

A Comparative Study of the Keynesian and Monetarist Views on Economic Stabilization Policy

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Introduction

The history of economic thought tells us that there are basically two diametrically opposed views in every major economic issues in each period of its development. It is but natural for economists to have two views on the role of money. Whether a change in the supply of money is the cause or consequence of changes in other economic activities is the crux of the debate between Monetarists and Keynesians. If a change in supply of money has great impact on the rest of the economy, then the monetary stability is needed to stabilize the rest of the economy. On the other hand, if there could be fluctuations in the economy quite independent of the supply and, in consequence, the demand for money could vary, then a discretionary monetary policy is needed.

The issue is whether money is nearly all that matters or merely one of many things that matter, as far as economic stabilization policy is concerned. Monetarists contend that changes in the money supply are the crucial determinants not only of the prices, but also of spending, production and employment. Monetary expansion, even if unaccompanied by an increase in Government spending, has a strong stimulative influence on the economy. Monetarists argue that the inflation of the post-war years has been due to an excessive creation of money. And the Great Contraction was tragic testimony to the power of monetary policy.

Keynesians agree that rapid inflation can persist only if the increase in the quantity of money keeps pace with the increase in the value of national income. But the increase in the quantity of money is not the CAUSE of the inflation. It is, however, a necessary condition.

Keynesians have remained unimpressed by the mass of historical evidence produced by Monetarists. They argue that there is no clearly definable "money". There is a spectrum of financial assets possessing varying degrees of "moneyness". Keynesians put stress on the

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concept of liquidity. For them, money is endogenous to the economy. They believed that any attempt to limit the quantity of a money would only result in the public using other monies.

Keynesians held that changes in the money stock, unless accompanied by appropriate changes in Government spending, have little influence on output and employment. They assigned monetary policy only a passive, supporting role to fiscal policy. Its role was the minor one of keeping interest rates low, in order to hold down interest payments in the government budget, contribute to the "euthanasia of the rentier," and may be, stimulate investment a bit to assist government spending in maintaining a high level of aggregate demand.

Classical View

The classical economists held that the economy is inherently stable. The basis of the classical theory of employment is Say's law of markets. It states that supply creates its own demand". If output is determined by the profit maximizing behaviour of entrepreneurs, competitive labour markets, the existing capital stock and the state of technology, then relative prices will tend automatically to adjust so as to eliminate a deficiency or excess of demand for goods and services. The classical theory of employment leads to the conclusion that forces operate in the economic system which tend to maintain full employment of productive resources.

The Classical economists did not see any necessity of Government intervention because private investment was sufficient to utilise the funds provided by private saving. Any attempt to increase total spending by raising Government expenditures and financing the Government deficit by either borrowing from the public or taxing them, merely induce changes in relative prices so as to reallocate the same level of real output.

Keynesian View

The Great Depression of 1929-33 seriously questioned the validity of classical theory of employment and its assumption of automatic full-employment. The British economist J. M. Keynes offered a non-monetary interpretation of the Depression. The fundamental argument of Keynes is directed against the belief that price flexibility can be depended upon to generate full employment automatically.

"There are no automatic processes that will produce under all circumstances adequate aggregate demand. Private consumption and private investment will not automatically produce this result. And no other explanation for this has so far been offered that is as satisfactory as that presented by Keynes".

Keynesians contend that the economy is oscillatory or subject to fluctuations and that it has a tendency to move about a position of underemployment equilibrium. So they advocate very active stabilization actions as a part of Government intervention in the economy. Even if a disturbance is absorbed in the transmission mechanism of the economic forces, Keynesians believe, the time lag is so long that economic welfare will be greatly reduced if short-run stabilization actions are not undertaken.

Keynes' *General Theory of Employment* is the Economics of Depression. Worldwide acceptance of the Keynesian theory and increasing Government intervention in economic affairs, represents the trend of post-depression thinking on stabilization policy. Keynesians assert that fiscal policy—the use of Government power to spend tax—offer the best way to bridge the deflationary gap between insufficient spending and full-potential output. The theoretical rationale given by Keynesians for such reliance on fiscal actions is the simple Keynesian multiplier analysis. It holds that an increase in Government expenditures or a decrease in the rate of taxation induces repeated rounds of spending by consumers and investors, resulting in a multiple expansion or total spending. Keynesians, thus, believe that any fiscal action, no matter how it is financed, has a substantial effect on real output.

Post-Keynesians put forward their main arguments for the supremacy of fiscal policy over monetary policy. Increases in Government expenditures add directly to aggregate demand and reductions in tax rates increase disposable income, thereby increasing aggregate demand. Both of these actions are supposed to have a multiplier effect. Government borrowing adds to wealth which increases spending. With a constant money stock, higher interest rates result which, in turn, reduce the quantity of money demanded. To the extent that the velocity of circulation increases there is a fiscal impact on aggregate demand.

Alvin H. Hansen was the earliest active proponent of the view that spending flows, almost irrespective of the behaviour of relative prices, serve to govern output and employment.

This Keynesian view has been challenged by Monetarists on the ground that it does not give adequate recognition to the influence on total spending of financing Government deficit by borrowing from the public or taxing them. Monetarists argue that Government spending financed by borrowing from the public or them, may reduce other spending to such an extent that there will be little, if any, net increase in total spending. This effect is generally called the "Crowding Out" of private expenditures by fiscal policy actions.

The defenders of the Keynesian view, on the other hand, still insist upon the efficacy of fiscal policy in economic stabilization. They assert that Government finance involves something more than a simple resource transfer from the private sector to the Government sector. An expansionary effect on the economy may be achieved by a rise in Government spending financed by an increase in tax receipts or by bond issuance either to the public or the monetary authorities.

An increase in the rate of Government spending at a time when the money base is not increased requires either of two methods of financing—borrowing from the non-bank public or taxing them. In either method spending by the private sector is reduced by an amount nearly equal to the increase in Government spending, resulting in little, if any, change in the rate of overall spending in the economy. However, if the Federal Reserve System makes it

possible for the commercial banking system to acquire sufficient Government debt to permit financing a rise in Government expenditures without taxing or borrowing from the public, spending will increase. These observations (regarding fiscal policy) have been recognized by both Keynesians and Monetarists. (Early) Keynesians held that changes in the money stock, unless accompanied by appropriate changes in Government spending, have little influence on GNP. Monetary policy was assigned only a passive, supporting role to fiscal policy. They consider fiscal policy extremely powerful tool of economic stabilization, regardless of the source of funds to finance a deficit.

Contemporary Keynesians believe that stabilization of the economy requires an appropriate "mix" of both fiscal and monetary actions. It is known as "Fine Tuning". It seems to be one policy in which flexible monetary actions by FED are combined with occasional but more massive shifts in fiscal action. According to them, changes in bank reserves initiated by FED affect the interest rates of diverse financial assets such as money market instruments and bonds. These interest-rate changes then produce adjustments in financial portfolios and changes in spending. The basic thesis behind it is that Federal Reserve actions operate through the cost and availability of credit.

Monetarist View

While Keynesians stress the necessity of both fiscal and monetary policy to stabilize the economy, Monetarists take a quite different view. They contend that changes in the money stock exert a strong force on aggregate demand, the price level, output and employment. Economic analysis based on the income-expenditure approach usually presupposes a constant price level, thereby abstracting from the distinction between nominal and real money balances and between market interest rates and real interest rates. This failure to take into account the distinction between nominal and real economic magnitudes has frequently led to erroneous stabilization policies.

Monetarists like classical economists believe that the economy is inherently stable, tending toward full employment and sustainable growth. In these circumstances, the best thing the government can do to help the economy realize its full-employment potential is to allow the money supply to grow at the same rate as the economy's capacity to produce. This is the simple "money supply rule".

Monetarists espouse the view that the Federal Reserve System can exercise close control over the nominal money stock. Thus it has the power to stabilize the economy, or at least to let the economy stabilize itself. Unfortunately, this power has been misutilized. They say that Keynesians have intensified rather than mitigated business fluctuations with their well-meaning attempts to stabilize the economy. Money supply growth, as a consequence of discretionary efforts to stabilize the economy, has fluctuated.

Changes in money supply growth are closely associated with changes in income, economic activities, and prices. The amount of money people wish to hold is tied closely to

the level of income. If the supply of money expands faster than the amount people wish to hold, they will try to spend away the unwanted position of their money balances, inflation results. If the money supply expands more slowly than income, rising less rapidly than the amount of money people wish to hold, people will try to build up their money balances by cutting back their spending, unemployment results. This is the basis of Monetarist theory.

Monetarists downgrade the importance of Keynesian fiscal policy and are unsympathetic to the idea of "fine-tuning" the economy.

Monetarists recognize, just as Keynesians do, that the economy is subject to unexpected shocks from changes in expectations and from adjustments to imperfections and structural changes in the economy, Monetarists do not argue that adherence to the "money supply rule" would produce perfect economic stabilization; they simply say that it would yield much better results than the flexible policy mix "fine-tuning" approach now in vogue.

Conclusion

Almost all economists today share the major goals of economic policy: high employment, stable price levels, and orderly economic growth. They agree, in general, that the Government should do what it can to influence total spending in such a way as to achieve these goals. But there is less agreement between Keynesians and Monetarists about the role of different economic policies (fiscal and monetary) in achieving these goals. There are some signs of agreement between them. Monetarist attacks have caused Keynesians to pay more attention than they previously did to the behavior of money. Monetarists are increasingly recognizing that the economy deviates from their theoretical assumptions, and are consequently qualifying the rigidity of their "money supply rule."

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