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WHAT IS MONETARISM?

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Q: What is monetarism?
A: Monetarism is the name given to a version of the quantity theory of money.

Q: What is the quantity theory of money?
A: It is an argument about the linkage between money and prices. Its origins go back centuries.

Q: What does it say?
A: It says that, if the amount of money in circulation increases, prices will rise.

Q: Is that all?
A: That is a rudimentary description of the general experience throughout recorded history. The quantity theory attempts to explain why this is so.

Q: Well, please explain it to me.
A: The explanation is in terms of the reasons for holding money. Empty your pockets.

Q: Pardon?
A: Empty your pockets. How much money do you have?

Q: Let’s see ... I have twenty-six pounds and fifty-three pence. So what?
A: Why do you have that amount? Why not twice as much, or half as much?

Q: If I gave it some thought, I could probably come up with a number of reasons.
A: Undoubtedly; and I expect that one reason might be the amount you typically spend in a day which, in turn, might be related to your income.

Q: Possibly.
A: The point is this: we are discussing your demand to hold money.

Q: What is there to discuss?
A: The linkage between money and prices rests upon a theory relating to the willingness (or otherwise) of individuals and institutions to hold money.

Q: Tell me about it.
A: Monetarism places the decision to hold money within the context of a wealth portfolio which contains different kinds of assets: money, bonds, equities, land, property, vehicles, furniture ... the potential listing is endless.

Q: And its relevance?
A: The critical feature is its composition. Is it balanced in respect of potential yields and risks? If it is not, some assets may be sold or exchanged for others.

Q: I presume that this is where you find the linkage between money and prices?
A: Indeed, it is. Suppose the authorities increase the amount of money in circulation (say, by or granting generous public sector pay increases). This new money enters asset portfolios belonging to the various recipients of that money.

Q: Doesn't it just circulate?
A: Money in circulation is always in someone's possession; so, money 'in circulation' is always resting within someone's asset portfolio. However, a willingness to receive money doesn't imply a willingness to retain it.

Q: It gets spent.
A: It may do. If an individual believes that he holds an excessive amount of money, he will get rid of it.

Q: By spending; but on what?
A: On anything: money, bonds, equities, land, property, vehicles, furniture ... anything.

Q: So?
A: This extra demand for goods has the general effect of causing prices to rise.

Q: A linkage between money and prices.
A: Yes!

Q: Neat. Who devised this theory?
A: A long list of notable contributors includes Jean Bodin (1568), John Locke (1692), David Hume (1752), John Stuart Mill (1848), Irving Fisher (1911), Alfred Marshall (1926) and Milton Friedman (1956).

Q: I've heard of Friedman.
A: Yes, Friedman takes credit for reviving the theory after its virtual abandonment in the immediate post-war era of Keynesian economics.

Q: When did this revival take place?
A: Friedman published a new technical exposition of the quantity theory in 1956, but his work became widely disseminated after his presidential address to the American Economic Association in 1967.

Q: What was Friedman's particular contribution?
A: He argued for a linkage between money and prices through the impact of inflation expectations in the labour market.

Q: We have discussed inflation and unemployment before.
A: Yes: the Phillips curve; but that simple relationship broke down as governments attempted to use inflation to reduce unemployment.

Q: Ah, yes!
A: Friedman (but credit must also be given to another American economist, Edmund Phelps) had predicted that breakdown before it happened.

Q: The breakdown occurred after 1967.
A: Yes. The 'disappearing' Phillips curve sent lesser economists scurrying to find out why.

Q: And this launched monetarism in a big way?
A: Indeed. Friedman's arguments were so distinct from Keynesian economics that a new terminology became necessary. In 1968, Karl Brunner called it 'monetarism' and the name has stuck.

Q: Monetarism seems such a simple and obvious notion.
A: Maybe; but it has generated great controversy.

Q: Why?
A: Largely because of its implications for Keynesian economic policy: for the idea that monetary policy is not an instrument for managing the economy.

Q: Please tell me more.
A: Keynes rejected the quantity theory. He said that it was relevant only at full employment.

Q: Why?
A: He argued that, when there is spare capacity, monetary expansion boosts output and jobs, not prices.

Q: That has plausibility.
A: Certainly it has. The vast majority of professional economists were taken in by the idea.

Q: Were you?
A: Of course not! Nor was Friedman; nor were others who forecast that attempts to maintain high demand by monetary manipulation would be self-defeating.

Q: Because it raises prices?
A: Because it raises prices.

Q: So how would you summarise the essential message of monetarism?
A: The most succinct statement is Friedman's aphorism: 'inflation is always and everywhere a monetary phenomenon'.

Q: What else could it be?

A: According to Keynesian economists, inflation is a ‘cost push’ phenomenon, rather than the consequence of an excess demand for goods which is created by an over-supply of money.

Q: ‘Cost push’ and ‘demand pull’ inflation!
A: That’s it! Keynesian ‘cost push’ and monetarist ‘demand pull’.

Q: Cost push is where (say) trade unions or rising import prices have been blamed for inflation ...
A: ... whereas the government is actually responsible by reason of an excessive monetary expansion.

Q: So Keynesians are associated with the political right, blaming inflation upon trade union militancy?
A: No! Keynesians are associated with the political left, blaming unemployment on too little public sector investment.

Q: And I thought that I had understood ...
A: ... you have, so far, but ...

Q: Can we stop there?
A: Perhaps we should.