Lecture Note 18:
The period after Keynes; monetarism and new classicals

The first several decades from 1945 and onwards may rightly be characterized as the Keynesian era in economics. However, many other directions remained active even of less attention was paid to them. One of these was the *NeoRicardian* school whose principal contributor was **Piero Sraffa,** mentioned in the previous note.

The economic policy following from the Keynesian macroeconomic ideas would consist in an active use of financial policy, using government expenditure and revenue to combat unemployment and to counteract business cycles. The political reaction against such policies was slow in materializing, but in the early 1950s it made itself felt, supported by economic reasoning. The most important of the theorists of this direction was **Milton Friedman** (1912 – 2006), giving rise to the economic school of "Monetarism" (the term was coined by **Karl Brunner** (1916 – 1989) in 1968).

Friedman originally chose to study economics under the impression of the great depression in the 1930s. He worked as aresearch assistent to Henry Schultz while estimating demand curves, and among his work of earlier years are those on the *Friedman-Savage hypothesis* (about utility functions under which individuals can be both risk averse and risk loving (buying both insurance and lottery tickets), and the *permanent income hypothesis,* which by now has entered most macro textbooks, according to which consumption is split in a permanent and a temporary component, the latter being the one which figures in the Keynesian short-run equilibrium whereas the other one is what is observed looking at time series og income and consumption.

It may be somewhat confusing that Monetarism obviously strives to reinstall the primary importance of money rather than investment or government expenditure as regulating aggregate demand and at the same time argues that the money supply should not be interfered with. There is however a common element in Friedman's early work and the monetarist ideas, namely the combination of temporary changes and long term developments. Basically, monetarism aims at reinstalling the quantity theory of money as the prime instrument of regulating the economy. According to the updated quantity theory, changes in the money supply will result in price changes which cancel the short run effects on quantities proposed in the Keynesian model, so that the economy will return to the original state but with changed a price level. This means that if the money supply is measured according to its purchasing power, the long term supply is constant. Since the short term regulation of the economy gives only temporary and rather unpredictable effects, the safest policy is to keep the money supply essentially constant, or, in case of underlying economic growth, at the growth rate.

A similar line of reasoning can be applied to other phenomena, notably to the Phillips curve, which became a central part of the macroeconomic discussion of the 60s and 70s, both for Keynesians and new classicals. If we think of the Phillips curve as a temporary phenomenon, conditioned by the actual situation of the economy and the expectations in the labour market, then an economic policy which reduces unemployment will make the workers and employers reassess their assessments of prices and wages, and the result will be an upwards movement of the Phillips curve. So, just as with the money supply, the economy will return to the original situation, only with a higher price level. In this way, the classical notion of a natural rate of unemployment has been reestablished.

A generalization of this reasoning, which appears in many different versions, shows that in all the cases, a short term change in the underlying conditions produces some temporary effects after which the original state of affairs is reestablished. In other words, the individual agents in the economy can be thrown out of an equilibrium state if something unforeseen happens, but after this they will adapt their actions to what has happened and the economy gets back to the equilibrium state. To specify what characterizes this state, the concept of *rational expectations* is introduced (originally by **John Fraser Muth**(1930 – 2005), but mainly connected with the name of **Robert Emerson Lucas Jr.** (1937 –)). Here it is assumed that all individuals know the working of the model (the economy if we identify the model with the economy) and act accordingly, so that they cannot be fooled by some minor changes.