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Patrick Bolton, Haizhou Huang, Money Capital. New Monetary Principles for a More Prosperous Society

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On 21 May 2024 a new book was published by Princeton University under the title *Money Capital. New Monetary Principles for a More Prosperous Society* written by Patrick Bolton and Haizhou Huang. It is worth mentioning that the book immediately received positive reviews from Charles Goodhart and Helene Rey, amongst others. Hence my decision to familiarise myself with this book and subsequently encourage other readers to follow my example.

Before reviewing this book here, it makes sense to say a few words about both the authors. Patrick Bolton has been associated with Columbia University since 2005. On his website it is written that his research and areas of interest are in contract theory and contracting issues in corporate finance and industrial organization. In other words, corporate governance seems to be his area of specialization. Haizhou Huang is Special-Term Professor of Finance at PBoC School of Finance and Shanghai Advanced Institute of Finance and an external member of the Monetary Policy Committee at the People's Bank of China. His credentials to assess monetary policy in full depth were positively verified when he was chosen to coedit in 2018 a prestigious undertaking under the name of *The Changing Fortunes of Central Banking*.

Both authors evidently try to reach the maximum possible number of readers, as they offer different approaches in presenting their deliberations, ranging from historical presentation and ending on rather complex numerical (mathematical) formulas. This rather versatile strategy stems from the fact that the book is not easy to read. A command of solid macroeconomic fundamentals makes the task easier. But the reward for assiduous readers is big. The authors achieve their goal, namely a presentation of their points, in a rather persuasive and convincing way. In some places they sound very interesting, in some cases in a very provocative manner. Interesting graphs and figures are an extra bonus for all the readers who decide to invest some of their valuable time in reading this book. Boredom and indifference to the conceived message seem to be out of question.

A combination of two experts, where one specializes in corporate governance and the other one in monetary policies may look somewhat awkward. But as Charles Goodhart points out in his

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recommendation of the book, its key added value consists in pointing at the fact that fiat money has important attributes in common with corporate equity – its value rises and falls in proportion with the strength of the issuer. This may be shocking at the first glance, but the authors put a lot of effort in persuading us that such connotations are justified. That is why Helene Rey, in her separate recommendation of this book, speaks about unexplored paths, as fiat money is perceived as the equity of a nation – a view that sounds somewhat intriguing but should offer incentives strong enough to familiarise oneself with this book.

There is no doubt that both authors are very fond of drawing parallels between monetary policies and capital markets. The authors are very honest and do not conceal their source of inspiration. Having attended a workshop organized by China's State Administration of Foreign Exchange in mid-2012 at the heigh of the sovereign crisis in the euro area and dedicated to Contingent Convertible Bonds (the so called CoCos), an intriguing idea occurred to the two authors. Could the issuance of the aforementioned CoCos have minimized the social pain in Greece? Under the assumption that it would have been the case, the authors had to face yet another question. If traditional CoCos allow their owners under certain circumstances to convert their bonds into equity, how then would a similar conversion look in the case of a sovereign CoCo? It would have been an equity of the issuer, which in this particular case, was the Greek government. But is there anything like equity for the nation?

Both authors started to look at fiat money in an attempt to find an answer. As a result of these efforts, a new concept occurred to them according to which fiat money printed by a central bank of a given nation could play the role of equity of this nation. If this was the case, a foreign currency/foreign law sovereign CoCo bond could be converted to a domestic currency/domestic law bond. If such a proposal had materialized earlier on, perhaps the drama of the Greek sovereign crisis would have indeed looked somewhat different (namely not inflicting such a painful social cost). All these deliberations helped to set out the focus of attention on sovereign power to exert control on its own finances.

Upon the aforementioned assumptions related to the sovereign state and its parallels to corporate finance, the authors try to find an answer to the intriguing question, namely how much money is needed for the adequate operation of a market economy. When it comes to the question itself, economists around the world have tried to address it since the dawn of time.

The versatility and scope of the offered answers was often so extensive, that some of their proposals could even be described as poles apart. That is why neither party could offer a really convincing answer.

Needless to add in the case of the book reviewed here, the search for an answer to the above--mentioned question was heavily impacted by the authors aforementioned assumption, where money is an equity. As a result, the entire transmission mechanism along with the entire macroeconomic mix (a coordination of monetary and fiscal policies) is put under review by the authors. After having drawn parallels between equity issuance and money debt, the authors undertake the task of presenting additional perspectives for policymakers in the area covered by money and monetary policies, including also elements of financial stability, and above all, central banks' role as the lender of last resort (LoLR).

That is why the aforementioned review is conducted upon the principles based on corporate finances. And the authors do focus on the fact that the issuance of new stock does not always go hand in hand with value creation. In other words, they focus on the link between the issuance of new stocks and the ability to preserve their value. Apart from the assumption that money is equity, the authors introduce further two assumptions: firstly, money is sovereignty, and then secondly, money is central banking, out of which the first one seems to be of paramount importance.

The importance of the sovereignty of issued money is emphasized with the help of the opinions expressed by Goodhart, who puts enormous value to the two following notions: political cohesion and centralization of fiscal competences. Even if Goodhart's words are referred, above all, to a monetary union, his mantra can easily be expanded beyond a single currency area. An interesting comparative analysis involving Hong Kong and Singapore (with the GDP per capita as the criterion) serves both authors as yet another argument with the help of which they try to point out the importance of the link involving money and sovereignty.

The assumption that money is equity is spread beyond domestic frontiers and it enables the authors to refer to the issue of exchange rates and above all accumulation of foreign reserves. Drawing further parallels between equity and fiat money, an increase in outstanding shares does not translate into their lower value, and neither does the printing of additional currency. Obviously a number of conditions must be met, but once they are met, this comparison holds. And the authors point of view is supported by the case of Switzerland, where the Swiss National Bank acted like a corporation that opted to issue more shares at the time when the equity of such a company was valued higher by financial markets. The huge accumulation of FX reserves by the Swiss central bank helped not only its domestic economy, but also proved to be beneficial to the investors outside Switzerland (as their appetite for safe haven assets had been saturated).

The same is true about capital structure and its parallels to a similar structure in the case of nations – an area referred extensively by the authors in this book. They try to distinguish sovereign debt from fiat money, with the former playing a role similar to a company's debt and the latter is almost identical to issuing equity by a given company. This distinction is quite helpful in approaching another key question, namely how a nation should finance its own investment. Each nation has two possibilities, either issue debt (in foreign currency) or resort to printing money. This question may bring negative associations, above all for the emerging economies, as the former option is usually associated with the "original sin" theory and the latter is often perceived as a recipe for inflation. Nevertheless, the authors do have enough courage to submit yet another provocative concept, where printing money may be more beneficial than increasing the country's debt even further.

Out of the seven chapters presented in this book, perhaps the most interesting is the fourth chapter dedicated to the Chinese economy. To be more precise, we receive in this chapter a detailed description of the Chinese transition, the beginnings of which go back to the late 1970s. A lot has been written about the Chinese economic reforms; however, in the majority of cases it is an expanded description whose coverage requires a lot of time from the reader (who usually suffers from a time deficit and not a surplus). The chapter under review offers us instead a concise description of the sequence of events – as a result of which China underwent the long journey from being a poor and backward country toward a modern and sophisticated economy – which in spite of the still significant deficiencies is one of the most important engines of the world economy. It is not a coincidence that focusing on the second largest world economy is most probably done on purpose – a point to which I shall return later in this text.

The authors are good at presenting the Chinese transition as a unique experience observed in mankind's history. Suffice to say that the urbanization processes, which in the case of Europe and the US needed a period of 150 and over 90 years, respectively, were accomplished by China in less than four decades. And this catching up process had been done in spite of an astonishingly poor starting position. A short look at the GDP per capita helps to add a new dimension to these achievements, as the Chinese GDP per capita in 1979 was merely RMB 423 (USD 270). Forty years later (in 2019) it amounted to

RMB 70,890 (USD 10,247) and was more than 167 times higher than in 1979. And all that in spite of having the world largest population during the analysed time framework. It is a breathtaking achievement by any standards. One can hardly disagree. As a result of this achievement and resorting to the rule of thumb, every fifth inhabitant of our planet managed to get out of poverty.

The fourth chapter of this book offers a bonus to prevailing theories (which hover around governance structure and incentives offered by the authorities to promote economic growth), with the help of which this breathtaking catching up process was achieved. However in the majority of cases, all these theories hardly focus on the importance of monetary and financial elements. The authors tried to fill this gap by pointing out the relevance of these two factors. They also emphasise that it was an internally financed growth – where capital inflows from outside played a rather limited role. And needless to add, they are convinced that the Chinese experience is the best reference point to prove their validity of a theory where fiat money is perceived as equity.

Perhaps the key question concerning the relevance of this book is the Asian contribution to economics as a science. After all, the Chinese economic miracle – no matter how impressive it may look – is a part of even greater economic phenomenon observed in Asia since the end of WW2. Prior to China's formidable experience, both the Japanese and above all South Korean track record as far as the catching up process also offer interesting lessons in an undertaking consisting of taking a large number of people out of poverty and thus helping them to enjoy better standards of living. Yet economists from this part of the world seem to get surprisingly little credit (if at all) for their spectacular achievements. It suffices to watch the list of winners of the Riksbank prizes (commonly known as the Nobel prize in the field of economics). This list is clearly dominated by economists originating mainly from North America and Europe. Obviously it is not my intention to deny the achievements of the economists coming from both shores of the Atlantic, but the presence of Asian economists is confined to two winners only (Amartya Sen in 1998 and Abhijit Vinayak Banerjee in 2019 along with Esther Duflo and Michael Kremer) both coming from India – a country which is yet to accomplish a similar catching up process) must to be considered as somewhat awkward. And to be totally honest, both Indian economists conducted much of their research outside the country of their origin.

Obviously, it may be a sort of overstatement, but the authors of the reviewed book do not seem to be happy with the aforementioned state of affairs related to the recognition of the Asian economists. If one disagrees with a given thesis, one can either ignore it (which seldom is a constructive approach) or to contest it. The latter, according to my judgement, seems to be closer to the authors preferences. And two outstanding examples out of many others addressed in the book will be presented in an attempt to justify my point of view. The first chapter is a massive critique of monetarism. Obviously, the heyday of monetarism ended a long time ago. However, monetary aggregates seem to be back in fashion partly due to the surge in inflation following the pandemic crisis (augmented by the outbreak of war in Ukraine). Nevertheless, the authors are quite wary to put their faith in this particular framework. And yet again they resort to the example of China, where a massive increase in M2 hardly translated into higher inflation. Bolton and Huang believe that the increase in the stock of money simply helped to finance investment, which in turn paved the way to higher production. In doing so, the role of the sovereign factor was again highlighted. And the focus on China may stem from the authors' intention to contest conventional wisdom in the area of economics prevailing around the globe.

The Bagehot rule is the one of the key principles for any LoLR in today's policies aimed at preserving stability in the financial system (and the banking system in particular). It is so common that

we take it for granted. Yet a careful scrutiny of the sequence of events, especially in Europe, makes us believe that the Bagehot rule has simply become obsolete. No matter how shocking this statement may be, there is a general tendency to overlook one important feature. The Bagehot rule dates back to the Gold Standard framework, which was abandoned a long time ago. The advent of fiat money almost out of principle had to reshape this principle. It is true that serious banking crises, both in Europe and North America, were not very common prior to the outburst of the Great Financial Crisis at the turn of 2007 and 2008. The run on Northern Rock in the UK was in a matter of fact the first one in almost 140 years. This was a long time for the Bagehot principle to become omnipotent.

But it was the GFC which posed the first real opportunity to see an alternative for the Bagehot rule. According to the authors, the further pursuit of the Bagehot rule would simply make all the efforts undertaken by any LoLR end in a costly failure. It was the ECB President, Mario Draghi, who offered a new framework for the LoLR. His famous "whatever it takes to preserve the euro" speech gives him enough credit for a call to rebaptize the Bagehot rule into the Draghi rule. If we scrutinize Draghi's response to the crisis further, we may arrive at a conclusion that perhaps there is a long way to the concept of sovereign CoCos, but the link between money and sovereign, which is strongly advocated in the book, has been to a great degree positively vindicated.

All in all, we receive a really interesting book. I am fully aware that not everyone may be impressed with its contents. The provocative tone is perhaps the key reason why some readers may not share my positive review of this work. Still, every reader who is open to an alternative perception of already well established trends should not be disappointed with its content. After all, the book is not about creative recipes for a better future. It is all about encouraging us to reconsider some of the well-established laws and terms in economics. And even if a reader disagrees with the proposed ideas in the book, he obtains a clue about the directions of discussions concerning the notion of money and monetary policies conducted thousands of miles away from his hometown.

Obviously one may have different attitudes towards events which are taking place in China (both in the area of economics and science), from wide enthusiasm to deeply rooted scepticism. But no serious economist can to afford ignore all these processes. The book reviewed here helps to keep the reader updated in these unprecedented events of an economic nature and this is the key reason why I strongly recommend you to familiarise yourself with this work.