Chapter 9: The Monetarist Counterrevolution

- The monetarist counterrevolution effect:
  - In 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 nominal 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)
  - \( M^d = k \cdot PY; M^d = L(Y, r) \) [remember the LM function]
  - \( MV = PY; M^d = L(P, Y, r_B, r_E, r_D) \)
    - \( P = \) 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 (\( \pi \)) 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)
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 *(holding* the quantity of money constant)
- Monetary policy is effective
- Assume an increase in G:
  - (1) Financed with taxes
    - Crowding out effect on household consumption
  - (2) Financed with (domestic) bonds
    - Crowding out effect on private investment
  - (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
  o Dominant influence in the short run: Money supply
  o 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
  o Market: Shock-absorbing
• Contrast with Keynesians
  o Monetary and fiscal policy should be actively used to stabilize the economy (can we do it good enough?)
  o 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: M1 Velocity (1979–2005)](image)