Free monetary policy and theory: a study of 1724 france essay example

Economics, Money

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Introduction

Monetary policy is a vital tool for the Government to mend economic problems in a country. Economic theory can be applied into monetary policy to know which move policy makers can do to meet their desired economic measures. For example, in economic theory, reducing the money supply will lower aggregate demand, because people will have lesser purchasing power. This will also lead to other economic fluctuations because of the decrease in aggregate demand. A very good example is the money contraction France did in 1724. By collecting ideas from Francois Velde (2009) on his analysis on the events that took place in France, this paper will try to discuss the direct real life effects of monetary policy to the economy.

In this particular paper, money contraction, as monetary policy, will be discussed as to how it affects aggregate demand (AD), aggregate supply

(AS), and the investment-savings (IS) and liquidity preference-money supply (LM) models, in theory and in real life.

Macroeconomic Suggestion

In theory, reducing the money supply will make the long run aggregate demand curve shift to the left (Mankiw, 2012: p292). By shifting to the left, while prices in the long run remain constant, to achieve the same level of output as before, prices should be reduced. At the same time, the LM curve will shift upward and thus increase interest rates for equilibrium (Mankiw, 2012: p322). Demand for money, because of the rise of interest rates, will be reduced. This will lead to a market that encourages saving than investing.

Francois Velde and the French

At that time, France has an unusual monetary system. Silver and gold were still used as money at that time that is why it is different from the contemporary monetary systems (Velde, 2009: p594). This was called a commodity money system where the system includes a circulating physical coin and what its unit, which is Francs and livres at that time. According to Velde’s summary for that time, paper was not used as money; instead “ gold and silver were freely minted” which means that the government does not have the control on how much the physical quantity of money is in the market (p594). The government’s only role in the production of money is that they choose the physical dimensions of the coins.

Money at that time only has value for a period of time. Demonetized money should be sold for reminting (Velde, 2009: 595). But there is another policy where the value of money can be changed as per instruction of the government. The decrease or increase of value has an instantaneous effect on the nominal money supply which is also to decrease or increase the supply respectively.

Velde used two indices to understand how policy makers in1724 led to the decision of reducing the value of money (2009: p595). The first index was the mint equivalent (ME). The ME is the value of the materials contained on a coin. This includes the weight of the metals and other materials used for the minting of the coin. The other index is that the mint price, where it is based on the value of the materials paid in new coins (Velde, 2012L p595). This means that the profit of the mint is ME minus MP. The events before the 1724 monetary policy was a time of stable coin value which changed because of costly wars that France engage in at the time. The changes include the increasing difference between ME and MP which forced the monetary policy that reduced the money supply.

Unlike the previous monetary policies, the one at 1724 was not foretold. Suddenly, people had less value of their money. There were three reductions on the value of money on that period and one increase in 1726.

The effects of the reduction on money supply instantaneously affected foreign market. However, in the domestic market, the reactions were delayed. The purpose of the money contraction was to reduce price in France. It was attained, but not instantly. Over a period of months and years, interest rates rose, prices fell, and investments and savings also changed.

Analysis

In the discussion of Mankiw about the effects of monetary policy on interest rates, he considered the Fisher effect and the liquidity preference effect on the equation (2012: p320). The bottom line of his argument is that, the effect of monetary policy differs in time. This can be seen in the effect of the monetary policy that happened in France at 1724. For example, real wages rose at the short run, but eventually fell in the span of two years. The attempt of France to control price was rather a success though its shortcomings when it came to the industry sector. But it can be seen that in this particular event, the formulas were accurate. After reducing the value of money by 20%, a 45% reduction on prices was expected and was almost achieved before the 1726 increase in money supply. Other affected parameters include wages and interest rates. But it is still a problem why the reduction on price was slow.

Conclusion

Though the theory is accurate in this instance, there are also other instances where money contraction had a different effect in real situations.

In the real world, there are still factors that are not considered by the study of Economics. Economics still works under the assumption of ceteris paribus. Quantifiable variables are the only ones that can be used in economic theory. In the study of macroeconomics, every possible variable should be considered to study the economics of a country or industry.

References

François R. Velde, “ Chronicles of a Defl ation Unforetold,” Journal of Political Economy 117 (August 2009): 591–634.

Mankiw, N. G. (2012). Macroeconomics 8th Ed. New York: Worth Publishers.