THE NEW CLASSICAL ECONOMY AND COUNTER-REVOLUTION OF THE MONETARISM

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Abstract
The new classical economy as a school of economic thinking is developed on the basis of monetarism during 70's and 80's of the last century. At that time, monetarism as an extreme monetarist formulation had its golden era when it was necessary to maintain the money supply fairly stable, and that will increase slowly each year , mainly to allow natural growth of the economy. Monetarism spread in favor of economists, and the relationship between different measures of the money supply and inflation proved to be less clear than many monetary theories suggest. In this paper will be analyzed characteristics of monetary position, neglected role of money in Keynesian's models, Phillips agreement for inflation / unemployment and the role of expectations.

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Classification JEL: *B0, B3, B22, E.*

1. Introduction

The centre of the monetarism is the University of Chicago, acquired its name for the first time in the 30's of the 20-th century. Its intellectual leaders in the 50s were F. Knight, in the field of theory and methodology and H. Simmons in the field of economic policy. In the next generation the most dominant role had M. Friedman, J. Stigler and D. Becker. Many economists who weren't educated in Chicago, joined the "Chicago positions," though many professors at the University of Chicago denied "Chicago doctrine." The best works of the Chicago School are Simons' Economic Policy for a Free Society and Friedman's book Capitalism and Freedom.

The interventionist monetary and fiscal policies that the orthodox post-war economics recommended came under attack in particular by a group of theorists working at the University of Chicago, which came to be known as the Chicago School. This more conservative strand of thought reasserted a "libertarian" view of market activity, that people are best left to themselves, free to choose how to conduct their own affairs. More academics who have worked at the University of Chicago have been awarded the Nobel Prize in Economics than those from any other university.

In the recent years, however, monetarism has spread in favor of economists, and the relationship between different measures of the money supply and inflation proved to be less clear than most monetary theories suggest. It is closely associated with Milton Friedman, who argued that, based on the quantity theory of money, the state should keep the money supply fairly stable, increasing it slowly each year, mainly to allow natural growth of the economy. Today, many central banks have stopped setting monetary targets, and instead of it, they accepted the stringent targets for inflation.

Authentic monetarist position is characterized by the premises: for short-term non-neutrality and long-term neutrality of money [1]. That can be realized by the means of:

- the institutions that will reduce uncertainty and
- encouraging the state to follow the rules instead of discretion rights.

The first works on the relations of money and the price level are characterized by:

(1) the relation does not depend on time and space; and
(2) there is an inverse relationship between the amount of money and the value of the currency.

This later developed into an attitude that money is non-neutral in the short-term (has real effects on output during the adjustment and transition from an equilibrium to another) but money is neutral in the long term, because the effects gradually disappear.

The leading neoclassicist (Jevons, Marshall, Fisher, Wicksell) were supporters of the gold standard and fixed rates because of preserving the transparency of money and obstruction of sudden fluctuations. Keynesian revolution, as a result of the concerns of different variations, moves the emphasis toward institutional arrangements that will allow the government and the central bank action which should cause or prevent any developments in the future.

Neoclassicist view the cycles as deviations from equilibrium for various reasons, so these cycles were considered as the natural flow of things. Keynesian's believed in "liquidity trap" interest rates reach their historical lows because of pessimism and mistrust and that any increase in the money supply can not topple them, and besides that the wages and rigid. This meant that monetary policy is ineffective (money-income link is weak, the changes are effected in the long run) and a different route than demand is needed, which should revive with fiscal stimulus. On top of Keynesian's fluctuations in economic activity are accepted only as a product of changes in the investment, the offer passively comply with the demand, and interest money and prices almost had no role in contemporary models.

2. Counter-revolution of monetarism

Monetarism is used as an important element of the theoretical basis for the conduct of economic policy in the US and some other developed countries. Monetarists point out that the "invisible hand" is more effective than state intervention, the private sector is inherently stable, the state should control the money supply, economic policy should rely on strict rules and, above all, on monetary policy. Monetarism advocates free market activity, increased role of the private sector in carrying out economic activity and limit the role and importance of the state of an economy. Supporters and representatives of monetarism paid particular attention to the study of issues related to monetary theory and monetary policy.

As so often happens, just about the time that Keynes's ideas were being triumphant in practice, they were losing their hold on the minds of scholars in the academies. A number of factors contributed to a change of attitude towards the Keynesian doctrine. One was the experience immediately after World War II. On the basis of the Keynesian analysis, economists and others expected the war to be followed by another great depression. With our present experience of over two decades of inflation behind us it is hard to recognize that this was the sentiment of the times.

But alike in the United States, in Great Britain and in many other countries, the dominant view was that, once World War II ended, once the pump-priming and government spending for military purposes ended, there would be an enormous economic collapse because of the scarcity of investment opportunities that had been given the blame for the Great Depression. Massive unemployment and massive deflation were the bugaboos of the time. As you all know, that did not happen. The problem after the war turned out to be inflation rather than deflation.

A second post-war experience that was important was the failure of cheap money policies. In Britain, Chancellor Dalton tried to follow the Keynesian policy of keeping interest rates very low. As you all know, he was unable to do so and had to give up. The same thing happened in the United States. The Federal Reserve System followed a policy of pegging bond prices, trying to keep interest rates down. It finally gave up in 1953 after the Treasury- Federal Reserve Accord of 1951 laid the ground-work for setting interest rates free. In country after country, wherever the cheap money policy was tried, it led to inflation and had to be abandoned. In no country was inflation contained until orthodox monetary policy was employed. Germany was one example in 1948; Italy shortly after; Britain and the United States later yet [2].

Monetarism is neoclassical "*counter-revolution*" against:

- Institutionalism in economic methodology
- Keynesian macroeconomics and intervention action

In the history of monetarism there are three phases: the first is focused on the neglected role of money in Keynesian models; the second on Phillips agreement inflation / unemployment and the third on the role of expectations.

In the first phase, K. Warburton first pointed out that the real cycles are associated with minority interest of money, that mistaken offer of money is the most important cause of vibration, that there is short-term non-neutrality of money on production and long-term neutrality. M. Friedman joined to his work in the mid-50s with labor Studies for the quantitative theory of money, Monetary History of the United States from 1867 to 1960, in which various ways he neglected Keynesian view on the role of money: money is a substitute for real and nominal assets, not just for bonds, so the potential of money is expressed in a broad portfolio of property; changes in money are closely related, naturally precede or late the change of actual units, and the Great Depression is not the result of demand deficit but the wrong adjusted monetary policy, rather than lower interest rates, turned to the gold standard. Followed by the works of leading monetarists who found that the demand for real balances is a function of interest and continuous income. Until 70's the hard core of monetarism is set out : the money grow or fall pro-cyclical; acceleration or deceleration of the money delay is followed by cyclical expansion or contraction of the real product; stable monetary growth that is relative to outcome is a sufficient condition for inflation; the growth of circulation is pro-cyclical [3].

In the sphere of politics the first phase highlighted the following: the economy can achieve greater stability if operational procedures are set up in a way that will remove the pro-cyclical money; the relation of money and production is a result of operating procedures, and it can be removed.

This was a monetary cause for the Great Depression, not as Keynes argued, the product of the inherent instability of the market economy and a lack of aggregate demand. Friedman and Schwartz's Monetary History of the United States argued that crises of 1920-21, 1929-33 and 1937-38 are caused by the collapse of the monetary amount (reduced real money supply at higher prices), a K. Brunner and Melder identified it with mechanical identification of the "low" interest with monetary "tightening" (eg the interest marked downward trend, the Federal Reserve of the USA allowed decline in the monetary base, producing an insufficient supply of money). There wasn't a distinction between pulses and amplifiers:

(1) monetary pulses have dominant, but not the unique role in initiating the recession;
(2) distribution of shock is not permanent (sometimes real or monetary ones are dominant;
(3) the relative importance of the shock depends on the nature of the monetary regime (in the gold standard everything depends on gold;
(4) a combination of real and monetary shocks, despite dominating the real ones, the choice of monetary regime double acts on stability: first, reducing the size and frequency of monetary shock and secondly, removing monetary response to real shock. Bruner writes about it: "Firstly, monetary impulses are the main factor of variations in production, employment and prices. Second, changes in the quantity of money is the surest measure of the nature of the monetary impulse. Third, the conduct of monetary authorities affect the movement of the quantity of money in the cycle [4]. The argument that that monetary policy is weak and ineffective has been replaced by arguments that the effects of money is uneven.

The second phase began in the mid 60's and has been focused on three issues: first, fiscal action of the country has small and insignificant effects on overall economic activity; second, stable proportion inflation – unemployment is elaborated in the spirit of the Phillips curve, as inability of trading with these aggregates on long terms, and finally the international aspects of inflation are explored.

The third phase brings joining the hypothesis of rational expectations and the natural rate of unemployment. The foundation of the "new classical macroeconomics" are rational expectations or attitude that individuals effectively use all the information and learn from past experience. They no longer look to the past, nor do extrapolate past behavior, but look to the future and considering that politics is guided by precisely defined rules, they are able in time to anticipate and hinder any adverse consequences. The biggest disadvantage, according to Brunner and Meltzer, is that "uncertainty, incomplete knowledge of the subjects in the economy and the cost of procurement of information and reducing uncertainty are all neglected ."

The approach of the new classical macroeconomics is based on asymmetric information handling: costs are zero or insignificant, and gains are significant. Instead, classical monetary view is that it is the uncertainty that initiated such institutions, such as money as a medium of exchange. Also, expensive information disable instant adjustment of prices and it is possible a short-term rigidity. Furthermore, economic processes are not deterministic and not so predictable and it takes a long time to discern them. Therefore, they conclude: Monetary, Keynesian and New classical approach to money-production ratio(relation).

Table No. 1. Monetary, Keynesian and New Classical approach

Problem	Monetarists	Keynesians	New-Classical
Monetary changes affect real income	**Yes**	**Yes**	**No**
Activist discretionary policy reduces fluctuations	**No**	**Yes**	**No**

Monetarist and most of the Keynesian accept that money influence economic activity and prices. "The radical Keynesians" and "new classical macroeconomics" deny any kind of money influence on production. According radical Keynesians money is a residual economic size, there are just as "credit money" as a passive variable determined by the volume of activity and changes in the volume of money and circulation are mutually canceled. The new classical macroeconomics clarifies the passiveness of money with the actual causes of the cycles of technological progress. First rigidity of prices translates it into an imbalance, and the second abundance of free information translates them into balance.

Monetarism has made a number of important and lasting contributions to modern macroeconomics. As a result of the monetarist counter-revolution it is now widely (but not universally) accepted that [6]:

- In the long run there is no trade-off between inflation and unemployment, and that the long-run Phillips curve is vertical at the natural rate of unemployment.
- Sustained inflation is a monetary phenomenon-a majority of economists and policy makers now emphasise the rate of growth of the money supply when explaining and combating inflation over the long run.

- The primary goal of monetary policy should be the pursuit of a low and stable rate of inflation. Interestingly, since the 1990s, inflation targeting has been adopted in a number of countries (see, for example, Mishkin, 2002 and Snowdon and Vane, 2005, Chapter 7). What has not survived the monetarist counter-revolution is the 'hard core' proposal put forward by some monetarists that the authorities should pursue a fixed rate of monetary growth. As mentioned earlier the case for such a rule was seriously undermined by the collapse of the stable demand for money function and the sharp decline in trend velocity in the 1980s in the US and elsewhere.
- The potential of activist discretionary fiscal and monetary policy is much -more limited than was once held to be the case in the 1950s and 1960s by orthodox Keynesians.

However, in 1965-1975 a "monetarist" economist was somebody who believed [7]:

(1) That's inflation expectations could not be kept far below actual inflation for long, and that proper microeconomic policy sought not to exploit any Phillips-Curve tradeoff but rather to focus on stable money-supply growth, stable nominal GDP growth, and an unemployment rate at its natural rate.
(2) Monetary policy was a more powerful and effective macroeconomic stabilization policy tool than fiscal policy.

3. Key propositions of monetarism according to M. Friedman

Milton Friedman (1912–2006) stands as one of the most influential economists of the late twentieth century. He won the Nobel Prize in Economics in 1976, among other things, for A Monetary History of the United States (1963). Friedman argued that the Great Depression had been caused by the Federal Reserve's policies through the 1920s, and worsened in the 1930s. Friedman argues laissez-faire government policy is more desirable than government intervention in the economy. Governments should aim for a neutral monetary policy oriented toward long-run economic growth, by gradual expansion of the money supply. He advocates the quantity theory of money, that general prices are determined by money. Therefore active monetary (e.g. easy credit) or fiscal (e.g. tax and spend) policy can have unintended negative effects. In Capitalism and Freedom (1967) Friedman wrote:

There is likely to be a lag between the need for action and government recognition of the need; a further lag between recognition of the need for action and the taking of action; and a still further lag between the action and its effects.

(1) There is a consistent though not precise relation between the rate of growth of the quantity of money and the rate of growth of nominal income. (By nominal income, I mean income measured in pounds sterling or in dollars or in francs, not real income, income measured in real goods.) That is, whether the amount of money in existence is growing by 3 per cent a year, 5 per cent a year or 10 per cent a year will have a significant effect on how fast nominal income grows. If the quantity of money grows rapidly, so will nominal income; and conversely.

(2) This relation is not obvious to the naked eye largely because it takes time for changes in monetary growth to affect income and how long it takes is itself variable. The rate of monetary growth today is not very closely related to the rate of income growth today. Today's income growth depends on what has been happening to money in the past. What happens to money today affects what is going to happen to income in the future.

(3) On the average, a change in the rate of monetary growth produces a change in the rate of growth of nominal income about six to nine months later. This is an average that does not hold in every individual case. Sometimes the delay is longer, sometimes shorter.

(4) The changed rate of growth of nominal income typically shows up first in output and hardly at all in prices. If the rate of monetary growth is reduced then about six to nine months later, the rate of growth of nominal income and also of physical output will decline. However, the rate of price rise will be affected very little. There will be downward pressure on prices only as a gap emerges between actual and potential output.

(5) On the average, the effect on prices comes about six to nine months after the effect on income and output, so the total delay between a change in monetary growth and a change in the rate of inflation averages something like 12–18 months. That is why it is a long road to hoe to stop an inflation that has been allowed to start. It cannot be stopped overnight.

(6) Even after allowance for the delay in the effect of monetary growth, the relation is far from perfect. There's many a slip 'twixt the monetary change and the income change.

(7) In the short run, which may be as much as five or ten years, monetary changes affect primarily output. Over decades, on the other hand, the rate of monetary growth affects primarily prices. What happens to output depends on real factors: the enterprise, ingenuity and industry of the people; the extent of thrift; the structure of industry and government; the relations among nations, and so on.

(8) It follows from the propositions I have so far stated that inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output. However, there are many different possible reasons for monetary growth, including gold discoveries, financing of government spending, and financing of private spending.

(9) Government spending may or may not be inflationary. It clearly will be inflationary if it is financed by creating money, that is, by printing currency or creating bank deposits. If it is financed by taxes or by borrowing from the public, the main effect is that the government spends the funds instead of the taxpayer or instead of the lender or instead of the person who would otherwise have borrowed the funds. Fiscal policy is extremely important in determining what fraction of total national income is spent by government and who bears the burden of that expenditure. By itself, it is not important for inflation.

(10) One of the most difficult things to explain in simple fashion is the way in which a change in the quantity of money affects income. Generally, the initial effect is not on income at all, but on the prices of existing assets, bonds, equities, houses, and other physical capital. This effect, the liquidity effect stressed by Keynes, is an effect on the balance-sheet, not on the income account. An increased rate of monetary growth, whether produced through open-market operations or in other ways, raises the amount of cash that people and businesses have relative to other assets. The holders of the now excess cash will try to adjust their portfolios by buying other assets. But one man's spending is another man's receipts. All the people together cannot change the amount of cash all hold—only the monetary authorities can do that. However, as people attempt to change their cash balances, the effect spreads from one asset to another. This tends to raise the prices of assets and to reduce interest rates, which encourages spending to produce new assets and also encourages spending on current services rather than on purchasing existing assets. That is how the initial effect on balance-sheets gets translated into an effect on income and spending. The difference in this area between the monetarists and the Keynesians is not on the nature of the process, but on the range of assets considered. The Keynesians tend to concentrate on a narrow range of marketable assets and recorded interest rates. The monetarists insist that a far wider range of assets and of interest rates must be taken into account. They give importance to such assets as durable and even semi-durable consumer goods, structures and other real property. As a result, they regard the market interest rates stressed by the Keynesians as only a small part of the total spectrum of rates that are relevant.

(11) One important feature of this mechanism is that a change in monetary growth affects interest rates in one direction at first but in the opposite direction later on. More rapid monetary growth at first tends to lower interest rates. But later on, as it raises spending and stimulates price inflation, it also produces a rise in the demand for loans which will tend to raise interest rates. In addition, rising prices introduce a discrepancy between real and nominal interest rates. That is why world-wide interest rates are highest in the countries that have had the most rapid rise in the quantity of money and also in prices—countries like Brazil, Chile or Korea. In the opposite direction, a slower rate of monetary growth at first raises interest rates but later on, as it reduces spending and price inflation, lowers interest rates. That is why world-wide interest rates are lowest in countries that have had the slowest rate of growth in the quantity of money—countries like Switzerland and Germany. This two-edged relation between money and interest rates explains why monetarists insist that interest rates are a highly misleading guide to monetary policy [8].

4. Conclusions

As Keynesian economics began to supersede the classical theory, which later proved not to be able to explain the events from 1930, Keynesian economics was caused, which again proved not to match to the economy in the 1970s. The model of Keynes argued that unstable aggregate demand causes instability of market economies, excessive aggregate demand and inflation cause expansions, and insufficient aggregate demand and unemployment cause recessions. The solution was to correct fluctuations in the private market with an opposing government policy or by slowing aggregate demand during the expansion, and increasing aggregate demand during a recession.

In 1970, in the United States followed a period of simultaneously rising of inflation and unemployment, but it was not in accordance with Keynesian model. Changes in aggregate demand caused inflation and unemployment to move in the opposite direction, but not together. Keynesian policy had no proposals for current economic problems. Some used expansionary policies to fight unemployment even at a cost of worsening inflation, while others used restrictive policy to fight inflation at the cost of worsening unemployment.

Since Keynesians had no immediate explanation or solution, people began to explore other alternative solutions. A small group of macroeconomists, led by Milton Friedman, caused the Keynesian economic thought, but because later it was proved not to function so well, they were not able to affect significantly the economic theory and government policy.

Friedman was also known for his work on the consumption function, the permanent income hypothesis (1957), which Friedman himself referred to as his best scientific work. This work contended that rational consumers would spend a proportional amount of what they perceived to be their permanent income. Windfall gains would mostly be saved. Tax reductions likewise, as rational consumers would predict that taxes would have to rise later to balance public finances. Other important contributions include his critique of the Phillips curve and the concept of the natural rate of unemployment (1968). This critique associated his name with the insight that a government that brings about higher inflation cannot permanently reduce unemployment by doing so. Unemployment may be temporarily lower, if the inflation is a surprise, but in the long run unemployment will be determined by the frictions and imperfections in the labour market.

In the end, the monetarist theory, as Friedman's reworking of the traditional quantity theory of money was to be called, progressed at the same time as the neoclassical synthesis and grew, apparently, in conflict with it, as it presented itself as a criticism of Keynes's economics, while the neoclassical economists of MIT were proclaiming themselves as 'neo-Keynesian'. The monetarist counter-revolution began in 1956, when Friedman published 'The Quantity Theory of Money: A Restatement'. This famous article was followed by other important works, later collected in The Optimum Quantity of Money (1969), which contains the foundations of monetarist theory.

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