M. L. Burstein
The New Art of Central Banking

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Preface

This is the book of an American abroad. But the theme of innocents abroad or of American *naïveté* and European worldliness, *à la* Henry James, is quite reversed: Americans are sophisticated about federalism and their romance with it was shattered by a bloody civil war. Mine is a cautionary political-economic tale told at the dawn of 1992. The success of American federalism mainly owes, I think, to two factors. One is unique: the character and persona of General Washington. The other is the American Constitution, a machine that runs by itself. Bismarck almost got it right: God looks after fools, drunkards and the United States of America. It is true that America owes nothing to the wisdom of its Congresses or the perspicacity of most of its Presidents. That is its strength: its Constitution protects its people from the unimpeded impetus of its elected 'leaders', who are condemned by the Constitution to jostle against each other. Do Europeans know that?

The bulk of the book concerns the theory of monetary control. It consolidates and expands bridgeheads carved out by my series of books (1986, 1988 and 1989a) breaking out onto a tundra on which financial institutions and substances cannot be distinctly discerned; one after another innovation in theory and praxis has obliterated once-salient monetary landmarks. Nor is it possible to pick up a regular pulse from the flux of inchoate events evolving on the economic tundra. Not surprisingly, then, the new art of central banking culminates in masterly inactivity.

The principles that survive the book's critique are classical or new-classical. I plodded on, and on, seeking what passes for truth in science; and *this* is what I found. The economic argument is not politically motivated. Nor is it peculiar to private-ownership economies: I recommend it for *perestroika* anywhere. But there is a point in political economy to be made. I should think that the book's principal results are quite ineluctable for the natural action of a private-ownership economy; while a socialist system must *select* modalities conforming to the logic controlling the theory. Professor Hayek has deeply probed this point; I leave the reader to her own devices.

*   *   *

I have never known what a 'monetary economy' is, importantly because there has never been a barter economy; nor am I intrigued by phantasies about barterers emerging from the primaeval slime. And, on reflection, I think the expression tendentiously inept. For the purposes of this book it suffices to say that radical innovation, going so far as to eject money from the economy, is quite consistent with what is called a monetary economy. The upshot is less anodyne for central bankers who must be dramatically affected by disappearance of money-stuff.

* * *

André Malraux called General de Gaulle a man of the day before yesterday and the day after tomorrow. This image readily transmutes into an essential property of classical art, or of science. To be successful, economic theory must *persist* in time and space. The fact that Galiani, Adam Smith, Thornton, Wheatley and Ricardo so inform the theory of monetary innovation bodes well for economics. Indeed the most brilliantly successful official action reported in the book is the open market purchase by the emperor Tiberius in AD 33.

The Right Honourable Nigel Lawson resigned in November 1989, after this book had been made ready for the printer.

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Acknowledgements

Citations from my own work are often in the form (198–) rather than Burstein (198–).

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Part I
Foundations of the New Art of Central Banking

1 Introduction

The new art of central banking pivots on a reformed (tabular) monetary standard, 'securitization' beyond the banking principle and other innovations in praxis, including debt-discharge (clearing) mechanisms. Its field of action is constricted by virtual convertibility; the transform of a central bank must operate in real space, the only space left; the 'monetary' authority must operate with real assets. What is more, intermediaries surviving beyond the banking principle (see Burstein, 1988) must back their liabilities with real assets; and public debt will also become virtually convertible into real assets – see Chapters 2 and 5 below.

The theory is woven from several strands developed disjointedly over some years before being integrated in 1988–9.

1.1 THE STRANDS OF ANALYSIS

The *tabular standard* exercises influence in two channels. In the first it reveals that much economic theory hinges on choice of measure – the inflation perplex is an example; and stability properties of difference equations typically depend on arbitrarily selected time dimensions (in economic applications). In the second channel, money-stuff loses its aura of immutability and is sucked into the mass of variably-priced substances.

When the analytic content of the theory of tabular standards is assembled, and then applied to the European currency debate, striking results are obtained. Desirable properties of monetary unity require neither Authority nor deliberate coordination. And virtual convertibility of government debt is imposed by the theory's innovated ECU standard: governments become committed to make virtually real payments. The set of constraints imposed by the theory's liberal régime is like the pre-1914 one; and works more stringently than constraints implicit in the Delors proposal. At national level prospects for *dirigisme* are dismal; pan-European authority proposals, when properly understood, are a retreat by anti-liberals to a final redoubt.

Interest on money leads to certainty that the *LM* curve is vertical. But then it cannot be located. So it must be discarded. (There is no

LM curve in nature; I refer to a conceptualization of ISLM theory –
and implicitly invoke the work of Immanuel Kant.)

Competitively determined interest on money makes intermedi-
aries' spreads pivotally important. And it greatly simplifies properties
of effects of liquidity-preference vibration: pressure is absorbed by
transient changes in spreads; and the laws of motion of effects of
monetary policy action are surprisingly intricate.

It is not adequately understood that vibration of liquidity prefer-
ence is substantially accommodated by covariant fluctuation in the
scale of financial intermediation. Intermediaries simply exchange
their paper for others' paper; their profits flow from their spreads.
Misperception of this point is central for flawed monetary theories of
trade cycles and may infect the work of Wicksell, as it surely does
that of the Wicksellians (see Part II, especially Chapter 9).

So we come upon another strand, *Wicksell's cumulative process* –
which I explored in Burstein (1988). Wicksell's theory, properly
understood, concerns money supply and prices relative to a quantity
theory hypothesis. And it suffers from a lacuna that should be filled
in: Wicksell supplies no motivation to hold the paper generated by
the cumulative process. I try to repair this fault in (1988) and in
Chapters 3 and 9 below.

Wicksell's cumulative process unfolds against an autonomously
evolving own rate of return on physical capital. Wicksell's is *not* a
monetary theory of the real rate of interest. But Wicksellian econ-
omics, especially when given a Keynesian twist, is intensely commit-
ted to monetary theories of real rates of interest, as are the City and
Wall Street.

It is explained in Chapter 3 that monetary theories of real rates of
interest (attacked from a number of directions in this book) have
exerted influence along two distinct lines of development. Keynes
centres on monetary aggregates in the *General Theory* – save for the
Appendix to Chapter 14, which is not integrated into the core
argument. (But Keynes may be the creator of the Wicksellian line of
development, in his *Treatise.*) Keynes readily acknowledges the
mercantilist origin of the idea that the equilibrium real rate of interest
is a decreasing function of the nominal quantity of money.

In Wicksell's model, the monetary authority (MA) announces it
will deal in paper at a decreed 'paper yield on paper' without limit.
Say that this administered rate lies below that consistent with the
equilibrium of a competitive banking industry. (The bizarre script is

influenced by effects of usury laws and other artificial constraints analysed by Ricardo, 1817.)

The financial press takes a Wicksellian (but not Wicksell's) tack. It reports that the MA takes decisions, day by day, on a spectrum of *real* rates of interest; and that the Phillips curve explains inflation effects – the MA's ploy supplies real stimulus to the economy, perhaps causing it to overheat, so that inflation spurts (the topic is pursued in Chapter 3, section 3.4).

Wicksell's theory is not Wicksellian. In Wicksell's theory the real rate of return on physical capital is autonomous for monetary analysis. When modified to accommodate portfolio equilibrium, his theory runs along the following lines.

Since competitive interest is paid on bank accounts in Wicksell's system, if the real running yield on bank paper is to fall, portfolio equilibrium requires its shadow convenience yield to increase accordingly. And *this* determines the real quantity of claims on banks in equilibrium. So long as the MA insists on real yields of bank loans below the own rate of return on capital, it pays to borrow from banks and redeposit the proceeds (to take round trips): the controlling arbitrage condition assures that the *total* marginal return on bank balances equals that on physical capital – in principle, the process can evolve in a hermetically-sealed monetary circuit. The rate at which bank paper depreciates against goods depends on how rapidly its stock expands: the largesse of the banks would typically be constrained by quantitative controls on bank credit – the script is bottomed on *dirigiste* intervention. In a purely competitive banking industry, rates at which banks deal key on Thornton's mercantile rate of profit; bank spreads transiently vibrate sympathetically with fluctuations in liquidity preference; the vibration's frequency depends on the open-ness of the economy, partially determining the elasticity of supply of liquidity.

Interpolation

Such dealing is partitioned from evaluation of credit risks and marrying suppliers and absorbers of real resources, i.e. from merchant banking. *Circa* 1790, Thomas Jefferson proposed a comparable partition for American finance. Jefferson (and President Andrew Jackson) opposed *issue*, not financial intermediation.

The last strand, *innovations leading to liquidity saturation*, culminates the theory. Liquidity premia are to disappear. And they ought

to disappear, since liquidity can now be created costlessly. See *Beyond the Banking Principle* (1988, inspired by securitization prospects; and see Chapter 4 below). In a moneyless monetary economy, the liquidity properties of a very wide spectrum of assets are undifferentiated.

The spontaneous evolution of monetary modalities leads to the own rate of return on physical capital ruling the roost. Samuelson (1947/1983) anticipates this result. Wallace (1983) builds on Samuelson's deep conjecture. And Ricardo (1817) set the table.

The argument is sent into a classical domain of economic thought: an economy saturated with liquidity, as Pareto optimality demands, behaves like the hypothetical non-monetary economy of general equilibrium theory. In particular, the Keynesian theory of interest evaporates: monetary assets cease to be unique; vacua do not rule roosts. So there is no sensible way to contemplate plans being made to divert flows from the income–expenditure stream towards paper assets: paper assets will be wanted only as evidence of claims to real ones.

1.2　CAPSULATION OF CHAPTERS 2–5

Chapters 2–5 are to be capsulated so that their contents are keyed to the strands of analysis.

1.2.1　Chapter 2: The Theory of Monetary Standards Applied to Pan-European Money and Monetary Control

Study of the pure theory of monetary standards leads to sharp conclusions about the ECU, the EMS and pan-European monetary authority proposals: *viz.* the ECU concept should be promoted, after being reformulated; and the pan-European monetary authority idea should be jettisoned; while the purposes of the EMS are better served without its serpent.

The idea of tabular monetary standards contains the seed of these conclusions, but my way has been roundabout. For years, I went backwards from *symmetallism*, studying properties of notional metallic systems, instead of forward into the domain of its ultimate extension, a full tabular standard. True, retrogression continues: this book goes back to the *electrum stater* of Cyzicus in ancient Asia Minor.