

Translated Article[†]

AUTHORITY OF THE CENTRAL BANK OF RUSSIA FROM PERSPECTIVES OF KEYNES'S LIQUIDITY PREFERENCE THEORY



Dorimendon Sh. GOGOKHIYA

Institute of Economics of Russian Academy of Sciences, Moscow, Russian Federation
gogohia.dorik@yandex.ru

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Abstract

Subject The article discusses and substantiates the authority of the Central Bank of Russia and points out drawbacks of such rationale.

Objectives The research provides the rationale for expanding the authority of the Central Bank of Russia not only as a creditor, but also as a borrower of last resort.

Methods The research involves the historical-logic and functional methods, methods of comparative economic analysis.

Results I found aspects to separate the demand for money as a means of savings and means of payment for productive resources and other capital assets. The article demonstrates that Keynes's liquidity preference theory, as put in *The General Theory of Employment, Interest and Money*, highlights the main guidelines for such aspects and ways to improve the existing monetary system as a central banking mechanism with fractional reserve of deposits.

Conclusions and Relevance As a result of the analysis, I identify specifics in the demand and supply in the monetary market and potential opportunities of the Central Bank of Russia to maintain the policy of differentiated interest rates and subsequently ensure the safety of monetary assets. The banking community has to admit that specific banking risks associated with the identification of rather reliable borrowers cannot be transferred to other financial institutions without affecting the quality of such risks management. The findings can be used to discuss and choose options of the monetary policy.

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Introduction

Discussions on the authority, tasks and policy of the Central Bank of Russia undoubtedly stem from the perceptions that monetary inflation is much easier to unleash than curb since the social construct of money is sluggish. Meanwhile, money is not just a social construct. Today's money historically and logically represents informal and formal institutions. To clarify

how they are organized and way to improve them, it is necessary to answer why the monetary system of any country and its development are shaped by respective central banks, implying fractional reserves of deposits.

Curiously enough, but the liquidity preference theory of John Maynard Keynes explains some key aspects of this issue.

Teaching of John Maynard Keynes in Retrospect

It is noteworthy that few economists, who worked before J.M. Keynes, doubted that in the capitalist

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society, available money, which was not earmarked for some consumer needs, flew to markets of capital assets through direct or loan-based channels. It is hard to deny that the commodity-based order of social production, when business entities make decisions on their own and independently on each other, the total value of anticipated monetary savings may differ from the total value of investment planned, i.e. money spent to purchase capital assets. This difference was considered to influence the market rate of interest, which would unavoidably equalize investment and savings after it reached a certain point, since changes in the interest rate had an equal effect on savings and investment. J.M. Keynes expressed serious reservations about the feasibility of such a simple solution concerning investment and savings [1].

According to the theory of J.M. Keynes, the interest rate should not be segregated from money as a marketable asset since in any society people perceive and use money as a form of wealth. Saving it, people feel more safe and secure seeing into the uncertain future. In this respect, J.M. Keynes (unlike contemporary authors) emphasized not only money liquidity as the possibility to use money for various (undefined beforehand) purposes, but the minimum costs of keeping it. People might accumulate goods to a certain extent instead of money, thereby intensifying the diversity and amount of their stocks. As J.M. Keynes reasonably puts it¹, money is a form of wealth, which does not trigger an increase in the carrying costs, while being saved or demanded to a greater extent. According to J.M. Keynes, all durable goods are liquid to a certain extent, causing carrying costs to be incurred. Expenditures on capital assets, which are conceivably less marketable than money, may trigger the risk of losses. Considering the specifics of the commodity-based order of social production, this conclusion seems rather sound. It should be admitted that interest is not a compensation for savings but rather a payment for the loss of liquidity, overcoming the fear of the risk of losses, when money is, in one way or other, invested or lent to other parties.

However, loans are inevitable just due to the fact that the capitalist society tends to purchase and sell capital assets for money. As per Keynes's theory, the demand for money arises from the future plans in such a case. However, if the demand for money results from the future plans, especially in different places, at

different time and on part of different people, and this does not correspond with the way idle funds are allocated, the equilibrium in the monetary market implies an opportunity to borrow money and, consequently, concentration of idle funds, which involves using rather reliable debt instruments. Otherwise autonomous monetary savings will mainly remain idle. Concurrently, governmental debt instruments usually play an important role in creating the comprehensive (internally integral) monetary system ensuring the stability of the national currency. However, it is not only because some demand for money, as a means of saving, shifts to debt instruments. The problem is that the interest rate on debt instruments, which are more reliable than private ones, becomes especially significant. According to J.M. Keynes, it cannot influence and concurrently remain irresponsive to pricing processes in all the markets.

It is worth mentioning that J.M. Keynes was absolutely right indicating that the public perceives and considers any durable business goods and benefits not only from perspectives of their direct purpose (an item of consumption and/or production means) but rather as an asset associated with a certain level of liquidity and costs. General proceeds or expected return on any resource holdings within a certain period equals $(q + L - c)$, where q is a specific service, benefit or income arising from the resource as a means to produce an item of consumption, L is the premium for liquidity, c denotes carrying costs. It is easy to notice, indeed, that price trends depend on the expected return on capital resources. Hence, the versatile formula of return $(q + L - c)$ shall unveil pricing processes, including those associated with term contracts (futures), which are particularly important. J.M. Keynes does not dispute on this issue. On the contrary, he supports the idea, emphasizing that the formula $(q + L - c)$ can serve for computing rates of return no matter whether it is expressed in money or goods.

Furthermore, whereas money is valuable due to high (L), the interest rate on money, which is measured in money itself, cannot be negative or zero². Therefore, it is reasonable, at least, to assess formal grounds and compare other rates of interest on the basis of the rate of interest on money. For example, if the rate of interest

¹ Chapter 17 of *The General Theory of Employment, Interest and Money*.

² Though, unlike commodities, money does not presumably generate income in the form of (q), costs (c) for money are zero too.

on money is, say, 5 percent, and price for wheat, as set forth under a term transaction (shipment within a year), is 4 percent as high as its current price, today's unit of wheat is exchanged for a 105/104th unit of wheat, which is to be shipped to the buyer in a year. In other words, the rate of interest on wheat will be about 1 percent in wheat units. Obviously, if the rate of interest on money was 3 percent, rather than 5 percent, the price for wheat under the term transaction would be different from the current one by 6 percent, rather than 4 percent, with the rate of interest on wheat accounting for about –2 percent. At any rate of interest on money, the weighted average rate of interest on commodities, i.e. rate of interest on various goods expressed in units of such goods, will be positive, negative or zero. Zero weighted average rate means that the market value of goods is not below or above money, thus revealing the mechanism for setting stable prices for goods and, correspondingly, exchange value of a monetary unit at any point of time³.

I should mention that J.M. Keynes was not interested in the equilibrium properties of the zero weighted average rate of interest as he should be. The comparison of commodity-based and monetary rates of interest was necessary to explain why the output and employment relate to money and rate of interest on money more closely than to the rate of interest on wheat or capital equipment, houses, etc.

In Keynes's opinion, the fact that durable goods are relatively rare results specifically in different rates of interest. Any standard of value will do to capture the difference. Meanwhile, whereas liquidity and carrying costs of economic resources vary, the lucrateness of an asset with the highest ($L - c$) for saving purposes can hamper substantial investment in other assets, thus affecting the production and employment particularly due to the fact that the elasticity of money production is null for the private sector. Post-Keynesian literature questions this conclusion since it has become evident for the recent

decades that monetary authorities let the money supply slide out of their control during the period of economic upsurge. It is no surprise, indeed, considering the ever lasting propensity of commercial banks and informal banking entities to dilute deposit reserve standards set forth by the Central Bank of Russia.

Banking is known to provide (promise) free access to money to those ones who own it, even if most of it has been invested in assets, which cannot be promptly converted into cash. Promising free access to money to business circles, despite its financial fragility, a commercial bank dominates other institutions that are called to accumulate funds as a form of wealth alleviating the anxiety in the face of the uncertain future. Neither development of production and financial markets is able to deprive the commercial bank of this role particularly because the capitalist society, in some way or other, engenders or intensifies what makes people worry in planning their future.

J.R. Hicks was shrewd to note that economy, which massively employs capitalist durable resources, would not have emerged if it had failed to discover what we currently call a bank (monetary) loan. Without knowing that, A. Smith reaffirms the idea describing gimmicks with promissory notes entrepreneurs have by prolonging their bank loans to finance long-term investment projects [2–4].

Condemning such tricky schemes, A. Smith holds that, unlike working capital, which recurrently returns to its owner for being further reinvested, fixed capital cannot be returned, being continuously stable in form. Therefore, banks should confine themselves to the finance of working capital (though it is not that necessary, according to ideas of A. Smith) [4]. Thus, in the uncertain world, people will devitalize considerable working capital only given there exist certain guarantees of free access to liquid capital, as J.R. Hicks indicated [3].

Whereas the demand for more liquid capital increases as the bank interest rate grows, a higher rate complicates the finance of long-term investment project, that obviously can trigger negative implications for the market economy as long as such projects multiply. The 'normal' interest rate is a controversial issue for the economic theory, especially in the post-Keynesian period, supporters of the Keynesian economics mainly believe that the insufficient flexibility of money supply is a key trigger of financial and economic crises. Furthermore, they often voice the idea

³ When the equilibrium rate of interest on money is formed, it is very important to consider the difference between the actual price for a piece of goods in the future and the expected (predicted) price which is set in markets of futures. (If price expectations were absolutely definite (completely justified), it would signify the non-existent risk of loss, and the rate of interest on money could approximate zero as much as possible like the weighted average rate of interest (Please refer to J.R. Hicks [4]). It should be clear, however, that people cannot have the full view of the future. Therefore, the positive rate of interest on money ensuring the zero weighted average rate of interest on commodity assets is or at least should be exceptionally important.

that the credit-linked substance of contemporary (banking) money has little to do with the former perceptions of money implying that the amount of money depends on their function of a medium of exchange [5].

In any society, money is obtained in exchange for goods and debt liabilities, i.e. on credit. When previously accumulated funds do not influence the volume of lending, like it happens in case of fractional reserves of bank deposits, a loan constitutes a special and independent source of money supply. As suggested in some hallmark versions of credit-oriented money concepts, the purpose of the central bank system with fractional reserves of deposits is to make the money supply completely endogenous, i.e. dependent on the demand from firms and households within this economic system⁴. The fact that money are exchanged for debt liabilities does not make the money supply more flexible provided the interest rate on bank loans remains rather low and stable over time, which corresponds with the design and capabilities of the contemporary monetary system. It is hard to overlook that central banks tend to increase their bank reserves during financial crises, actively granting loans to major commercial banks at low interest rates. Commercial banks, however, usually temporize making the soft lending proposition to their customers, thus limiting the money supply. It certainly affects the financial position of people who are used to cheap loans when buying goods. This circumstance becomes significant for the economy as a whole when productive resources are concerned [3, 6].

J. Schumpeter noticeably advocates for the credit-linked substance of money. As stated in Schumpeter's *Theorie der wirtschaftlichen Entwicklung: eine untersuchung über unternehmergewinn, kapital, kredit, zins und den konjunkturzyklus* [7], banks create money mainly because innovative entrepreneurs demonstrate their demand for it. Certainly, J. Schumpeter expresses apt views, emphasizing that productive resources can be employed in a new and more efficient manner in the market economy (given the prevalence of private ownership) only if the purchasing power of economic entities changes. In the mean time, as J. Schumpeter also notes, the market economy is modernized not only by innovative entrepreneurs, but also their successors and competitors who master successful innovations, i.e.

those ones which will be, more or less, able to reduce comprehensive costs striving to gain a unit of useful effect, whether it be in manufacturing or mining sectors, transport, commerce or agriculture. Mass demand for money due to such innovations apparently induces the practice of making fractional reserves of bank deposits at least when the practice obviously grows and becomes generally accepted.

What seems to be important is that banking (monetary) lending is effective as a means to place productive resources to the extent to which holder of those productive resources treat and use money not only as a means to acquire goods. J. Schumpeter made a lot of effort proving that the monetary form of capital is a separate aspect to consider, and the stock of money as the fund of purchasing power shall not be equated with the stock of whatever goods. This statement can be convincingly substantiated only if net monetary income (as a source of monetary savings) is recognized as a common motivation for all business entities. In other words, exchanging goods and money, every business entity shall pursue deriving monetary income (through planned purchase and sale). In such a case, entrepreneurs will manage to obtain sufficient resources which are held by others⁵ [7, 8].

It is noteworthy that the specifics of business activities does not discard the fact that any profit is a kind of net monetary income, which is generated by any entity, if people want to save and accumulate products of their activities and performance in the monetary form, willing to pay with goods and thus expanding, if possible, their supply. Making a historical retrospect, J.M. Keynes illustrated that people had such intentions no matter what epoch they lived in.

Demand for Money

In the contemporary society, the stock of money includes not only those forms of money (cash and call deposits) which are spent to purchase goods or make other payment, but also funds in savings accounts and term deposit accounts (money aggregate M2), and monetary funds invested in reliable governmental

⁴ Please refer to researches [3, 6] for the analysis of the existing versions of the endogenous money supply.

⁵ The price for a certain item (for example, manpower services) can be raised but this will not expand the supply of such items if goods are offered in the market solely to acquire other goods. Furthermore, in case of an increased price, the seller gains the same income selling fewer goods, i.e. the income which would suffice to satisfy customary needs. According to M. Weber, such response to increased prices was quite natural before the industrial revolution since it stemmed from a certain lifestyle, which grew even more stable as it was assigned the ethical meaning [8].

securities (money aggregate M3). Certainly, monetary savings, in part or full, may be spent by those who borrow money. Moreover, the existence of bank deposits means that if they did not exist, money invested in them would mainly not have been spent because money in bank accounts was placed in banks for safe-keeping. What banks do with it and why banking development results in the practice of fractional reserves of deposits is another issue, which enables banks to accept money for safe-keeping without any fees as it used to be, but on the contrary pay interests to their depositors. However, this is the other point to discuss since the demand for money as a means of saving should not be mixed with the demand for money as a means of payment for goods, which is to be made by borrowers. It is no coincidence that the demand for money as a means of saving is the focal point in Keynes's proceedings. There are many indisputable points in his system. For example, he holds that the fact that there are liquid assets in the uncertain and risky environment, undermines the reasonableness of holding physical assets and employment-generating production respectively.

I should clarify the idea of J.M. Keynes. It is possible to point out two facts that matter for the contemporary economy. Motivation to save money has been always and everywhere stable and strong, making today's economy no exception. However, the more specific and peculiar physical assets and the higher their carrying costs, the weaker the motivation to accumulate them. The lower (*L*) and the higher (*c*) are assessed, the more expensive (unprofitable) the maintenance of physical assets and sale (the least peculiar asset) in case of unfavorable changes in the market conditions. As J.M. Keynes mentioned, in certain situations business entities continue employing physical assets, notwithstanding that they cause losses, since, in addition to zero proceeds, net losses from simple storage is higher than the losses from use. Furthermore, in addition to physical assets and money, there are financial assets, including securities generating a positive interest yield on their nominal monetary value. In this respect, it is natural to ask whether there are reasonable grounds to keep (accumulate) money more than the final stock requires as part of a transaction, while the market offers such securities.

J.M. Keynes confirms this since those who acquire securities shall understand what they can count on or

have to use their securities before the maturity date. If it happened, securities should have been sold in the open market. However, if the market interest rate on securities increases within the period from the initial investment of funds in the securities and its disposal date, the holder of the securities may fail to find a buyer which would be capable of paying at least the initial price, to say nothing about a higher price at which the securities were purchased. This contributes to the importance of expectations about the future changes in interest rates (expectations shaping the current rates of interest), motivation for being prudent and speculative motive for creating the demand for money. Shall the entire amount of interests be considered in relation to risk factors? That is the risk of partial depreciation due to the uncertainty of the future interest rates?

Economists made attempts to develop the theory of demand for money. To an extent their views are difficult to deny. Assume that there is a so short-term item of securities and so reliable (issued by the Central Bank, for instance) that both types of risks are almost indistinguishable. Will interests on such an item of security be almost zero as well? They will obviously not [9–10].

If people could easily acquire reliable securities without additional costs and convert them into cash likewise, they would invest their money into securities until some interest income can be derived. But difficulties and costs that may arise from certain deals still matter for them. These are the reasons why the uncertainty of the future interest rates cannot offset the amount of interests, especially when it concerns the rate of interest on rather reliable assets.

If decisions to purchase, hold and sell reliable securities are not exposed to any risk, simply entailing some transaction costs, why do people avoid paying for goods with securities like is done with money? This question may be simply settled if we remember that, unlike money (as a medium of exchange), even the most reliable securities are not a generally accepted means of payment. If it were different, people would definitely use securities like money to pay for goods, thus reducing transaction costs. Money should not necessarily be a medium of exchange so that business entities could pay with it for goods [7]. People abstain from paying with securities concerned simply because they prefer to rely upon them as a means of saving. Assume that the central bank issues money and

a promissory note and commits to accepting (buying) the promissory note every day at the par or increasing value until the maturity date. In other words, issuing the promissory note, the central bank communicates to would-be holders the price or value of this promissory note as of any day preceding the maturity date. Will such an absolutely reliable promissory note circulate like money? It is highly unlikely that it will not. It may not be due to the fact that some business entities are reluctant to accept such a promissory note as a payment for their goods but rather because many people will not choose to exchange it for goods. In the early 20th century, the U.S. Treasury issued two-dollar notes, undertaking to recall them in three years and pay interests. The notes disappeared from the circulation immediately, though they were issued to increment the money supply circulating in commodity markets.

Therefore, the positive demand for money beyond the reserve required for transaction purposes is easy to explain if market actors may be offered assets which are as functional as money (a means of wealth storage). Short-term governmental debt instruments or saving interest-bearing deposits, which are even better, virtually serve as money since the risk of depreciation on such assets is not higher than the risk of cash depreciation. The very existence of such assets signifies that money invested in them would at least not be spent if there were not such assets. Bank deposits are money, notwithstanding whether they generate interest income or not, *inter alia*, because any bank deposits can be requested back at any time. This aspect is important in terms of money properties as a preferable form of wealth storage mitigating uncertainty risks. Anxiety or fear of unforeseeable circumstances in the future do not make any form of money more preferable if any form of money can be converted into the other at any time. The rate of interest on monetary assets can be adjusted as often as necessary, without having a considerable impact on the demand for money as a means of wealth storage, which is in contrast to the rate of interest on loans borrowers took out using the money to purchase productive resources. The market economy would definitely become more stable if the fluctuating rate of interest on loans is leveled by adjusting the rate of interest on monetary assets more frequently. Hence, the money supply would become more flexible given the demand for money as a means of wealth storage is steady.

Central Bank as a Creditor and Borrower of Last Resort

The State (government or legislature) is the party which always unavoidably participates in the establishment of a central bank. However, the undeniable fact is that the hierarchical banking system rightfully originates as banking business develops.

When bankers began to lend money deposited with them, they were sure to be always capable of performing their obligations, i.e. being able to regain amounts they were called to repay without delays even if some deposits were granted as loans at interest. For instance, they believed that, if needed, they would sell some assets or collaterals provided by borrowers. However, loans from other larger banks appeared to be the only solution to quickly replenish reserves. Some monetary reserves should be kept in major banks' accounts so that they could be more confident in such situations. Banking systems which were growing at the end of the 18th century (England and Scotland) hardly ever differed from today's ones in this respect.

Meanwhile, whereas contemporary central banks issue respective national currencies without being constrained with reserve requirements, they can have an incomparably more flexible policy on interest rates in order to encourage the production of goods, on the one hand, and stabilize prices (exchange value of money), on the other hand. Revising interest rates on monetary assets (bank deposits) can cushion the fluctuating rate of interest on goods, to a certain extent, and commodity value respectively. The rate of interest on asset can adapt itself to the rate of interest on commodities (commodity values) so that the weighted average rate of interest on commodity assets would not significantly deviate from zero. As much as commodity values change due to the modernization of the market economy, which sometimes additionally requires considerable financial injections (depending on the scale and profundity of modernization), there are not reasonable grounds implying that the equilibrium rate of interest on monetary assets, which makes the purchasing power of money stable, will not exceed the rate of interest on bank loans needed to finance innovation. Such a correlation of the interest rate is understood to have a detrimental effect on the financial position of private banks, but the central bank is a different case.

The government should confer the authority of a credit and borrower of last resort on the central bank so as to ensure the sustainable economic development in the long run and address relevant issues. The simplest solution is to make commercial banks act as ordinary branches of the central bank when accumulating funds on their deposit accounts. This will, in no way, affect the pool of commercial banks' resources, if the Central Bank of Russia not only grants ordinary loans but also limits the volume of lending to commercial banks at a low interest rate in line with the amount of funds a commercial bank collected as deposits it opened upon the Central Bank's instruction, guaranteeing the unconditional remedy against inflation. Revising the rate of interest on the deposit (let it be the stabilization account of the central bank) and individual loans, the Central Bank of Russia is able to meet the inflationary expectations within a short period of time and enhance development opportunities of sectors and enterprises notwithstanding their focus on external or internal markets. There are no obstacles to provide a double solution to interest rate issues. It is necessary to prevent that money lent at a preferential interest rate to some bank will be found in the stabilization account of the central bank with other banks. It is not difficult to do so by freezing the difference between the time when loans are granted and interests are paid on this account. A commercial bank will have no gain but rather incur losses if it takes out a comparatively cheap loan from the Central Bank of Russia and places it in the stabilization account with other banks. It is to repay the amount it borrows strictly at the specified date. If the holder of the stabilization account is eligible to interest payments only in a longer period of time (at least one day longer), it will not be profitable and

beneficial to manipulate cheap loans for profiteering purposes.

If the Central Bank of Russia instructed the entity to open a permanent account, it does not mean that the rate of interest on this account will be higher than the rate of interest on loans which commercial banks adhere to as the price for centralized reserves. The rate on deposits will be revised (adjusted) more frequently. This will specifically prevent inflation rates from growing so much so that the deposit rate would be higher than the rate of interest on loans to curb it. Furthermore, equal rates will be quite a normal situation during an increase in the economic growth rates.

As a conclusion I should add that what makes the concept of the stabilization account of the central bank noteworthy is that its implementation will cause the stagnation of market incentives for bank liabilities management. The competition and innovation will be superseded with standardized procedures, which is not a sign of setback in this case.

First, the banking community has to keep in mind that specific banking risks associated with a choice of rather reliable individual borrowers are impossible to transfer to other financial institutions without a detriment to the quality of their management.

Second, those involved in production of goods will finally get what they need, i.e. the absolute preservation of value of their savings and transparent and customary procedures for managing personal bank accounts on permanent terms and conditions. The opportunity to have the value preserved will contribute to more efficient competition in bank lending specifically because there will be no competition of prices in pursuit to attract idle funds to bank account.

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