance, if \( e_d = 1 \) and \( e_w = 1 \), but also:
\[
\text{if } e_d = 1, \quad e_w = 0 \quad \text{and} \quad e_e e_o = 1
\]
or
\[
\text{if } e_d = 1 \quad \text{and} \quad e_o = 0
\]
and of course a variety of other combinations.

However, “on plausible assumptions relating to the real world,” according
to Keynes, it is very unlikely that the elasticity of the price level with respect to
a change in the quantity of money will turn out to be equal to 1, and therefore
it is “safe to make the generalization [that] \( e \) as a rule [is] less than unity”

Keynes provided us with a description of a transmission mechanism in
which behavioral relationships are ordered according to a clear chain of
causes and effects. As Kahn later put it, the novelty of the approach is the view
of the monetary and credit mechanism as “a matter of straightforward
cause and effect expressed in terms of physical realities” (Kahn, [1958]
1972, p. 145)

The transmission mechanism from monetary to real factors is broken down
into a series of steps, which may lead to very different outcomes. For instance,
an increase in the quantity of money may not generate a proportional increase
in effective demand; the increase in effective demand may not give rise to a
predictable rise in wages, and the rise in output and employment and prices

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Even Keynes, however, appears to be sceptical about the reliability of such a mechanical description: “I do not
myself attach much value to manipulations of this kind; and I would repeat the warning, which I have given above,
that they involve just as much tacit assumption as to what variables are taken as independent (partial differentials
being ignored throughout) as does ordinary discourse, whilst I doubt if they carry us any further than ordinary
discourse can” (Keynes, [1936] 1973, p. 305).
may occur in various combinations so that there is more than only one possible outcome.

Keynes's generalization of the quantity theory follows a line of reasoning similar to that employed in the theory of income determination: the quantity theory results apply under very special conditions: far from being a general proposition it can be applied in very special circumstances that rarely occur in the real world.

It might well be, however, that the attempted reconciliation with the tradition, as in many other instances of Keynes's tactics against the orthodox view, ended up serving its rehabilitation, as indeed in the aggregate demand (AD) and aggregate supply (AS) models. These models—of which there is more than one variety resulting in a distorted interpretation of Keynes's ideas—became popular in the late 1980s, following the joint effect of monetarism first and the inability of the so-called Keynesian models (IS–LM with Phillips curve) to explain double-digit inflation with unemployment. It was also the effect of the lost battle engaged in by Keynes's close followers against the reinstatement of a quantity theory–based approach.

**Kahn and Kaldor: Against the two blades of the monetarist scissors**

Already in his “Some Notes on Liquidity Preference,” Kahn ([1954] 1972) had outlined the basic elements of his understanding of the working of financial markets. According to his view, in the financial markets there are two kinds of investors: those who hold definite expectations for the future of interest rates and those “who do not have a clue” whether the rate of interest is going to increase or decrease. The same division exists in the mind of the investor himself, who can reveal contradictory preferences and decide to hold money and securities at the same time, while rational behavior (and expected utility theory) would imply a definite choice between the two. Based on this observed behavior, Kahn argues that a finite elasticity of the demand for money relative to the rate of interest is associated not only with the heterogeneity of opinions held by the public divided between bulls and bears but also with the lack of conviction individuals show in their own conjectures. It is as if bullish and bearish sentiments “operated inside each person’s mind, one being responsible for his holding securities and one for his holding money” (Kahn, [1954] (1972), p. 88).

So the liquidity preference is not a relationship that can be assumed to be stable. It follows that changes in the supply of money bring about changes in the interest rate only if the schedule of the liquidity preference can be thought of as a stable relationship. However, this is precisely Kahn’s main point, that is, “the unsuitability of thinking of a schedule of liquidity preference as though

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7For a review of the flaws of AS/AD analysis, see Colander (1995).
it could be represented by a well-defined curve or by a functional relationship expressed in mathematical terms or subject to econometric processes,” and he held Keynes responsible for giving way “to the temptation to picture the state of liquidity preference as a fairly stable relationship” (Kahn, [1954] 1972, p. 90).

In his evidence to the Radcliffe Committee, Kahn restated the argument in relation to the efficacy of monetary policy, since the quantity of money necessary to bring about a fall in the rate of interest varies with the circumstances and the state and responsiveness of the market, where expectations play a crucial role. “If the market likes to help by altering its expectations … the authorities will not have to do so much. If the market proves very obstinate and does not believe that they are going to succeed in doing what they are trying to do, then they will have to do much more” (Kahn, 1958, pp. 742–743).

In this respect, as observed by Dardi (1994, p. 104), Keynes and Kahn shared the same conception of monetary policy, not as “the engineering of aggregate variables but a policy of opinion.” As for the determination of the level of prices, Kahn insisted that his approach “differs fundamentally from those treatments of the subject which attribute to the quantity or supply of money a direct influence on prices, or an indirect influence on wages and so on prices” (Kahn, [1958] 1972, p. 145); the level of prices, as in Keynes, being the outcome of three factors: “the level of money wages, the state of productive equipment and technical knowledge and efficiency, and the level of demand” (ibid., p. 137).

Kaldor also tackled the issue against monetarism from the angle of the supply of money, challenging the alleged exogeneity that is the presupposition of the quantity theory equation. He went so far as to assert that even Keynes, who “retained traces of his old beliefs” in the General Theory, is to blame, since “the supply of money is treated as an exogenous constant in the same way as in the quantity theory” (Kaldor, 1985, p. 8).

Kaldor’s ideas on the money supply and monetary policy can already be found in his “Speculation and Economic Stability” (Kaldor, [1939] 1960). He pointed out that the quantity of money in a credit economy comes into existence as a result of bank lending and is extinguished through the repayment of bank loans; this volume of bank lending is limited only by the availability of creditworthy borrowers. Accordingly, the money supply becomes a passive element varying automatically with the demand for credit.

He developed these points in his evidence to the Radcliffe Committee (Kaldor, [1958] 1964) and in several papers in the 1970s and 1980s, where

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8Also Kaldor in his evidence to the Radcliffe Committee (1958) denied that the velocity of circulation could ever be assumed to be constant and determined by factors that are independent of the supply of money or the volume of money payments (see Targetti, 1992, p. 273).

9Kaldor himself made this claim in an interview to the present author: “I already explained my ideas on the endogeneity of the money supply in 1939” (Kaldor, 1986, p. 73).
he attacked the monetarist view. The basic error of the quantity theory–based arguments lay—according to Kaldor—in the “assumption that regards the money supply as the source of the demand for goods and services” (Kaldor, 1985, p. 4). So, according to Kaldor, the increase in the supply of money in circulation is the response to increased demand and not an autonomous event. Without credit expansion, the Central Bank’s willingness to expand the monetary base will not produce effects on the money supply.\footnote{Drawing on Kaldor, Wray (1990, pp. 73–74) summarized the point: “money is supplied because someone wants it. Money supply and money demand are simply different sides of the balance sheet. From the firm’s point of view, money demand is the willingness to go into debt, and money supply is the IOU it issues. Of course, the firm’s IOU is not money unless someone is willing to accept it. From the bank’s point of view, money demand is indicated by the willingness of the firm to issue an IOU, and money supply is determined by the willingness of the bank to hold that IOU and to issue its own liabilities to finance the purchase of the firm’s IOU.”.}

In conclusion, the bottom lines of Kahn’s and Kaldor’s criticisms, are leveled against the two fallacies of the quantity theory–based argument: the assumptions that the money supply is exogenously determined by the monetary authority and that the demand for money, as a proportion of income, is a stable one. Deprived of the two blades of the scissors, the demand and supply of money as independent and stable functions can hardly be considered useful for determining the price level, even assuming a level of income close to full employment.

The notion of liquidity is at the center of the Cambridge critique of the quantity theory; it amounts to denying the separation between monetary and real factors (monetary neutrality) and the determination of the level of price as the outcome of the interplay of a transaction demand for money and an exogenously given money supply.

**Conclusion**

If the quantity theory holds, as long as the velocity of money remains stable, the rate of inflation should equal the difference between the growth rates of money and real gross domestic product. To confront this hypothesis with the data, Graaf (2008) referred to a panel comprising yearly data from 1991 to 2005 across 105 countries and concluded, “these analyses leave no doubt that for our sample period, i.e., the years since 1991, the classical proportionality theorem does not hold.” And even more disheartening is the conclusion reached by the author at the end of his review of recent empirical literature on the validity of the quantity theory: “both sceptics and proponents of the quantity theoretical explanation of inflation can refer to sound evidence to support their claims.” (Graaf, 2008, p. 26).

Today, the all-time record of money growth expansion by the Bank of Japan, Federal Reserve, and European Central Bank offers an exceptional experiment for testing what has been the pièce de résistance of macroeconomics since the 1970s. We have enough evidence to conclude that quantity
theory is a bad predictor of inflation and—at least according to Friedman’s own methodological prescription—should be dismissed on this ground.

Even a strong supporter such as Martin Feldstein was forced to admit quite recently: “The low rate of inflation in the United States is a puzzle, especially to economists who focus on the relationship between inflation and changes in the monetary base” (Feldstein, 2015, p. 1; see also Tutino and Zarazaga, 2014).

On the other hand, the quantity easing experiment has proved the validity of the Keynes-Kahn-Kaldor arguments: markets have been flooded with liquidity, but rather than inflation we have witnessed a general deflation because of the liquidity trap environment in which the banking system operated, and we observe only inflated asset prices. It is the liquidity preference theory—namely, the idea that the speculative motive is the key determinant of the demand for money in a context of uncertainty—that offers the explanation: if money is being held as a store of value at the margin, the money that banks receive from Central Banks primarily pads out their cash reserves, without ever really entering the economy and therefore having little impact on the price level and real income. The private sector is also struggling to remain liquid in the face of uncertainty and looking for opportunities in asset rather than goods markets.

So two forces are at work: banks’ liquidity preference and absence of borrowers in the private sector for investment in the real sector. As Koo remarked:

Even though a central bank can always inject as much liquidity as it wants into the banking sector via QE, for that money to actually enter the real economy the banks must lend money…. But if the private sector as a group is deleveraging, this liquidity cannot enter the real economy because of an absence of borrowers. This means the liquidity remains trapped within the financial system, leaving the central bank with no way to expand the money supply in the real economy. (Koo, 2016)

While all major central banks now, at least in practical terms, have shelved the quantity theory since the early 2000s, it has not been dislodged in textbooks and its critics have been too little acknowledged. I hope this note will be seen as a small contribution to rehabilitating the insights of John Maynard Keynes, Richard Kahn, and Nicholas Kaldor.

References


