THE THEORY OF MONEY AND FINANCE

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THE THEORY OF MONEY AND FINANCE

RICHARD COGHLAN

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PREFACE

This is a practical book, or that at least is its intention. It introduces the concept of *money* and deals comprehensively with the basic monetary theory required for an undergraduate course on money or macroeconomics. There is also, however, detailed discussion of empirical work in the area of monetary economics, and emphasis is placed on the problems encountered in giving practical expression to abstract theory. In this context it is particularly necessary to distinguish clearly between the various possible definitions of money. While this is likely to prove crucial to the role money is to play in the economy, it is very poorly dealt with in the literature, and more usually money is presented as an homogeneous commodity, implying that it makes no difference to, say, the specification of a demand for money function which definition is employed.

An introduction to flow-of-funds accounting, and the operation, and significance, of financial markets and institutions is also provided. It is hoped that this will help the student to relate his economic theory to the published data and to existing financial institutions. Often, theory is presented in a completely abstract manner and little attempt is made to introduce the student to the raw data which will form a basic material input to any practical application of economics.

The financial institutions, and the financial flows they generate, are generally not dealt with in any detail, and yet they are fundamental to an understanding of the role of money, and are anyway important in their own right. The economy, and the financial markets and institutions, develop together, and any study of the growth of output requires an explanation of how the increasing financing requirements are accommodated.

Finally, the process of money-supply creation is dealt with in some detail. This is in two parts. The first, Chapter 9, deals with the standard money multiplier approach and the criticisms that have been raised against it, in particular the debate surrounding the 'New View'. The second part, Chapter 10, develops an

argument in terms of the lending activities of banks to explain the process of money creation. This provides a dynamic, disequilibrium, framework which justifies a direct relationship between the supply of money and income/expenditure markets. There have already been some interesting empirical studies which have attempted to explain the importance of money within disequilibrium models, and the number of such studies is increasing.

This book is primarily intended for students following a second- or third-year course in monetary or macroeconomics, and who have already become familiar with elementary economic theory. It should, however, also have a wider use. It should prove useful for courses dealing with financial analysis and portfolio choice, providing a link with the operation of financial institutions and the role of money and finance in the economy. In addition, much of the book should be accessible to those working in a financial market environment.

The practical approach adopted, and the requirements of modern applied economics, have required the occasional inclusion of a few econometric and statistical terms. These need not cause concern to those unfamiliar with the terminology, and it should be possible to follow the presentation without necessarily understanding the detailed derivation.

Much of the material included in this book was originally written up in separate papers, and, at that stage, benefited from discussions with colleagues both inside the Bank of England and elsewhere. In particular I would like to thank Charles Goodhart for his perceptive comments. In addition I am most grateful to Michael Artis and Brian Hilliard, who have read the book in its complete form and whose comments and suggestions have been invaluable. The Bank of England were generous enough to provide facilities for drawing the many diagrams included in the book, and I am indebted to Amy Crosby, and all those involved, for their splendid work. Finally, I would like to thank my family, who have provided support and inspiration during the long evenings and weekends that I have been locked away in my study.

RICHARD COGHLAN

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