Monetarist interpretation of Business Cycles

Let us explain how monetarist theory explains business cycles with upward sloping short-run aggregate supply curve and changes in money supply or changes in growth of money supply. We first take the case how recession is caused in this theory.

According to monetarists, when there is slowdown in growth in money stock by the action of the Central Bank of the country, aggregate demand decreases. With the upward sloping short-run aggregate supply curve, given the wage rate, the decrease in aggregate demand brings about decline in both price level and national output and employment causing unemployment in the economy.

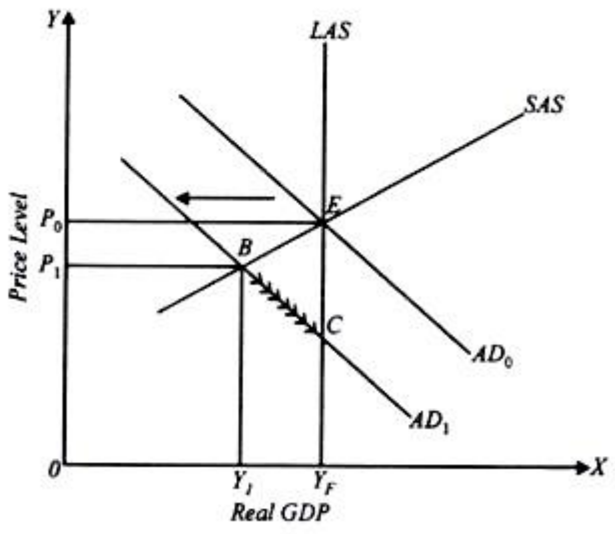

Fig. 27A. 2 *Explaining Recession: Monetarist Theory.*

That is, the economy experiences recession. This is shown in Fig. 27A.2 where to begin with AD_0 is the aggregate demand curve which cuts both the vertical long run aggregate supply curve LAS and the upward-sloping short-run aggregate supply curve SAS at point E.

At point E the system is in long- run equilibrium. Now if there is a slowdown in growth of money supply causing a leftward shift in aggregate demand curve from AD_0 to AD_1 . As a result, the economy moves to the new equilibrium point B at which aggregate demand AD_1cuts the short-run aggregate supply curve SAS. It will be seen from Fig. 27A.2 that at point B aggregate output is smaller than the potential GDP level, unemployment in the economy will emerge.

However, as mentioned above, monetarists believe that wage rate is only temporarily sticky. When aggregate demand decreases due to slowdown in growth of money supply and causes increase in unemployment, money wage rate will eventually begin to fall. As shown in Fig. 27A.2, with the fall in money wage rate short-run aggregate supply curve (SAS) shifts downward result in fall in price level.

Short-run aggregate supply curve (SAS) goes on shifting downward until the equilibrium is reached at point C at the level of potential GDP level V_F where full employment prevails. Thus, according to monetarist theory, through adjustment in money wage rate and price, the economy again reaches full-employment equilibrium and unemployment is eliminated.

In this way monetarists explain how with the fall in growth of money supply, the economy goes into recession and then through adjustment in wage rate and price level new full-employment equilibrium is automatically achieved at lower wage rate and price level.

Importance of lags:

If the monetarist theory would have stopped at explaining that changes in money supply are the major source of cyclical fluctuations in the economy, it would not have been much impressive as many Keynesian also believe that changes in money supply are important source of macroeconomic instability.

There must be more in monetarist theory as it emerged as an important alternative to Keynesian explanation of cyclical fluctuations in the economy. However, monetarists view of cyclical fluctuations has been founded as much on empirical evidence as on theoretical reasoning in terms of money shocks to the economy causing cyclical fluctuations.

Friedman and his followers quoted a lot of evidence of historical episodes in favour of their viewpoint but also showed that there is a time lag between changes in money supply and their actual effect on aggregate demand and the real economy and further that this time lag is quite uncertain.

That is, changes in money supply do not immediately affect aggregate demand or spending on goods and services. The initial effect of changes m money supply is on interest rate and wealth. The initial expansion in money supply is spent on financial assets, i.e. bonds and shares etc. driving their prices up and thereby lowers interest rate.

Eventually lower interest rate and increase in their wealth leads to increase in investment demand for capital goods and demand for consumer goods and services (note that rise in prices of bonds and shares causes wealth of individuals to increase).

How this changes in aggregate demand for goods, both capital and consumer goods, affect the price level and aggregate output (GDP) depends on, as explained above, on the response of supply of output to it. It needs to be emphasized that the lag between the increase in money supply and its effect on aggregate demand is uncertain and variable.

It may be a few months, a year or more for a given increase in money supply to produce its effect on aggregate demand and hence on price level and output. It is errors of judgement on the part of Government or monetary authority about when recession starts in the economy.

It may happen that the Central Bank injects more money supply to fight recession when trough of recession might be several months in the past. If so, the injection of more money supply at such time may magnify the expansion already in progress and possibly may cause the economy to overheat so that aggregate demand increases beyond the potential GDP level.

According to the monetarists, such excessive aggregate demand pressure generally prompts the Central Bank to contract money supply (or reduce the growth of money supply) which will cause AD curve to shift to the left and ease demand pressure.

However, according to them, the Central Bank may decide to contract the money supply when aggregate demand is already slowing down on its own. If such is the case, the contraction of money supply at this time could push the economy into recession.

Thus, according to monetarists, intervention by the Central Bank through changes in money supply only aggravates the natural tendency of cyclical fluctuations to be of small amplitude. These small natural fluctuations, according to them, are caused by imperfect information, weather shocks and changes in international factors.

Critical Evaluation:

Most economists, even Keynesians, believe that large money supply changes have a destabilising effect on the economy. But the monetarist's view that money supply changes alone are responsible for cyclical fluctuations does not appear to be correct.

As Keynes asserted even without any significant money supply changes, changes in investment demand due to changes in marginal efficiency of capital (i.e., expected return on capital) are important factors that determine changes in aggregate demand and cause cyclical fluctuations in economic activity.

Besides, it has been observed that when to pull the economy out of recession, the Central Bank takes steps to increase the money supply it may have no effect on aggregate spending due to lack of investors' confidence and bleak prospects for profit making.

For example, in 2007-08 when worst ever recession took place since the Great Depression of 1930s, the Federal Reserve had pumped into the economy a large amount of money, reduced its lending rate to almost zero, but it did not lead to greater investment and consumption spending.

In fact, those who got the extra money decided to hold on to it rather than spending it due to uncertain future economic environment. Because of the limitation of monetary expansion to revive the American economy, along with the expansionary monetary policy the adoption of fiscal stimulus policy measures helped the recovery of the US economy.

Further, monetarists think that economy is inherently stable and left to itself it would automatically correct itself through adjustment in wages and prices to restore equilibrium at full-employment (i.e. potential GDP) level. Therefore, they are of the view that Central Bank or Government of the Country should pursue non-interventionist policy.

However, the experience of past (most recently recession of 2007-09) has abundantly showed that the automatic correction has failed to occur. Therefore, an important lesson from the past experience is that the roles of Government and Central Banks to fight recession and curb inflation are of paramount importance.