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What it Means to Be a Monetarist

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İstanbul University, Economics Faculy

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Abstract – The pioneer of Monetarism is M.Friedman and other other notable Monetarists are Karl Brunner, and his student, later colleague Allan Meltzer and other less known economists. But M.Friedman stands out. He was an early critique of Keynes and leaned towards traditional Classical and Neo-Classical macroeconomic system. In 1956, he had published his famous "Quantity Theory – A. Restatement" in his studies in Quantity Theory of Money (Chicago). Later, in 1963 he published along with David Meisalman "The Relative Stability of Monetary Velocity and the Investment Multiplier in the US 1897-1958" in which study the showed that the classical velocity of money was a more stable parameter for the time studied compared to the Keynesian multiplier. This was a powerful attack on Keynes. Later, the New Keynesians, however, used the same data with different lags and proved the reverse, that is, the Keynesian Multiplier was more stable than monetary velocity of money. All throughout the '50s and '60s Friedman's voice was a minority because Keynes was very much in vogue both in academic circles and among practitioners, consultants and policy formulators.

Keywords – Monetarism, Monetarist Policies, Short Run Phillips Curves, Vertical Long Run Phillips Curve, Natural Rate of Unemployment, Adaptive Expectations

I. Introduction

The pioneer of Monetarism is M.Friedman and other notable monetarists are Karl Brunner, and his student, later colleague Allan Meltzer, and also other less known economists. But M. Friedman stands out. He was an early critique of Keynes and leaned towards Traditional Classical and Neo-Classical macro system. In 1956 he had published his famous "Quantity Theory – A Restatement" in his studies in Quantity Theory of Money (Chicago). Later, in 1963 he published along with David Meisalman "The Relative Stability of Monetary Velocity and the Investment Multiplier in the US 1897-1958" in which study the showed that the Classical Velocity of Money was a more stable parameter for the time studied compared to the Keynesian Multiplier. This was a powerful attack on Keynes. Later, New Keynesians, however, used the same data with different lags and others and proved the reverse, that is, the Keynesian Multiplier was more stable than Monetary Velocity of Money. All throughout '50s and '60s Friedman's voice was a minority because Keynes was very much in vogue both in academic circles and among practitioners, consultants and policy formulators.

II. Demand For Money And Supply Of Money

M.Friedman offered a Demand for Money equation which was more general compared to Keynes but which, however Classical Theory as follows:

$$M^d = (r_B, r_E, r_D).P.y$$

M^d: *Money Demand in nominal terms*
r_B: *interest rates on Bonds (Keynesian)*
r_E: *interst rates yielding for Equities*
r_D: *interest rates yielding for Durable Goods*

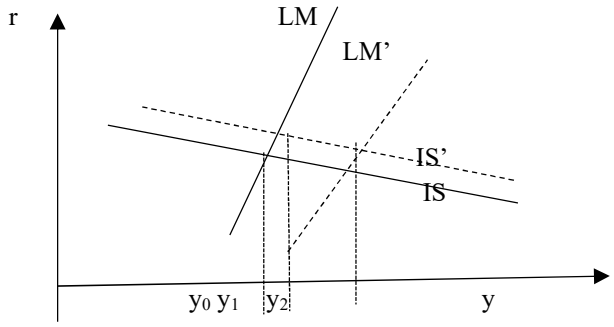
Corresponding Author: Özlen Hiç

Supply of Money (M) was given, determined by Monetary Authorities, hence an exogenous variable. So we have:

$$M = M^d = k(r_B, r_E, r_D).P.y$$

And as a short cut and in a more strict Classical form we had:

$$P.y = \frac{1}{k}.M \qquad (as\ in\ the\ Cambridge\ Equation: M = k.P.y)$$



M.Friedman allowed M^d as a function of "r" as well as "y", however, with the basic difference that the negative interest elasticity of Money Demand being smaller than 1, $(-ie_{M^d} < 1)$.

III. IS-LM Analysis For Monetarists

This gave us a rather steep LM curve while Friedman visualized an elastic IS curve as in diagram below.

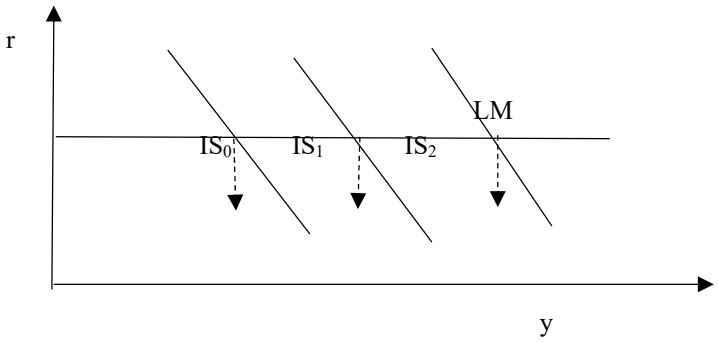
IV. Chosing The Right Economic Policy

Under these conditions, obviously, as M. Friedman argued fiscal policy is not effective in raising the y and N while monetary policy is effective. However, that according to Friedman, this effectiveness is only for the Short Run (SR) and in the Long Run (LR) any increase in M_s would only result in an increase of the Prices (P) only as is the Traditional Classical Quantity Theory.

V. The Drawbacks Of Fiscal Policy

According to M.Friedman there are other reasons why fiscal policy has drawbacks. For example, if we raise government expenditures (g), then, as a result, the interest rate (r) would go up creating a crowding-out effect for private investments, if we decrease t(y), on the other hand, then of this decrease in t(y) is considered temporary, accordingly. The consumption analysis of M.Friedman which divides income into "permanent income" and "transitory income" components and the decrease in t(y) would have at any rate a very small effect on the consumption expenditures (c) even if it is deemed permanent. For an analysis of the overall behavior in the LR and SR of the consumption function and theories offered by Duesenberry, Friedman and Modigliani as opposed to the Keynesian "absolute income hypothesis" one refer to as an example, Branson, while a short explanation is given in Hiç.

In comparing his assumption of a steep LM curve as opposed to the Keynesian nearly horizontal LM curve with a high – Le_r, M.Friedman explains that M^s was increased by monetary authorities in order to keep the interest rate constant. This gave the mistaken conclusion that LM was horizontal, monetary policy, hence, was ineffective and fiscal policy was effective as in diagram below.



VI. The Best Monetary Policy

For Friedman, we should underline here the effectiveness of monetary policy, which is, raising y and N by increasing M_s which is valid only for the SR. This is explained by M.Friedman's analysis of SR vs LR Phillips Curve and the assumption of "adaptive expectations" on the part of workers with respect to future price rises. With this analysis, Friedman won the Nobel Prize. We shall analyze this along with Friedman's concept of "natural rate of unemployment" (nru) in detail, at a later stage, but this analysis leads to the conclusion that in the LR, an increase in the quantity of money would have no effect on y and N, it would only raise P while the economy will return to nru. Thus, in the LR, the Classical conclusion of Neutrality of Money holds true. M.Friedman, therefore, concludes that the best monetary policy would be the one, in which monetary authorities should raise M^s at a constant rate which is approximately equal to the yearly increase in the overall productivity of the economy. For he believes and shows that, in the past, business cycles arose mainly because of wrong monetary policies followed, such as, overblown monetary expansions followed by monetary contractions. The policy recommendation is again similar to the Traditional Classical School, so is the explanation of the "business cycles" based on erratic M_s policies followed by monetary authorities (e.g. A. Marshall, Hawtrey). The policy formulation of a constant increase in Money Supply in the litmus test for monetarists as opposed to some of the more modern times Keynesians who rely mainly on monetary policy and not fiscal policy.

VII. The Effectiveness Of Monetary Vs Fiscal Policies For Monetarists

A broad, perspective offered with the aid of LM and IS has lead us to the conclusion that due to different elasticity of the LM curve, monetary policy was ineffective and fiscal policy was effective during the depression periods (i.e., low income ranges). While monetary policy was effective and fiscal policy was ineffective in the high income ranges which means that a broader Keynesian policy interpretation should as follows. In order to fight depression we should of course use fiscal policy as recharged by Keynes. But if a recession occurs during a period of high income level then the proper or effective policy is monetary policy and not fiscal policy. This is mostly the present situation in the developed economies. To fight inflation, on the other hand, in theory, both fiscal policy and monetary policy could be effective. But for practical and political reasons monetary policy is used instead of fiscal policy. There are several reasons for it. First of all, fiscal policy has to pass through the parliament, which takes time and the final policy recommendation coming out from political organs could end up being distorted as well. Furthermore, if we start with a low t(y), then it becomes politically very difficult to raise it. Raising or lowering "g" on the other hand, would also bring about lots of political discussions on what project and what region this increase would go. Therefore, the general tendency today, even for Keynesians, is to use monetary policy and not fiscal policy. But, it should be remembered the litmus test Keynesians advocate that M_s should be increased whenever we meet with recession and it should be decreased, that is, the rate of increase of of M_s should be decreased if we have inflationary tendencies in the economy. In contrast, Monetarists (Friedman) advocated a constant increase in M_s whatever prevailing economic conditions with the belief that this is the best way to stabilize the economy, that is, to prevent business cycles and stimulate growth with price stability over the LR.

In analyzing fiscal policy and reaching the conclusion that it is ineffective, Friedman underlines that we should not take the case of increasing "g" along with a budgetary deficit which is financed by increase in M_s because this would be a combination of fiscal and monetary policy and in the SR, of course, monetary policy would be effective giving the wrong impression that increasing "g" is effective. Therefore, according to Friedman, the effectiveness of fiscal policies can be studied only when the increase of "g" and budgetary deficit is financed not by any increase in money stock but by selling government bonds

VIII. Conclusion

To recapitulate the above, the main characteristics monetary propositions can be summarized as below.

1- The Supply of Money is the dominant influence on nominal income.
2- In the LR, the influence of Money is primarily on the Price level and other nominal magnitudes. In the LR, real variables, such as real output and employment, are determined by real, not by monetary factors.
3- In the SR, the Supply of Money does influence real variables. Money is the dominant factor causing cyclical movements in output and employment.
4- The private sector of the economy is inherently stable. Instability in the economy is primarily the result of government policies.

From these four propositions we will see that there follow two policy conclusions.

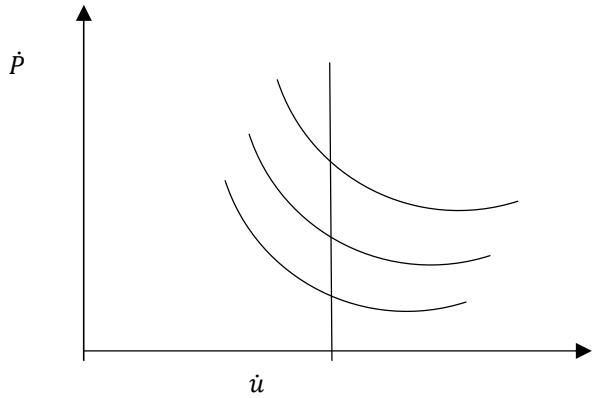
I- Stability in the growth of the Money Stock is crucial for stability in the economy. The Monetarists believe that such stability is best achieved by adopting a rule for the

growth rate in the Money Stock. M.Friedman has long proposed a constant Money growth-rate rule. Other Monetarist favor less inflexible rules, but Monetarists generally favor rules rather than the discretion of policy makers for determining Money growth.

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

Appendix

"NRU", LR and SR "Phillips Curve" and "Adaptive Expectations":

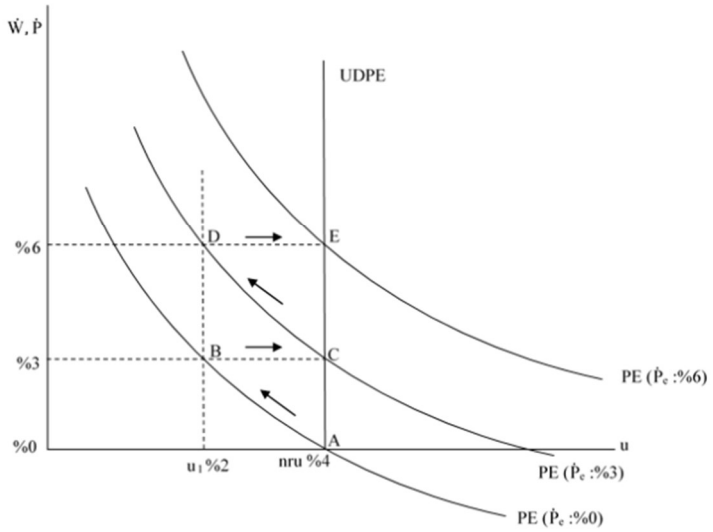


This inspired M.Friedman to make a distinction of a vetical P.C. with several SR negatively sloped P.C.'s. To this Friedman added two more novel concepts. One is the "nru", and M.Friedman hypnotized that the LRPC would be vertical at nru. Theoretically, Friedman explains nru as that level or rate of unemployment at which prices would be stable and any deviation and attempt to decrease unemployment below nru would give rise to increase in prices. The negatively sloped SRPC's on the other hand, is explained by M.Friedman with his concept of "adoptive expectations". According to M.Friedman, workers would tend to make mistaken price predictions, that is, price expectations just as Keynes had assumed. But according to M.Friedman, this is only for the SR. In the LR, the workers would correct their price expectations and hence SRPC will shift upwards,

During the 70's most of the western economies was thrown into a tumult mainly because of the effects of price rises the ensuing stagflation, which is, cost inflation along with a decrease in y and N which was also accompanied by serious budget of payment (BOP) problems as well. Thus for the year '70s, the data failed to give a regular negatively shaped Phillips Curve. Instead we had a vertical line over the LR with also shorter period negative curves. Schematically it is given as below:

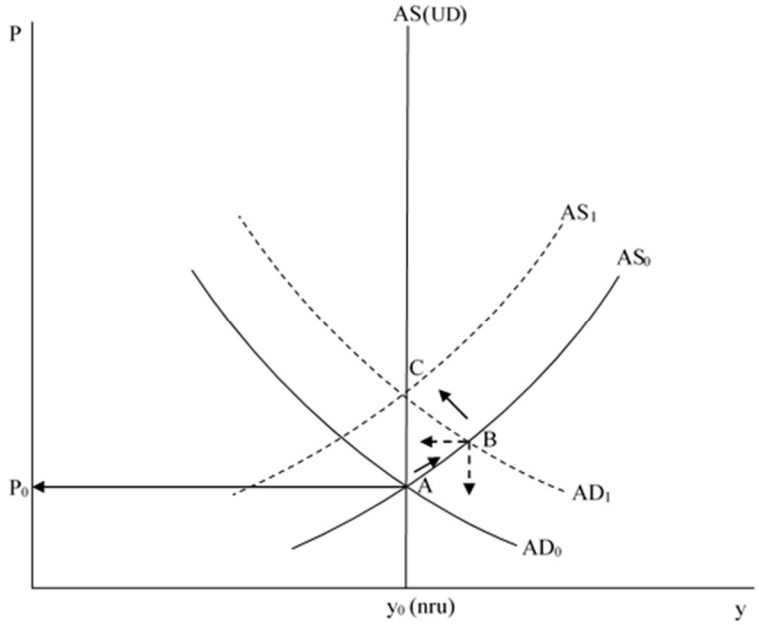
because workers will raise their nominal wage to catch up with the increase in the price level. Thus the economy would go back to the nru again except that we should now have a higher price level prevailing. This is the basic reason why the effectiveness of monetary policy in raising y and N, i.e., in reducing unemployment, is only valid for the SR, but in the LR, the Classical Quantity Theory result will prevail, we will be back on the nru with the increase in M_s increasing only the nominal variables with no effect on the real variables.

This analysis is depicted in the diagram below. Under the simplifying assumption that we have no productivity increases in the economy over time so that any increase in the nominal level is equal to an increase in the price level.



In this analysis by M.Friedman, it should be noticed that instead of the Classical and Neo-Classical full-employment equilibrium point, we have the concept nru to which the economy will automatically return in the LR. But nru creates both theoretical and empirical problems. The theoretical problem is that as Solow pointed out it is a very vague concept because the definition is that it is that point which, if we want to leave and raise y and N, we should meet with an increase in costs and prices. So it is a very vague general condition. The empirical problem with nru is that when a change occurs in the unemployment rate of an economy, it is impossible to pin point it as a temporary or SR change in unemployment or else as a permanent shift of the nru.

The above analysis by Friedman with the aid of LR and SR, PC's is offered below with the aid of AD and AS curves to accompany the above analysis – as diagram below.



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