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A Note on Money Neutrality

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Pascal Salin's approach to monetary issues has been recognized by many as an eclectic yet self-contained and complete system. One of Salin's most recent publications, *The International Monetary System and the Theory of Monetary Systems—New Thinking in Political Economy* (2016), is a prime example of his comprehensive treatment of domestic and international monetary issues. The paper under discussion in this symposium, like that volume, displays both a comfortable command of monetary theory, as well as a number of very particular idiosyncrasies which characterize Salin's take on these issues.

These distinctive features of Salin's monetary thought are most prominent when he seeks to bridge the Austrian approach to monetary theory with some of his earlier influences, particularly Chicago monetarist views. Although Salin's desire to build such bridges, as well as his efforts to smooth out the differences between schools of monetary thought, is admirable, it is difficult to see the need or the urgency to integrate the Austrian approach with other approaches. Salin has not yet made a convincing case that the Austrian approach to monetary issues is lacking. More importantly, despite his general mastery of such compromises, "The Monetary Economics of the Austrian School and the Chicago School" highlights several reasons why such reconciliation between the two traditions is impossible.

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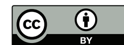

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The main issue I wish to focus on in this brief comment is money neutrality, which Salin correctly points out plays a central role in both approaches and with which his discussion begins. In my view, the issue of money neutrality encapsulates the core of Ludwig von Mises's approach to monetary theory, and as a result, it is the linchpin of Austrian monetary economics correctly understood.

Salin wishes to bring the Austrian and the Chicago understandings of neutrality closer by first claiming that the scientific attitude "consists in extracting some main features from reality at the expense of a comprehensive description of it" (287). This definition is correct. However, Salin uses it to justify two very different methodological approaches which have important consequences for how the role of money in the economy is understood. Thus the paper subtly argues that "the Austrian approach and the Chicago approach may differ more as regards what deserves to be emphasized than as regards their basic monetary theory" (286). But a closer look at their methodological underpinnings shows that the two approaches emphasize different things because their understandings of money are very different and are not easily reconciled.

Firstly, there are two ways to extract key features from reality in economic analysis. According to Long (2006, 7), "A precisive abstraction is one in which certain actual characteristics [of reality] are specified as absent" (for example, a horse with no color), "while a nonprecisive abstraction is one in which certain actual characteristics are absent from specification" (for example, a horse of unspecified color. For Mises, abstraction means reducing reality to a minimum of analyzable concepts, concepts which must nevertheless be true of the reality which is being described. For Milton Friedman, by contrast, an appropriate abstraction is one in which, for ease of theorizing, certain features of reality are specified as absent, thus falsifying reality. Friedman and the Chicagoans are not concerned about starting with a descriptively false set of assumptions as long as the predictive power of their theory is sufficiently satisfactory by the end of the analytical process. For Mises and the Austrians, however, the theory and its initial assumptions cannot be descriptively false and must be shown to be true before being accepted. Thus, while both Mises and Friedman employ abstractions in their analysis, it cannot simply be concluded that the differences between them are of mere emphasis.

We can illustrate the consequences of this by showing how Salin uses precisive abstraction when he refers to "temporary," or "first-step," assumptions that would bring Austrians close to monetarists if Austrians were to accept them.

Salin begins by arguing that "Austrian economists are right in stressing that relative prices are continuously changing within an inflationary process" (287). But arguing that prices have a tendency to increase during an inflationary period describes price changes in an economy under inflation in a nonprecisive way. Possible decreasing prices and different levels of price increases are unspecified but are not specified as absent either. However, Salin argues that "in order to simplify the analysis, it may be useful to assume (temporarily) that all money prices *increase in the same proportion*" (287; emphasis added). This, however, does not follow from the earlier statement. In fact, Salin's temporary assumption about prices in an inflationary economy is a precisive abstraction in which changes in relative prices are deliberately specified as absent, making it descriptively false.

In fact, the latter assumption contradicts Salin's initial point that the scientific attitude consists in extracting some of the main features of reality. An increase of the same proportion in all prices is not a feature of reality. Mises makes it very clear in a discussion on the drawbacks of the mechanistic quantity theory of money that "there can be no doubt that those hypothetical preconditions under which inversely proportional changes [in the value of money] would have to occur never exist in the real world" (Mises [1918] 2002, 4).

Furthermore, Salin finds debatable Mises's disagreement with the view that according to the traditional quantity theory of money, "if there is a once-for-all deficit and a once-for-all money creation, there is a return to what could be called full equilibrium in which the final relative prices are identical to the initial relative prices. From this point of view monetary shocks have no lasting real effects on relative prices."(290) Yet Mises disagrees with this interpretation because he never assumes, as Salin does, that all goods' demand and supply are stable (i.e., that the real determinants of supply and demand are unchanging). Methodologically, for Mises, this assumption is another vitiation of reality, because each and every "once-for-all" money creation must affect

> the material position of various individuals to different degrees. . . . The market system before and after the inflow or outflow of a quantity of money is not merely changed in that the cash holdings of the individuals and prices have increased or decreased. There have been effected also changes in the reciprocal exchange ratios between the various commodities and services which, if one wants to resort to metaphors, are more adequately described by the image of price revolution than by the misleading figure of an elevation or a sinking of the price level. (Mises, [1949] 1998, 409–10)

Mises's mention here of metaphors is particularly poignant. In fact, when it comes to money neutrality, economists, and particularly Chicago economists, often use metaphors to disguise their methodological suppositions. Friedman's favorite metaphor about the monetary adjustment process that occurs when a once-for-all deficit is dealt with through a once-for-all money creation, is described by Leland B. Yeager (1966, 96) as

> a more delicate and selective method, operating directly where changes are really required. General price and income adjustments resemble arranging for more daylight hours after work on summer evenings by having everyone adjust his daily schedule so that he does everything one hour earlier. Instead of making these myriad detailed changes in our habits, we simply adopt daylight saving time.

What the metaphor implies is that changes in nominal values have no impact on real variables such as relative prices. But for Austrian economists, the money supply and the structure of prices are never independent of each other, and their movements are necessarily *comovements*. The eventual rescaling of macroeconomic variables is nothing but the result of the uneven and gradual modification of individual variables from within aggregated magnitudes. Barring analytical tricks, the structure of money prices adjusts to changes in the money supply only in a succession of myriad detailed changes; and because these changes are not quantitatively nor, to a certain extent, even qualitatively foreseeable, it is impossible for manipulations of the money supply to neutralize the original changes in money demand or to purposefully reshuffle the structure of prices along intended lines, even for a one-time temporary theoretical analysis.

The reason why Austrians cannot accept Salin's temporary assumptions is straightforward: according to Mises,

> the essence of monetary theory is the cognition that. . . . If this unevenness were absent, money would be neutral; changes in the money relation would not affect the structure of business, the size and direction of production in the various branches of industry, consumption, and the wealth and income of the various strata of the population. Then the gross market rate of interest too would not be affected either temporarily or lastingly by changes in the sphere of money and circulation credit. The fact that such changes can modify the rate of originary interest is caused by the changes which this unevenness brings about in the wealth and income of various individuals. (Mises [1949] 1998, 552–53).

In other words, it is not merely that "the Austrian theory of the business cycle gives an example of a situation in which money is particularly 'nonneutral'" (291) in explaining economic crises, but that booms and busts would not occur were it not for the nonneutrality of money. We should therefore not look into degrees of money neutrality. Instead, we could look into degrees of money soundness and search for those monetary systems where governmental intervention is least present. In this, perhaps, the two approaches could try to find more common ground.

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