Development of Financial Markets and Institutions

I. Introduction

Leipzig University | October 14, 2024
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I. INTRODUCTION

1. About the Course
2. Structure and Requirements
3. The Nature and Origins of Money
4. The Nature of Finance
5. What Is Next?

1. ABOUT THE COURSE

THE PURPOSE OF THE COURSE

- To investigate the origins of financial markets and institutions
- To understand the interrelations between money and finance
- Give an overview of the history of the financial and monetary system
- Investigate the relations between finance, economic development, and economic crises

WHY A HISTORICAL APPROACH?

Institutionalist View

- Economic life determined by institutions
- Institutions understood through historical and empirical studies

Schumpeter's View

- History needed to prevent error in economic analysis
- Knowledge about the past makes us alert

Mises's View

- Economics deals in eternal scientific laws
- Historical investigation and understanding needed to understand present institutions and the concrete data of our experience

MISES, *THEORY AND HISTORY*, P. 21

It is a task of history, for example, to trace back the origin of India's caste system to the values which prompted the conduct of the generations who developed, perfected, and preserved it. It is its further task to discover what the consequences of this system were and how these effects influenced the value judgments of later generations. But it is not the business of the historian to pass judgments of value on the system as such, to praise or to condemn it. He has to deal with its relevance for the course of affairs, he has to compare it with the designs and intentions of its authors and supporters and to depict its effects and consequences. He has to ask whether or not the means employed were fit to attain the ends the acting individuals sought.

MORE CONCRETELY

Matters of Theory

- What is money?
- What are financial assets?
- What determine their value?

Matters of History and Institutions

- Why do we use euros, pounds, etc. as money?
- How did the central banks originate?
- How do banks create money?
- How are the fields of money and finance connected?

Our course therefore combines both *theory* and *history*

2. STRUCTURE AND REQUIREMENTS

WEBSITE AND MATERIAL

https://www.wifa.uni-leipzig.de/institut-fuer-wirtschaftspolitik/

https://www.wifa.uni-leipzig.de/institut-fuer-wirtschaftspolitik/studium/winter-2023-2024/development-of-financial-markets-and-institutions-1

Moodle

- Moodle will be used to share readings
- Please check weekly!
- Slides are uploaded to institute website

LECTURE AND SEMINAR DATES

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	Date	Time
1.	17.01.2025	11:15 – 17:00
2.	24.01.2025	11:15 – 17:00
3.	31.01.2025	11:15 – 17:00

READINGS

Background readings

J. B. Baskin and P. J. Miranti, A History of Corporate Finance, Cambridge, 1999.

B. Eichengreen, Globalizing Capital: A History of the International Monetary System, Princeton, 2008.

L. von Mises, The Theory of Money and Credit, Part I, chaps. 1, 3 and 4, and Part III, chaps. 1 and 2, Yale University Press, 1953.

Further suggestions

N. Ferguson, The Ascent of Money: A Financial History of the World, Allen Lane, 2008.

L. Neal, The Rise of Financial Capitalism, Cambridge University Press, 1993.

E. Chancellor, The Devil Take the Hindmost – A History of Financial Speculation, Farrar Straus Giroux, 1999.

R. I. McKinnon, The Unloved Dollar Standard, Oxford University Press, 2013.

Ed. Stringham, Private Governance, Oxford University Press, 2016.

G. Davies, A History of Money: From Ancient Times to the Present Day, University of Wales Press, 1994.

J. G. Hülsmann, The Ethics of Money Production, Ludwig von Mises Institute, 2008.

Th. Mayer, Austrian Economics, Money and Finance, Routledge, 2017.

L. H. White, The Theory of Monetary Institutions, Blackwell, 1999.

F. S. Mishkin, The Economics of Money, Banking, and Financial Markets, Pearson, 2019.

TERM PAPER

- Research paper on any topic related to the course
- 5,000-6,000 words
- Standard formal requirements
- Paper topic must be approved by the beginning of December
- Start thinking about ideas for the paper early!

SEMINAR

Discussion Seminars

- Planned for December and January
- Students will present important articles, controversies, historical episodes…
- Followed by discussions

Paper Presentations

- Each student presents an aspect of their paper / an important article
- Presentation and time slot assigned – independent initiative welcome!
- 25 minute presentation and about 20 minute discussion

3. THE NATURE AND ORIGINS OF MONEY

DEFINITIONS

Money

- The most commonly used medium of exchange

Finance

- From Latin *finis, finire, finalis*
- To finance – to provide the means to an end
- “Self-finance” vs. “other-finance”

Capital

- The (estimated) money equivalent of assets devoted to productive/acquisitive purposes
- Capital is an abstract concept – but always embodied in concrete goods
- To finance something means to provide the capital

THE TWO MEANINGS OF VALUE

Use Value

- Utility to the possessor
- Purely subjective

Exchange Value

- Market value, price, exchange ratio: the ratio at which one good exchanges for another
- Objective in the form of past prices
- Subjective in the form of future estimated or expected prices

The subjective aspect is always in play – "Capital" is always the *estimated* value of assets

THE FUNCTIONS OF MONEY

Money has these functions four…

- Medium of exchange
- Measure of value (unit of account)
- Standard of deferred payments
- Store of value

The first is key

- The essence of money is that it is the primary (or only) medium of exchange
- The other uses or roles of money follow from this primary role

The *emergence* of money and its *value* are intimately connected

THE VALUE OF MONEY

Purchasing Power and Demand for Money

- A person demands money because it has purchasing power – objective exchange value
- But money only has value because it is demanded by people
- We thus explain demand by purchasing power and purchasing power by demand
- Circular reasoning!

The Temporal Element

- An individual's demand for money today depends on the purchasing power of money yesterday
- Yesterday's demand for money depends on the purchasing power the day before
- And so on into the past. The "regression" stops when the commodity used as money was not yet valued as money
- On that day, it's price was determined solely by supply and demand for non-monetary purposes

THE ORIGINS OF MONEY – LIMITATIONS OF BARTER

Problem of Coincidence of Wants

- Person A will only exchange with person B if A has what B wants and B has what A wants

Problem of Indivisibility

- It is impossible to exchange parts of an indivisible good
- E.g., you cannot exchange 1/1,000 of a house for a hammer

Problem of Specialization

- How do you barter the services of a skilled artisan, which only a few people want?

Problem of Calculation

- There are an overwhelming amount of exchange ratios with only a handful of goods

THE ORIGINS OF MONEY – MENGER'S SOLUTION

Indirect Exchange

- Some goods are more in demand than others – they are more *marketable*
- Over time, individuals realize this
- Sellers of less marketable goods will exchange these for more marketable goods
- The more marketable goods come to be demanded simply to be spent again
- They become *media of exchange*

THE QUALITIES OF MONEY

What makes a commodity a good medium of exchange?

- Marketability (widespread demand)
- Divisibility
- Fungibility
- Durability
- High value per unit mass/volume

Historical money

- The precious metals, gold and silver, were the dominant money across most of the world
- Salt, tobacco, cowrie shells have been used as money in different countries

GRAEBER'S CRITIQUE

David Graeber's *Debt: The First 5,000 Years* (2011)

- Argues that the state of barter is purely mythical
- Primitive societies did not engage in exchange, rather they gave and received gifts, promised to pay back – essentially credit system

Some Answers

- The state of barter would only be brief – the rewards to exchange are obvious
- Graeber's gift economy is a straw man – trade and money originated in exchanges between **"outsiders"**
- A gift economy is impossible here, the precondition is lacking: **mutual trust**

CHARTALISM

G. F. Knapp, *The State Theory of Money* (1905)

- Money is instituted by the state
- The taxing power of the state enables it to designate this or that token as money, as settlement of tax debts

Chartalism and Credit Theory of Money

- Money was a way to keep track of debts as gift economies became more complex
- The debt (to a central authority) was the primary thing, money the embodiment of individual debts

Problems

- Why use silver and gold for these purposes? Evidence suggests they were already money
- A theoretical problem: how would such tokens become valued in exchange? They cannot simply acquire value by fiat

COINAGE AND GOVERNMENT

Coinage

- Money is coined, stamped with a guarantee of its weight and fineness (Hülsmann 2008)
- Historical evidence suggest private merchants were the first to stamp bars of gold and silver (Le Rider 2001)
- Later history is also rife with private mints (Selgin 2008)

Coinage and Government

- Governments early on attempted to monopolize coinage
- A key *regalian right* in the Middle Ages
- Control of the coinage is a way for governments to increase revenues
- Manipulation of the coinage was very important for development of money and banking (Gresham's Law)

4. THE NATURE OF FINANCE

FINANCIAL EXCHANGES

Nature of Financial Exchanges

- Exchanges of present for future goods
- The **debtor** exchanges future goods for present goods
- The **creditor** exchanges present goods for future goods

To Finance: To provide the means for an end

- Money for (durable) consumer goods
- Capital for productive use
- Mostly, the means is a sum of money (of ”capital”), the end is a (larger) sum of money

Finance is Derivative

- “Real” economic action itself is always using means to achieve ends

FINANCIAL TRANSACTIONS AND FINANCIAL ASSETS

Types of Financial Transactions

- Direct loans between creditors and debtors
- Market-based: loans and shares that are *negotiable*, i.e., tradable
- Credit intermediation: the intermediary borrows money from creditors, lends it on to debtors

Financial Assets

- Direct loans and intermediation give rise to *financial assets*
- All financial assets are claims to future income
- Not all financial assets are negotiable – that depends on the financial and legal institutions

TIME PREFERENCE AND INTEREST RATES

Ends and Means

- We always prefer the end to the means in any action, it always has a higher value to us
- Stated differently: we always prefer a presently available good to the same good in the future – we prefer the shortest possible path to our goals
- This is the universal phenomenon of ***time preference***

The Rate of Interest

- In monetary terms, this means we will only invest money if we expect a positive return
- The rate of interest is not "the price of time" – it is the **ratio between present and future prices**
- Accounting interest and economic interest is not the same thing

MONEY AND CREDIT EXCHANGES

Barter and Credit

- We can have credit exchanges in a nonmonetary economy – Graeber is right about this!
- Such credit exchanges are no different from simple barter exchanges
- We cannot meaningfully talk of a rate of interest in barter exchanges
- Form of barter credit: person A preferred good X sometime in the future to good Y now, person B had the opposite preference ranking

Psychic and Monetary Profit

- A barter exchange involve ***psychic profit*** or ***psychic income*** – but we cannot analyze this psychic income into component parts
- To isolate a specific interest return, we must be able to calculate in money prices

MONEY AND CREDIT

Value of Money and Value of Credit

- Money is valued for its purchasing power
- The value of credit is a question of time preference

Essentially Different Valuation

- To increase your demand for money, you give up goods and services (including future goods and services)
- To increase your demand for present goods and services, you give up future goods and services – demand for credit is not demand for money!
- **It's a key goal of this class to show how these two clearly distinct economic spheres are historically and institutionally deeply entangled**

FINANCE AND THE VALUE OF MONEY

Short-term Credit

- Financial exchanges can economize on the need to hold money
- If people pay be short-term bills, settlement of bills reduces the need to pay in cash

Clearing System

- Banks and other financial institutions economize on money through clearing
- Claims and liabilities are settled periodically against the central clearing house
- This minimizes the need to transfer money

Effects

- Both clearing and short-term credit tend to reduce the demand for money and hence the value of money

FINANCE AND THE VALUE OF MONEY

Increasing the Money Supply

- Banks issuing bank notes that are accepted as money increase the money supply
- Bank deposits subject to check (or similar) also increase the money supply
- Great economic debates have concerned the question of money and banking – and we too will delve into it in depth

Some Key Questions

- What are the economic consequences of an increase in the money supply by banks?
- Is a banking system that can create money stable?
- Who gains and who loses from such a system?
- What is the role of central banks in this process?

5. WHAT'S NEXT?

WHAT'S NEXT?

- Consult the readings – they are essential for the course
- Consider what you would like to present in the seminar
- Start thinking about paper topics – I'm here to help, don't hesitate to get in touch with questions

LITERATURE

Graeber, D., 2011. *Debt: The First 5,000 Years*, London: Melville.

Hülsmann, J. G., 2008. *The Ethics of Money Production*, Auburn: The Ludwig von Mises Institute.

Le Rider, G., 2001. *La naissance de la monnaie. Pratiques monétaires de l'Orient ancien*, Paris: Presses Universitaires de France.

Mises, L. v., 1957. *Theory and History: An Interpretation of Social and Economic Evolution*, New Haven: Yale University Press.

Selgin, G. A., 2008. *Good Money: Birmingham Button Makers, the Royal Mint, and the Beginnings of Modern Coinage, 1775-1821*, Ann Arbor: University of Michigan Press.

VIELEN DANK!

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