The Monetarists Counterrevolution

FROYEN CHAPTER 9:
A monetarist is someone “who thinks it is more important to regulate the supply of money in an economy than to influence other economic instruments.”

- *The Economist*

- After Keynes death, the early Keynesians continued his successful attack on the classical orthodoxy.
- One of the most scathing attack was on the classical quantity theory of money.
  - That money was of little importance in determining output
- Monetarism led by M. Friedman came back in an attempt to reassert the importance of money.
The Monetarists Propositions

I. The supply of money is the dominant influence on nominal income.

II. In the long run, the influence of money is primarily on the price level and other nominal magnitudes.
   - In the long run, real variables, such as real output and employment, are determined by real, not monetary, factors.

III. In the short run, the supply of money influences real variables.
   - Money is the dominant factor causing cyclical movements in output and employment.

IV. The private sector of the economy is inherently stable.
   - Instability in the economy is primarily the result of government policies.
### Assertions under Proposition I

- Economic activity in current period is determined primarily by money supply
  - Causation is from money to income
- Changes in money supply cause changes in nominal income
- The level and rate of growth of money supply are assumed to be determined primarily by the central bank

### Assertions under Proposition II

- In the long run economic activity in real dollars is not determined by money supply
- Real output in the long run is determined by real factors such as;
  - the stock of capital goods, the size of the labour force and the state of technology
- The long run effect of money is to equi-proportionately determine the price level
 Assertions under Proposition III

- In the short run, output and employment are strongly influenced by changes in the supply of money.

- Prices are also influenced in the short run,
  - but because prices and wages are not fully flexible, changes in money supply in the short run only has a partial effect on prices. Part of the effect goes to output and employment.
  - the stock of capital goods, the size of the labour force and the state of technology.

 Assertions under Proposition IV

- The private sector (businesses and households) are not the source of instability in the economy.
  - Private sector is essentially a shock-absorbing, stabilizing and self-adjusting sector.

- Instability in the economy is from the public sector.
  - Government causes instability through the growth in money supply.
  - Government also destabilizes the economy through interference with the normal adjustment mechanisms in the private sector. Examples minimum wages, rent controls, ceilings on interest rates.
Policy Conclusions from Propositions

I. Stability in the growth of the money stock is crucial for stability in the economy. Such stability is best achieved by setting a constant growth rate for the money stock.

II. Fiscal policy, by itself, has little systematic effect on either real or nominal income. Fiscal policy is not an effective stabilization tool.

The Reformulation of The Quantity Theory of Money

- According to M. Friedman according to the classicals

\[ MV = PT \]

Where \( V \) (velocity) was assumed to be stable and thus changes in \( M \) would be reflected in either changes in \( P \) or \( T \)

- This came into disrepute as a result of the Great Depression of the 1930s from Keynes criticism.

- According to Freidman the criticism against the classical QTM was misplaced
  - Yet he therefore found it necessary to reformulate the QTM taking most of Keynes contributions into consideration
Money and the Early Keynesians

The Keynesians believe that the primary causes of the Depression were autonomous declines in consumption, investment, and exports.

The decline in these components of aggregate demand were the result of:
- the stock market crash of 1929,
- overbuilding in the construction sector by the late 1920s, and
- the breakdown of the international monetary system.

Although they believed that money played a role, it was not the overriding determinant of economic activity.

Money and the Early Keynesians

The Keynesians believe that factors such as government spending (G) could also affect the level of economic activity.

For instance in the case of an expansionary fiscal policy:

\[ \uparrow G \Rightarrow \uparrow Y \text{ Shifts in IS rightward } \Rightarrow \uparrow r \text{ (because } \uparrow Y \Rightarrow \uparrow M^D \Rightarrow EDM \Rightarrow ESB \Rightarrow \downarrow P_B \Rightarrow \uparrow r \text{) } \Rightarrow \downarrow \text{Inv. } \Rightarrow \downarrow AE \Rightarrow \downarrow Y \text{ from } Y_c \text{ to } Y_1 \Rightarrow \downarrow M^D \text{ back to } M^D = M^S \]
Upward Sloping AS and AD shocks

Expansionary Monetary Policy

$\Rightarrow G \Rightarrow Y \Rightarrow$ Shifts in IS rightward $\Rightarrow r$ (because $\Rightarrow Y \Rightarrow M^D \Rightarrow EDM \Rightarrow ESB \Rightarrow P_B \Rightarrow r$)

Because IS shifts rightward AD also shifts rightward $\Rightarrow P \Rightarrow$ shifts LM upwards to $LM_1 \Rightarrow r$ from $r_c$ to $r_1$

$\Rightarrow \text{Inv.} \Rightarrow \text{AE} \Rightarrow Y$ from $Y_c$ to $Y_1$

Contractionary Fiscal Policy

Opposite is also true

Expansionary Fiscal Policy

Real GDP

Expansionary Fiscal Policy
Money and the Early Keynesians

- The early Keynesians (1945-50), relying on what they believed to be the experience of the 1930s, thought that
  - the demand for money was highly interest elastic (because interest rate was so low during those times)
  - that investment was highly interest inelastic (because under depression there was low utilization of existing plant and machinery and excess capacity)
- the LM curve was flat
- the IS curve was steep.
- In this case, increases in the quantity of money have little effect on the level of income.

Money and the Early Keynesians

- The early Keynesians also believed that the demand for money was unstable and, therefore, changes in the money supply would not have very predictable effects on either the interest rate or the level of income.
Friedman’s Restatement of the QTM

- He argued that demand for money was stable
- He insisted that unlike that early Keynesians thought the interest sensitivity of $M_D$ was small and not infinite
- In that case the quantity of money was the dominant influence on the level of economic activity
- This conclusion rests on his restatement of the QTM
- Friedman’s QTM was very close to the Cambridge version of the Classical QTM.
  - That approach focussed on the demand for money

Friedman’s Restatement of the QTM

- The Cambridge version of the Classical QTM states that

  $M_D = k PY$

- Expresses a proportional relationship between $M_D$ and the level of nominal Income (PY).
- They assumed the factor $k$ to be constant in the short run.
- Thus given the exogenously determined nominal $M^S (M)$ the Cambridge equation was

  $M = M_D = k PY$
Friedman's Restatement of the QTM

\[ M = M^D = k \cdot P \cdot Y \]

or alternatively

\[ \frac{1}{k} M^\nu = P \cdot Y \]

- Friedman modified the above Cambridge equation to incorporate some of the arguments that Keynes advanced in his demand for money theory.
- According to Keynes

\[ M^D = M^D_T + M^D_P + M^D_S = f(P, Y, r) = f(+, +, -) \]

Friedman's Restatement of the QTM

- Friedman accepted Keynes treatment of the role of money as an asset.
- He unlike Keynes believed that rather than see bonds as the alternative asset, there are three types of alternative assets namely:
  - Bonds
  - Equities
  - Durable goods
- Although durable goods do not explicitly pay interest the return on holding these assets is the capital gain obtained with an increase in general price level.
Friedman’s Restatement of the QTM

\[ M^D = L(P, Y, r_B, r_E, r_D) \]

- Difference with Keynes
  - Money demand function is stable
  - Money demand is not segmented to transactions, precautions and speculative motives
  - Focusses on three alternative assets and the nominal yields on each rather than only bonds
- To restate this in terms of the Cambridge equation
  \[ M^D = k(r_B, r_E, r_D) \cdot PY \]
- A rise in any of the yields will cause \( k \) to fall. So if there is any instability it will come from these.

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Friedman’s Restatement of the QTM

- The equilibrium condition is
  \[ M = M^D = k(r_B, r_E, r_D) \cdot PY \]
- Conclusion: An exogenous increase in \( M \) leads to
  - increase in \( PY \) or
  - Decrease in \( r_B, r_E, r_D \)
- Since \( k \) is believed to be stable then it implies that
  - Increase in \( M \) would change \( PY \) and so its important in determining \( Y \)
Monetary and Fiscal Policy

- Friedman believe that the interest sensitivity of investment was high and that interest rates affect AD significantly
  - A change in interest rate affects investment demand by a greater extent if we consider that investments do not depend only on interest on bonds but also on durable goods and equities.
- That interest sensitivity of money demand is very low because money demand is completely independent of the rates of return on the three alternative assets
- Thus steeper LM and flatter IS curve

IS-LM: Monetarist Views
Unstable Velocity and Declining Influence of Monetarism

- By end of 1970s to mid 2000s the velocity of money rather than being stable fluctuated and thus rendered the monetarist propositions invalid
  - 1985-1987 and 1989-1993 sharp declines in the velocity of money
  - 1994-2001 there was a sharp increase in velocity of money
- These made money demand unstable lending credence to the Keynesian view of unstable money demand.