LECTURE NOTES

Chapter 9: The Monetarist Counterrevolution

- The monetarist counterrevolution effect:
    - *[i]n one sense we all Keynesians now; in another, nobody is any longer a Keynesians* –Milton Friedman
        - In one sense: We all use Keynesian theory (with different assumptions)…
        - … in the other sense: Nobody follows Keynesian policies any longer (because of the different assumptions)
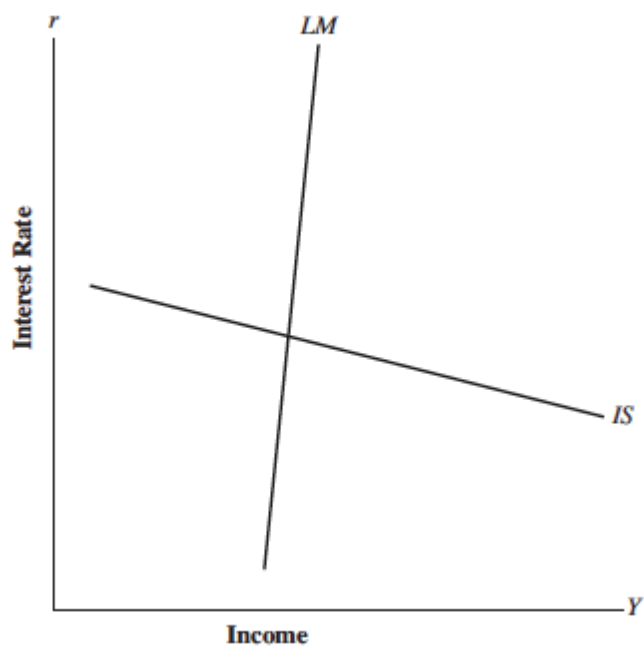
1. Monetarist Propositions

- Four propositions:
    - (1) The supply of money is the dominant influence of <u>nominal</u> income
    - (2) In the long run, the influence of money is primarily on the price level and other *nominal* magnitudes. In the long run, *real* variables (output, employment, etc.), are determined by real, not monetary, factors
    - (3) In the short run, the supply of money does influence real variables. Money is the dominant factor causing cyclical movements in output and employment
    - (4) The private sector is inherently stable. Instability in the economy is primarily the result of government policies
- Then:
    - Correct management of money supply is key for economic stability
    - A monetary rule is better than monetary discretion (more on this in chapter 17)
    - Monetarism is the free market version of the Keynesian model

2. The Reformulation of the Quantity Theory of Money

- Keynesian system: Money demand is variable and unstable (loose or un-anchored expectations)

- Monetarist: Money demand is stable (fairly constant)

  - $M^d = \bar{k} \cdot PY; M^d = L(Y, r)$ [remember the LM function]

  - $M\bar{V} = PY; M^d = L(P, Y, r_B, r_E, r_D)$

    - $P = price\ level$

    - $Y = real\ income$

    - $r_B = nominal\ interest\ rate\ on\ bonds$

    - $r_E = nominal\ interest\ return\ on\ equities$

    - $r_D = nominal\ return\ on\ durable\ goods$ [expected capital gains]

    - Inflation (π) is implicit in Friedman's money demand

  - Friedman does not separate on the three Keynesian components (precaution, transactions, and speculation.)

  - $M^d = k(r_B, r_E, r_D) \cdot PY$

    - Why is money demand constant?

      - Given: Assumed from empirical observation (right or wrong)

      - Movements in r_B, r_E, r_D cancel out (i.e. bonds and equities tend to move in opposite directions)

  - In terms of the IS-LM model:

    - LM schedule is more steep (inelastic)

    - IS schedule is more horizontal (elastic)
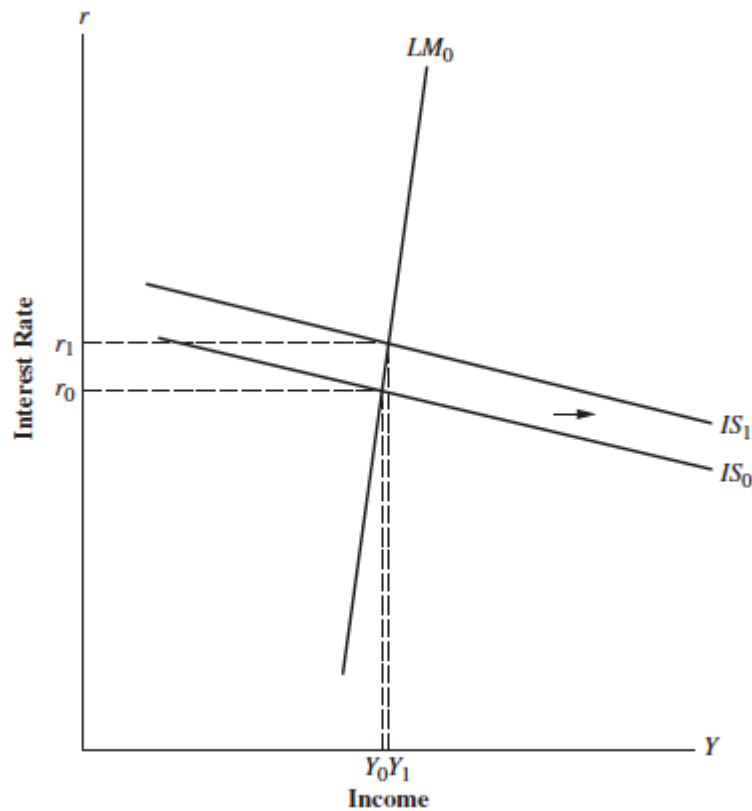
FIGURE 9-3   *IS–LM*: A Monetarist Version

In the monetarist view, the *IS* schedule is quite flat, reflecting a high interest elasticity of aggregate demand. The *LM* schedule is nearly vertical, reflecting a very low interest elasticity of money demand.

3. Fiscal and Monetary Policy

- Fiscal policy is ineffective (<u>holding</u> the quantity of money constant)

- Monetary policy is effective

- Assume an increase in G:

    o (1) Financed with taxes

        ▪ Crowding out effect on household consumption

    o (2) Financed with (domestic) bonds

        ▪ Crowding out effect on private investment

    o (3) Financed by "printing" money

        ▪ This is monetary policy!

FIGURE 9-5   Effects of an Increase in Government Spending: The Monetarist Case

An increase in government spending shifts the *IS* schedule from IS_0 to IS_1. With the relatively flat *IS* schedule and the nearly vertical *LM* schedule, this fiscal policy action has little effect on income (*Y* rises only from Y_0 to Y_1).

- Monetarist position
    - Dominant influence in the short run: Money supply
    - A strict monetary policy produces fewer mistakes than the monetary authority trying to do "fine-tuning."
        - Example 1: The Great Depression
        - Example 2: The Great Recession
    - Market: Shock-absorbing
- Contrast with Keynesians
    - Monetary and fiscal policy should be actively used to stabilize the economy (can we do it good enough?)
    - Market: Shock-producing

4. Unstable Velocity and the Declining Policy Influence of Monetarism

- But, is money demand (velocity) constant?

- If not… what do we have left?

FIGURE 9-6   MI Velocity (1979–2005)