On the interdependence of money supply and demand

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Money is a component of the total liquidity of the system. A traditional view, which goes back to the Currency School, sees money demand and supply as independent. According to this conception, the central bank has the ability of controlling money supply by expanding or constraining the monetary base, independently of money demand. This is the typical monetarist exogenous view, which looks at the monetary base as a control variable. It is shared by the 'new neoclassical-synthesis', which, combining Keynesian and classical elements, assumes sticky wages and prices and a stable LM curve and proposes a questionable policy of inflation targeting.

This picture, which reflects the orthodox view, is not realistic. Today a large part of the nominal supply of money consists of endogenous credit money issued on demand of firms by commercial banks, in form of bank loans and overdraft facilities, to meet the needs of production. This is inside money, not a legal tender, but a liability for the issuer.

The exact nature of the nominal supply of money in an economy where fiat and credit money coexist is still a matter of debate. It is convenient to distinguish between 'narrow' and 'broad' money supply. The monetary base – the sum of currency in circulation and reserve balances – is usually supposed to be under direct control of the monetary authority, but there are authors who consider it endogenous, as ultimately influenced by the decisions of commercial banks (Rochon and Rossi, 2003). Broader aggregates of money, which include demand deposits, are fully endogenous.

A basic issue concerning the choice of the control variable of monetary policy is the direction of causality of the transmission mechanism of the shocks involved. Does the causality relation go from the supply of money to the real economic variables, through the banking system, or the other way round ('reverse causality' between money and income and between deposits and loans)? Is the supply of money an effect of the demand for money, or a cause of it? This is not simply a point of doctrine. What is at stake is the role and the relative effectiveness of monetary and fiscal policy.

Absolute reverse causality is assumed by those full endogeneists who think that the influence of aggregate demand is equally important in the short and in the long-run and that so does the effectiveness of monetary policy on real variables (Lavoie, 1992). Our personal view is somewhat different: it is that there is fundamentally a bidirectional causality and a basic interdependence of money demand and supply, especially in the long period.

Most post-Keynesians (PKs), in the Banking School tradition, consider the supply of money infinitely elastic at the interest rate established by the monetary authority. They regard it as fully endogenous, that is as credit-driven and demand-determined, and represent it by a horizontal line in the interest-money space (Moore, 1988). This position is shared by some 'monetary circuitists', who consider money a means of payment created *ex nihilo* by banks, without limits, to meet the demand for finance of firms. Not as a possible store of value, nor a result of portfolio decisions.

It has been objected that this view is not reconcilable with Keynes's liquidity preference theory, that it presupposes a monetary equilibrium framework, not ensured by the closure of the monetary circuit, and that by downgrading the relevance of the monetary base and bank reserve requirements as tools to regulate the endogenous money supply, it underrates the role of the central bank in the money creation.

The endogeneist view of money supply is opposed by the monetarists of the Chicago School and by all those who believe in the long-run validity of the quantity theory of money and in the logical priority of savings over investments. The vertical money supply schedule these economists have in mind is seen as suitable to be shifted rightward or leftward by open market operations of the monetary authority, and as matched by a downward-sloping curve of the demand for money.

A different, less fundamentalist position is held by those 'structuralists' who consider the supply of money a positively sloped line, due to the presence of institutional constraints, uncertainty and increasing financial risk (Palley, 1991). They are PKs who deny that the expansion of credit money can go on indefinitely and maintain that banks have a liquidity preference which can affect negatively their responsiveness to the demand for credit.

Other scholars of established heterodox reputation reject from an authentic Keynesian perspective the idea of a long-run neutrality of money and the "New Keynesian Consensus" vision of a central bank following an interest rate Taylor rule and of inflation as an exclusively monetary phenomenon. They refuse a policy of inflation targeting, do not identify all money with transferable credit rights and do not ascribe to the nominal supply of money a definite endogenous nature, implying a view of the central bank as an accommodating price-maker and quantity-taker lender of last resort. They accept the idea that money supply is essentially endogenous, but think that a fully accommodative reserve policy by the central bank is unrealistic in the presence of policy constraints. What is truly endogenous is the real supply of money, which depends on the velocity of circulation (Cavalieri, 2006).

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