THE MONETARIST COUNTERREVOLUTION

Monetarist propositions

① The supply of money is the dono dominant influence on nominal Y.

② In the LR, the influence of money is primarily on the price level & other nominal magnitudes. In the LR, real variables, such as output & emp, are determined by real, not monetary factors

③ In the SR, the supply of money does influence real variables Money is the dominant factor causing cyclical movements in output & employment.

④ The pvt. sector is inherently stable. Instability in the econ-omy is the primarily the result of govt. policies.

⑤ Monetary policy affects output directly & not through the bond mrkt

Thus from above monetarist propositions we can conclude that Stability in the gen. of M^S is crucial for a stable economy. Monetarist believe that such stability is achieved by adopting a rule for MP.

Acc. to Friedman higher money can finance more transactions which can incentivise people to produce more in SR & they do not have to be incentivised by a fall in interest rate to ↑ I dd

Friedman's restatement of QTM:

The QTM model given by Friedman was very similar to what was provided by Fisher & cambridge approach. Friedman introduced his changes by incorporating Keynesian dd for money in his monetary theory. He acknowledged that money demand is an alternative in terms of other assets but unlike Keynes he did not classify all others as "bonds". He classified other assets as equities, bonds, durable goods etc. and gave his theory that people could hold any of these assets as alternative to money.

P = Price level
Y = real income
r_B = Nominal roion bonds
r_E = Nominal roion equity
r_D = Nominal roion durable goods

Friedman's QTM eqⁿ: $M^d = k(r_b, r_e, r_o).P.Y$.

this meant that in Friedman's analysis money dd was depending on nominal income, monetary & non-monetary assets. Acc. to him money dd would remain stable & ↑ in M^S by govt. will definitely ↑ nominal income or decrease in return on other assets.

But it assumed that large impact of ↑ M^S will be on nominal income ∴ he restated QTM but went beyond considering money to be demanded only for transaction but stopped short of acknowledging speculative dd for money.

Thus M_d depends on nominal income (PY). An increase in nominal income would ↑ M_d. For a given level of PY, Friedman assumes, as did Keynes that the amt. of money demanded depends on r_0, γ (rate of return) offered on alternative assets. i.e bonds, equities & durable goods such as consumer durables land & houses.

NOTE:- Durable goods do not pay an explicit ≠ interest rate. There return is expected increase in the price of the good over the period for which it is held. Thus expected rate of inflation is also determinant of M_d.

Friedman's theory differs from Keynes in several respects:

First, Friedman views the money demand ≠ fn as stable. Keynes view was that the demand for money fn was unstable, shifting with changes in the public confidence in the economy.

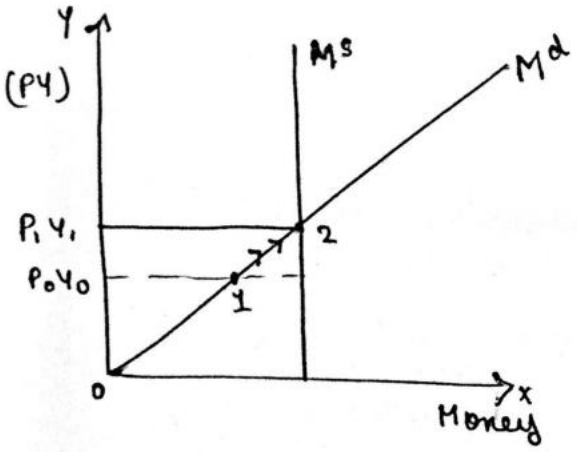
second, Friedman does not segment money demand into components representing transaction balances, speculative dd, and a precautionary demand. But keynes does ~~set~~ specify separate demands based on each of the uses of money.

The third diff; Friedman includes separate yield for bonds, equities and durable goods. whereas Keynes focus on choice of money versus bonds.

In Friedman's view, a quantity theorist believes the following

① the money dd fn is stable
② this dd fn plays an imp. role in determining the level of economic activity.
③ the qty of money is strongly affected by M^s factors.

Graphical representation



In fig. we see the relation b/w nominal income (PY) on Y-axis & money on X-axis.

At the output level P_0Y_0, money ss is more than money dd, hence there is excess M^s in the market. As a result people will start demanding more commodity which will ↑ Price level & further output will also ↑se in order to fulfil ↑ in dd. ∴ the economy will gradually reach pt 2 from pt 1. Hence we see that money is deciding the level of output.

In Friedman's analysis eqlᵇ in money market will det. eqlᵇ in eco. If nominal output is less than what is needed for eqlᵇ (output level P_0Y_0 in the fig.) then there will be excess ss of money which will ↑ dd for output & price. output will adjust to being eqlᵇ in the economy (output level P_1Y_1 in fig.)