67. ECONOMIC SCHOOL OF MONETARISM

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Monetarism is an economic school of thought that stresses the primary importance of the money supply in determining nominal GDP and the price level. The "Founding Father" of Monetarism is economist Milton Friedman.

Inflation was high and rising through the 1970s and Friedman argued convincingly that the high rates of inflation were due to rapid increases in the money supply. He argued that the economy may be complicated, but stabilization policy does not have to be. The key to good policy was to control the supply of money. In the short term M. Friedman stated there may be a trade off between unemployment and inflation.

Therefore in the long term output has stated the same but inflation has increased. Higher inflation has not been accompanied by lower unemployment. Any reduction in unemployment due to increased combined demand would only be temporary. Monetarist argues that Unemployment cannot be altered by combined demand in the long run. But will remain at its Natural Rate which would be 5 %.

Friedman argues that, in the short run, both price level and real output increase when the money supply increases. As real output increases, the employment level will change as well, since the increased output has to be produced by a greater number of workers (the level of technology is assumed to remain unchanged in the short run).

Monetarism is a mixture of theoretical ideas, philosophical beliefs, and policy prescriptions. The theoretical foundation is the Quantity Theory of Money. The Fed should be bound to fixed rules in conducting monetary policy. They should not have discretion in conducting policy because they could make the economy worse off. Fiscal Policy is often bad policy. A small role for government is good.

An economic theory proposes a positive relationship between changes in the money supply and the long-term price of goods. It states that increasing the amount of money in the economy will eventually lead to an equal percentage rise in the prices of products and services. Proposition — that money supply has a dominant effect on nominal income — is the most basic part of the theoretical structure of the monetarist counterrevolution.

Monetarists explain the increase in employment and real output as an increase in money supply leads to an increase in price level. However, workers do not ask for increases in nominal wages to offset the price increase, as they are initially unaware of it. However, producers know the increased prices their goods and services are commanding. Thus, from the producers' (employers') point of view, the real wage paid actually falls (i.e., the dollar wage paid remains the same whereas the price level increases). This effectively lowers the cost of hiring workers and they employ an increased number of workers, leading to higher employment and higher real output.

Crucial to increases in output and employment is the decline in real wages paid to workers. However, the decline in real wage was caused due to workers being unaware of the increase in price levels. It is argued that workers cannot remain uninformed about the price level increase, as they pay higher prices for the goods and services they consume.

Monetarists rely on a macroeconomic model that illustrates that the private sector of the economy is not prone to massive fluctuations and is inherently stable. Monetarist policy recommendations basically assert that the government should not use monetary and fiscal policies to stabilize the economy. Monetarists argue that beneficial effects of monetary policy are short-lived and harmful effects prevail. This is one of the reasons monetarists do not recommend using discretionary monetary policies.

Monetarists thus advocate using neither discretionary monetary or discretionary fiscal policy to stabilize the economy — they would like to see money supply grow at a constant rate.

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