Money, Debt and Liberal Economics

Keith Rankin, 11 January 2014

One of the most interesting books I have read this summer is "Money; The Unauthorised Biography", by Felix Martin (2013, Bodley Head). This is a thought-provoking book that suggests that the history of money is quite different to what most of us assume it to have been, and that economists' misunderstandings about money have led the discipline into an unhelpful policy cul-de-sac.

Money is generally supposed to be a commodity (a physical thing) that came to be used as a medium of exchange to enable more complex forms of barter. In more advanced historical societies, that thing was most likely to be gold or silver tokens. Modern credit-based money, based on the banking system, is presumed to have emerged from metallic money, and to continue to behave much as commodity money was understood to have behaved.

Martin convincingly shows that money's origins were actually an artefact of early accounting practices. Indeed we can claim that accounting is the world's oldest profession, dating back to Sumerian times, if not earlier. Money (along with writing) originated as an accounting technology, as credit, as promises to pay a debt.

For these early promises to qualify as money, they would have to circulate; they needed to be transferable and 'liquid'. To be liquid meant that promises by third parties would hold their value and therefore could be easily 'sold'. It meant people had to be confident that the signatories to the promises could and would make good on their promises. Further, to be fully-fledged money, the promises needed to be expressed in some unit of universal value, rather than in sheep or wheat or whatever.

Martin argues that it was the emergence of democracy in ancient Greece – with its idea of the underlying equality of men – that embedded the concept of universal value which gives money its capitalist power. Money, through the powerful concept of public equity, evolved from an accounting technology to a social technology.

The persons whose credit was trusted the most were sovereigns (kings – later states – who had special powers to make good their promises). Further, any circulating medium that the sovereign would accept as payment – eg to pay taxes – could become money. Thus money came to be linked to the sovereign, and it was the representation of the reigning monarch that ensured the required liquidity. Coins were minted as tokens of the sovereign's credit, and the use of durable precious metals such as gold and silver reinforced that credit.

The crucial point, in Martin's argument, is that what gave a coin its value was its representation of the credit of the sovereign, and not the amount of gold or silver that such coins contained. This was easily verifiable, because coins generally circulated regardless of whether they had been 'debased' (minted with less gold or silver) or clipped, much as a dirty note circulates on the same basis as a crisp new banknote does today. (It's the signature on the note that matters, not its physical purity.)

The 1690s, especially in England, was the critical decade in Martin's account. England was the world's emergent commercial power. And the English had deposed their King in 1688. The 'Glorious Revolution' put an end in Britain to the 'divine right of kings' that underlay absolute monarchy. Further, the Dutchman installed on the throne of England and Scotland (William) fought in Ireland against his predecessor, and, more expensively, against King Louis of France, still the epitome of an absolute monarch. The British Treasury ended up with massive war debts. Further, inflation, common in wartime, had meant that minted coins would buy less than their metal content was deemed to be worth, so coins were withdrawn from circulation.

The solution was the newly founded Bank of England, which acquired the sovereign's debt as its core asset. Bank notes, effectively guaranteed by the sovereign, became the new money. This represented a quantum leap in the evolution of money.

Martin claims that the process of creating bank money as a medium of payments was effectively hijacked by the pre-eminent liberal philosopher of the era, John Locke, who was asked to review proposals to mint coins with less silver content than the older ones which were disappearing from circulation.

'Liberal' means, essentially, to be in opposition to absolute monarchy, to espouse the importance of private property, and to emphasise 'natural law' as a higher authority than any human contrivance. An expanding social technology that gained its value from the public authority simply did not reflect the emerging liberal view. The sovereign – represented increasingly as 'the state' – should be as much subject to natural law as everyone else. The laws that governed humankind were seen as analogous to the laws of gravity; laws recently discovered by Locke's scientist friend Isaac Newton (now Warden of the Royal Mint).

Thus Locke asserted that the value of money was the value of the gold or silver contained in that money. Gold and silver should rule (and restrain) the Kings and Queens, not the other way around. Under Locke's sway, and against pragmatic advice, a rigid silver standard was adopted. In practice, the new money continued to be withdrawn from circulation (because at prevailing prices it was more valuable hoarded) and a price deflation took place. (Not unlike the deflation that Greece experienced in 2013.)

In the subsequent story, the liberal economics that evolved over the next two centuries – founded upon both Locke's general philosophy and upon his conception of money – became a form of theism. Liberal economics is and always has been more religion than science; a faith in which natural law governs, at times quite harshly (as in the Irish potato famine). So long as everyone played their roles correctly, natural law would underpin a society that ran like clockwork. Martin's language is imbued with references to the underlying theism of liberal economics.

Because the liberal economists redefined money as a simple thing (rather than a technology) – a commodity with its own price much like any other thing – then, Martin notes, economics evolved as if money was absent, or at least able to be taken for granted.

Martin well-illustrates the quandary of 21st century liberal economics when he addresses the 'Queen's question', posed in November 2008 at the official opening of an extension to the London School of Economics. Why had none of the economists and financiers seen the financial crisis coming? The monarch had struck a chord. Although stripped of her ancestral divinity in 1688, Martin uses a cartoon to show that it was not the empress who had lost her clothes.

Neither liberal economics nor high finance have credible answers to this question. While economics and academic finance share techniques of price-determination, Martin notes that both have substantial blind-spots in their understanding of real-world market processes.

Economics fails "to engage with the central problem of monetary society", "the unsustainable accumulation of debt". Indeed I believe that, rather than its being oblivious towards the true nature of money, liberal economics' bigger weakness is its debt-blindness. Martin's focus on money rather than debt constrains the clarity of his policy recommendations.

While not all credit is money, Martin emphasises that money is credit; it's a promise, not a thing. But credit is just debt from a lender's perspective. Hence money is debt, by its very nature; money is a balance-sheet liability. What it all means is that debt is absolutely central to ancient and modern market society, and that our moral aversion to debt (but not to credit!) prevents us from understanding the true mechanics of the marketplace. (In liberal economics, everything is explained through the 'price mechanism'; debt is not required to explain anything.)

As social scientists we should never be averse to investigating the crucial role of debt in actual rather than ideal market-based societies. We can acknowledge the public's debt-aversion by choosing to investigate solutions that might lessen the accumulation of debt; but only if economists properly address the issue.

The older sibling of debt is equity, another concept that is central to the evolution of capitalism. We might note that liberal concepts of capital are essentially equity-based rather than debt-based. And we may note that Islamic Finance is very much equity-based, given Islam's particular and ongoing aversion to the payment of interest.

Martin tentatively suggests solutions to our present problems that look to equity, mentioning a sovereign equity scheme suggested by US economist Robert Shiller. Martin is more tentative than I am; I have consistently advocated solutions based around public-equity (such as universal basic income) to our problem of income maldistribution.

The following is an example of a critical 21st century issue that illustrates the differences between equity and debt-based solutions.

We are exhorted to "save for retirement". What this means is that we, as savers, build up credit balances which will become a huge liability (ie debt) to those of working age when we retire. This is the 'funded' approach. The alternative 'pay-as-you-go' approach to retirement provision is, instead, equity-based. The idea is that one generation pays taxes that are used for, among other things, providing equal support to our seniors. New Zealand Superannuation is an example of such equity distribution. Universal pensions should be seen as more akin to equity dividends than to unemployment benefits. Interestingly, it is those most infused with liberal economic thinking who are leading the attack on such existing public-equity entitlements, favouring saving-schemes that create debt obligations.

Liberal economics is not a science. It has many characteristics of a religion. Liberal economics is a story – at its core a simple, beautiful and seductive story – a story that is neither true nor false. A story such as Jane Austen's Pride and Prejudice cannot be regarded as either true or false. While it's a story that contains many truths, they are literary rather than scientific truths.

A scientific form of economics would be able to raise alerts if not precise forecasts of economic crises. It would understand money for what it is, a necessary social technology that works according to terrestrial rather than celestial principles. And it would recognise the realities of debt and public equity as being central to the functioning of modern economies.

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