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**A SELECTED SURVEY OF
SOME ASPECTS OF MONETARISM**

Dissertation Submitted to the
UNIVERSITY OF POONA
In Partial Fulfilment of the
Requirements for the Degree of
Master of Philosophy

by
UMESH NAIK

**Gokhale Institute of Politics and Economics
PUNE - 411 004.**

JULY 1982

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INTRODUCTION

Monetarism is a full-fledged paradigm (in the Kuhnian sense). It rose to prominence as a counter-revolution against the neo-Keynesian orthodoxy; it is now an orthodoxy (or nearly so). Monetarist doctrines now are under counter-attack from neo-Keynesian quarters as well as subject to post-Keynesian criticism. Therefore at this juncture, several internal shifts in the monetarist structure are taking place. Some new assumptions have been adopted, generating new theorems consistent with the monetarist gestalt - the rational expectations hypothesis is one such assumption. But, as is natural, an orthodoxy tries to retain intact its maintained hypotheses although several supplementary hypotheses may be modified or discarded.

We propose, in the ensuing chapters, to trace the broad contours of the monetarist paradigm; summarize past research effort and place it in juxtaposition with recent monetarist work; we question some of the assumptions and maintained hypotheses of the monetarist doctrine. To this end, several issues have been highlighted. These are the issues which it is felt are most controversial and crucial for the monetarist research programme. Further research effort will have to be directed towards clarifying their theoretical basis.

It is acknowledged that the broad coverage compressed in a few pages may do injustice to the richness of monetarist

thought. But a complete characterization is not intended. It must be stressed that this survey is selective. The details must be filled in with the aid of further references provided.

Monetarists are not regimented to an identical outlook, but have freedom to emphasize aspects according to their own predilections within a broad framework. An interesting study could be made of the different shades of monetarism. Especially, as we are concerned with monetarism as a paradigm under stress of change, the differentiation of monetarist thought could be tied in with internal shifts within the paradigm. For instance, the rational expectations approach is a response to criticism, and constitutes a different angle of approach. This, however, will form the subject of a contemplated monograph.

The first chapter opens with a discussion of the seminal essay on the quantity theory of money by Milton Friedman. This work laid the foundations for the new monetarism as distinct from the old quantity theory tradition. The common core of propositions accepted by monetarists, as enunciated by Karl Brunner, are presented. These are in the form of maintained hypotheses, and there is occasion later in the chapter to question them. The crucial issue of the transmission mechanism is focussed on, within the context of aggregative monetarist models.

The next chapter moves on to focus on detail in the monetary sector: the demand and supply of money. The main issue for the demand for money is its empirical stability. The supply of money is postulated in monetarist literature

as an independent variable in the quantity equation. Further, monetarists assert that it is the supply side of money which has been the source of frequent destabilizing impulses. Money supply functions which seek to embody these propositions are discussed.

The third chapter dwells on the problem of inflation. An important element of models explaining inflation is the Phillips Curve which purportedly enables a division of a monetary impulse into a price change and an output change. A stable Phillips curve provides the rationale for stabilization policy. Friedman's exposition of the (adaptive) expectations augmented Phillips Curve denies any exploitable long run trade-off between inflation and unemployment. The rational expectations hypothesis when introduced into the monetarist model denies even a short-run trade-off between inflation and unemployment. There is the problem of explaining stagflation. There is also the problem of tracing the transmission of the monetary impulse to the price level. Some of the monetarist models discussed throw light on these issues.

The chapter on rational expectations discusses a major new development in monetary macrodynamic models. The rationale for the separate discussion is that it matters very much how expectations on the part of economic agents are assumed to be formed. They must be consistent with individual optimizing behaviour. The rational expectations hypothesis incorporates the insight of information theory and employs consistently the

idea of 'equilibrium' macro-dynamic models. Equilibrium implies that (a) markets clear (b) agents act in their own self-interest. The notion of equilibrium is that of an economy following a multivariate stochastic process satisfying conditions (a) and (b) at each point in time. The implications of the rational expectations hypothesis for the neutrality of money, transmission mechanism, stabilization policy are discussed.

The chapter on monetary policy pulls together in a general way the results on stabilization policy discussed in the earlier chapters. Friedman's summing up has been the most influential general statement of monetarist policy recommendations. Also discussed are empirical attempts to determine the effectiveness of alternative policy prescriptions. The procedures employed raise several methodological considerations.

The concluding chapter considers methodological issues of a general nature that should be taken account of whilst evaluating the monetarist programme. A summing-up closes the present discussion of the monetarist paradigm.