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# Theory of Monetarism and Monetary Policy Reality under Conditions of Transition Economy

*The article deals with the essence and the main principles of monetarism, and analyzes the monetary policy of Ukraine in the light of monetarism concept*

There is an opinion within the Ukrainian academic and political circles that the current economic policy of the state is based on the theory of monetarism which is considered to be the main cause of an independent or forced course of reforms and downward trends in the national economy. According to V. Kolomoitsev, People's Deputy, Doctor of Economic Sciences, Professor, keeping to monetarism in implementing necessary reforms which is accompanied by the growing impoverishment of the population is the main factor of further degradation of Ukraine's economy.

To agree with such an assertion is to acknowledge that the failure of reforms has been caused by the failure of implementing monetarism's ideas which according to many scientists form the ideological basis of market transformations. However, are such considerations well-grounded in the light of the main principles of the monetary theory? Can monetarism and strict policy in the sphere of monetary relations be identified?

Answers to these questions depend on the objective consideration of the monetary theory which is based on a specific approach to the economic regulation in the framework of neo-conservatism as a concept of protecting traditional market values — free entrepreneurship, free competition and private property.

## FROM THE HISTORY OF MONETARISM

Historical sources of monetarism spring from the works of Adam Smith, Jean-Batist Say, David Hume, representatives of the classical school of the economic theory and other scientists who considered a market as a self-regulating system and grounded the advantages of free competition.

The monetarism concept was based on the classical quantitative theory of money which determines the causation between the changing volumes of money in circulation and the level of commodity prices. The most well-grounded expression of this dependence is the equation of the American economist I. Fisher ( $MV=PQ$ ) which was the basis upon which the monetarist theory was formed.

It is considered that monetarism emerged in the 1950s when a group of scientists from Chicago University headed by M. Friedman came out against the Keynesian postulates of the state economic regulation. The first scientific work on monetarism. *Studies in the Quantity Theory of Money* edited by M. Friedman was published in 1956. For the first time the term "monetarism" was introduced by the American researcher K. Brunner in 1968. By using this term he wanted to emphasise that quantity of money in circulation had the decisive impact on the market economy's status.

However, it was only in 1970 that the theory of monetarism was recognised in academic circles when its recommendations helped the developed countries to fight stagflation which the dominant Keynesian theory could not explain.

The policy of deficit financing proposed by the Keynesians was directed at stimulating economic growth at the expense of increasing budget expenses. This policy finally resulted in the loss of control over inflation which was accompanied by falling production and high level of unemployment until the mid-1970s.

That is why, in contrast to the Keynesian theory, the monetarist ideas of stimulating free entrepreneurship, limiting state intervention in the economy and the priority of monetary policy were supported by governmental and scientific circles of the developed countries. In order to fight inflation it was necessary to carry out a comprehensive analysis of the monetary factors' role in the economy. It became possible due to the fact that the founders of monetarist theory modernised the classical quantitative theory of money.

**The important postulate of monetarism based on the quantitative theory is the conclusion that GDP, reflecting the level of business activity, is changed proportionally to the money supply dynamics.** Based on the equation of exchange this conclusion determines the influence of money  $M$  on the price level  $P$  under constant velocity of monetary circulation  $V$  and maximum utilised industrial capacity  $Q$ .

In order to ground this assertion, it was necessary to prove that the velocity of money circulation in a long period was the constant. The founders of the monetarist theory proved it by investigating the nature of demand for money, since the demand is the main factor to determine the velocity of monetary circulation. As Friedman put it, the quantity theory is the theory of demand for money. He considered demand for money of separate individuals who formed their own assets portfolios depending on three

<sup>1</sup> Фридмен М. Количественная теория денег. — М.: Эльф пресс, 1996. — С.19

factors:

- ◆ capital volume
- ◆ profitability of each kind of capital investments

- ◆ consumers' tastes and advantages.

The total demand for money is determined by a number of variables:

- 1) income level
- 2) price level
- 3) bonds' profitability
- 4) shares' profitability
- 5) inflation level
- 6) investments in human capital
- 7) money profitability in the form of deposits

8) other factors, including economic agents' tastes and preferences.

The growth of price and income level increases demand for money, whereas an increase in the profitability of shares, bonds and other assets decreases it.

According to monetarists the functional connection between demand for money and the above changes is constant, and the function itself is stable because a change in any component is compensated by changes in others.

This means that the rate of money circulation is stable, i.e. its changes are insignificant, and the factors which it depends upon can be forecasted. In addition, the speed of money circulation does not depend on a change in the money supply.

The money supply, according to the monetarist theory, is an exogenously specified value which is not directly connected with the economy functioning. Therefore, the main result of a change in it, on condition that demand for money remains stable, is an appropriate change in the price level, i.e. the nominal GDP.

On condition that demand for money is stable and an individual's wealth is distributed between different kinds of assets, a certain part of income is in the cash form. The growth of the money supply increases collective demand because people spend more cash to decrease its level in their portfolio to a habitual level. A consequence of the growing expenses is the general growth of the price level.

Based on the foregoing monetarists have made an important conclusion: **to ensure equilibrium in the economy and to avoid inflation bursts it is necessary to secure a stable level of the money supply, i.e. to make the rate of the money supply growth dependent on the rate of production growth.**

From the viewpoint of monetarism the market economy is a stable system with the inherent tendency to grow smoothly. According to monetarists cri-

sis phenomena therein are caused by exogenous factors the main of which is a change in the money supply. Since demand for money is stable and does not fluctuate sharply as a result of a change in economic conditions, changes in the money supply are unpredictable. Such fluctuations of the monetary stock are caused by the governmental measures

***It is not always justified to identify monetarism with strict monetary policy***

to stimulate collective demand which is proposed by the Keynesians and the central bank's incompetent monetary policy.

Monetarists distinguish two stages in the business cycle of the economy — production upsurge and recession. Sharp fluctuation in the money supply results in unexpected changes in demand and affects the recurrence of development of the economy.

Based on the analysis of empirical data the adherents of the monetarist theory make an important conclusion: each recession in production is preceded by a decline in the money supply and, in contrast, an upsurge is preceded by an increase in the money supply. In other words, changes in the volumes of the money supply obligatorily precede analogues changes in the state of the economy, the term of such preceding being 12—18 months.

To confirm this conclusion M. Friedman and A. Schwartz analyzed the state of money circulation in the USA for almost 100 years. In their book *A Monetary History of the United States, 1867—1960* they prove, using statistical data, that all production recessions in the American economy were preceded by a decrease in the rates of the money supply growth. Primarily this concerns the Great Depression of 1929—1933 when money supply, due to erroneous actions of the Federal Reserve System, decreased by 34%.

The conclusion made by the monetarists has been proved by statistical research: the maximum rates of money supply growth in any business cycle were observed directly before the peak of the cycle, and minimal rates before the cyclic recession.

Using this basis the monetarists have formulated an important postulate: a competent and considered monetary policy prevents protracted depression or an excessive heating in the economy. Therefore M. Friedman proposes to refuse the Keynesian policy of "the cyclic adaptability" which plays a stimu-

lating role during recession (money supply increment) and a restricting role during upsurge (hampering the growth rates of money supply in the economy). The monetary policy produces results with a certain temporal lag, so they may prove different from those expected. While realizing the monetary policy, M. Friedman proposed to use the method of automatically regulated money supply which he called a monetary rule. The main point of it consists in the fact that the central bank must uphold moderate and stable rates of the money supply growth regardless of a change in the phases of a business cycle. According to M. Friedman such growth should be at the level of 3—5% per annum, which answers the real GDP growth in a long-term perspective.

In the monetarists' opinion an advantage of the monetary rule is the removal of undesirable and unpredictable fluctuations in collective demand which have a negative impact on the development of the economy. In addition, the monetary policy stability based on the monetary rule excludes the possibility of inflation aggravation, particularly owing to inflation expectations stimulating a rise in prices. According to the mone-

***The monetary rule envisions automatic regulation of money supply***

tarist theory a change in the money supply can affect the dynamics of real production and employment during a short period (6—8 months) after which it has an impact on prices, i.e. inflation.

**According to M. Friedman inflation is considered a purely monetary phenomenon caused by the fact that the monetary stock growth rate exceeds the volumes of the real GDP growth rate.** So, the monetarists put forward the only goal of the economic policy — inflation fighting which the monetary rule is directed at.

Monetarist ideas were first embodied in the economic policy of developed countries in the 1970s when the growing inflation, instability of currency rates, an increase in interest rates, the aggravation of production recession and the growing unemployment resulting from excessive interference of the state in the economic processes began to seriously threaten the economies of these countries.

In 1974 the Bundesbank determined the benchmarks for the banking reserves and cash growing for a 12-month period. Switzerland, at the same time, introduced a maximum admissible level of the monetary stock M1 growth.

In 1975 the US Congress obliged the

FRS to publish data concerning the dynamics of the monetary aggregates growth. The path of the United States was followed by Great Britain, France and other European countries.

The years 1979—1980 are considered to be the period when monetarist ideas were officially acknowledged, particularly when conservative governments headed by Margaret Thatcher and Ronald Reagan came to power in Great Britain and the USA.

In the late 1970s inflation in the USA expressed itself in two-digit numbers (in 1979 consumer prices index was 11.1%, and wholesale prices index 12.4%), and unemployment embraced 8% of the active population.

The measures of the USA economy improvement program, approved by R.Reagan's administration in 1979—1980, had three main directions, namely:

- ◆ anti-inflation monetary policy based on monetarism
- ◆ financial policy of business stimulation using additional privileges
- ◆ reduction of state interference in the economy (canceling of many state expenses and subsidies).

The USA Federal Reserve System's orientation towards keeping the established parameters of the money supply increase by means of regulating banking reserves has become the basis of the monetary policy.

In spite of the fact that the FRS policy cannot be considered as purely monetarist since the limits of the money supply growth were often revised and the monetary policy instruments were supplemented by other measures (for instance by the credit system's restructuring and improving), — positive results of anti-inflation regulation were recorded in the period of Reagan's economy. The index of consumer prices decreased from 13.5% in 1980 to 2.0% in 1986.

M.Thatcher's government which came to power in Great Britain in 1979 officially declared of its disposition towards monetarism and attracted American economists M.Friedman and K.Brunner to take part in developing its program.

The components of the conservators' monetarist program are as follows:

- ◆ restrictive monetary policy
- ◆ liberalized currency regulation
- ◆ reduced state expenses and liquidation of budget deficit
- ◆ state debt redemption.

Realizing the program the Bank of England determined the limits of money supply growth not for one year as before but for five years. Strict anti-in-

flation measures reduced price growth rates from 18% in 1980 to 3—4% in 1986—1987.

Despite the fact that this result was achieved not only due to the monetary policy measures (changes in the budgetary sphere and structural rebuilding of the economy, large-scale privatization in particular, were of great importance as well), the monetarist recommendations as a whole had a positive impact on the British economy.

Thus, the main ideas of monetarism are as follows:

1. The market economy is a steady system with internal potential for self-management and balance renewal.

2. Economic crises emerge as a result of wrong regulating measures of the state and hence the state interference into economic processes should be minimal and restricted by the monetary policy measures.

3. The amount of money in circulation influences directly the GDP volume since a monetary supply increase in short period leads to production growth and after the complete use of production capacities — to price growth.

4. One of the main reasons of production curtailment is lack of correspondence between circulated money supply and GDP needs, therefore to weaken the business cycle's negative phenomena it is necessary to keep the rates of money supply growth in the economy at a stable level.

5. As a change in money supply does not influence the economic system at once but with a certain lag, the monetary policy should be stable and oriented at a long-term perspective since its frequent changes due to the lag of the results can produce an opposite effect.

It is natural that speaking of monetarism we somewhat simplified and generalized the main postulates of the subject since it is impossible to cover such a complicated and multisided economic teaching within the limits of one article. At the same time the considered aspects enable us to make conclusions concerning substantiation of the assessment of monetarism as a theoretic basis of Ukraine's economic system market reformation.

## MONETARISM IN TRANSITION ECONOMY AND IN UKRAINIAN ECONOMY IN PARTICULAR

 his topic concerns the possibility of using monetarist ideas under conditions of the transition economy,

since this theory was worked out for the developed system of market economy where recession alternates with upsurge. Ukraine's economy is in the state of permanent decline in all its sectors over the whole transitional period. In particular, GDP decreased more than 50% in real measurement during the years of reforms.

Can production decline during transitional period be compared with developed market economy recession under similar conditions? Of course not.

A cyclic crisis in the market economy has internal prerequisites for its economic growth, namely: noncompetitive and technically backward industries stop functioning, as a result outdated equipment is replaced, production expenses decrease and the next cycle starts on a qualitatively new basis with more effective production.

During a transition period economic entities are forced to act under special conditions connected primarily with a transformational decline characterized by a deep economic crisis caused by abolition of planned mechanisms of economic activity arrangement and weak market institutes (or their absence). To create them and make them capable of functioning need deep institutional and structural changes in the economy since the crisis of the transitional period does not contain internal impulses for restoration of economic growth. As a rule this crisis is of a systematic character when high inflation combines with a decline in production, unemployment growth (including hidden unemployment) and a fall in living standards of the population.

It is understandable that without creating institutes of private ownership, free competition and effective antimonopolistic regulation, without an efficient mechanism of bankruptcy and canceling the ruinous practice of subsidizing unprofitable enterprises by the state, effective structural rebuilding of the economy and therefore overcoming the transformational decline are out of the question. Under such circumstances the monetarist theory of business cycles and the fundamental concept of the monetary policy fulfillment (monetary rule) developed on this basis cannot be used.

Under these conditions the idea of the monetary rule concerning the guarantees of stable rates of money supply growth according to the real GDP growth is apprehended as insufficiently adequate to the existing conditions. In a transition economy money demand and money supply fluctuate essentially which

disagree with the concept proposed by M. Friedman.

This is caused by the following factors:

1. Liberalized prices caused hidden inflation to be transformed into open inflation, which stimulated a sharp increase in money demand for current transactions.

2. High rates of money supply increase, which initially were observed only after a rise in prices, began to generate high inflation level.

3. Inflationary expectations caused by unstable money supply led to structural deformations in the market entities' individual assets the majority of which belonged to investments in material and currency supply rather than to cash balances or profitable investments (assets, bonds, etc.), i.e. became a means of insurance against inflation.

As a result an excessive money supply under conditions of a production de-

**Fighting inflation is put in the foreground by the monetarists, which is the aim of the monetary rule**

cline and a decrease in demand for real cash balances (flight from money — a classical factor of inflationary expectations) formed the so-called "money overhang" — an essential index of inflation and destabilized economy as a whole.

Thus, the monetarist statement to the effect that the total money demand is stable and cannot cause inflation is not confirmed under conditions of the Ukrainian economic system. At least such a confirmation cannot be easily found allowing for irregular payments of salaries and pensions (the government's debt in this sphere is about UAH 12 billion) and the growth of mutual indebtedness among enterprises the volume of which has already exceeded the GDP total volume (payables being more than UAH 120 billion).

Under such conditions inflationary factors reveal themselves not only on the part of money supply but also on the part of money demand which accumulates a considerable inflationary potential, whereas economic agents are not inclined to maintain the structure of their own portfolios of assets at a stable level and at the first opportunity try to convert cash balances into currency and material supplies.

In the light of monetarism it is necessary to analyze such a link of monetary policy as money supply formation. It can hardly be called monetarist because the monetary rule practically does not function in our sphere of monetary regulation.

Monetarist targeting in the classical meaning of the word (as determining target benchmarks of money supply growth) was planned in the main directions of the monetary policy in Ukraine, but in practice was not always fulfilled. Emission covering of the budgetary expenses with NBU credits caused inflationary splashes, especially in 1992 and 1993. The price index of the consumer market at that time reached 2,100 and 10,256% respectively. For example, the average monthly rates of money supply growth in 1993 were planned at the level of 8—13% but actually it increased 26 times.

In 1993—1994 the monetary policy of Ukraine was based on the budgetary rule rather than on the monetary rule, the state budget deficit being covered almost completely at the cost of the NBU's direct credits. It is understandable that monetarism and direct financing of the government's needs by the central bank are incompatible phenomena by definition.

The hyperinflation of 1993 caused the largest slump in production which in 1994 amounted to 22.9%. It should be noted that the monetary policy when the NBU's entire initial emission was directed at covering state expenses and supporting ineffective enterprises (which gave them a chance to escape bankruptcy and delay structural reforms) did not rouse any charges in monetarism.

The situation changed in 1994 when

**The monetary policy of Ukraine can be associated with monetarism so much as it is directed against inflation**

the NBU impeded inflation rates and provided for financial stability.

A number of restrictive measures were taken for this purpose:

- ♦ discount rate was raised
- ♦ interest on banks' credit and deposit operations reached positive level relative to inflation rates
- ♦ norms of required reserves were raised
- ♦ credit auctions were introduced instead of credit resources centralized distribution. As a result funds distribution among banks has acquired a market character
- ♦ operations with state securities were introduced as the main source of covering the budget deficit.

All these measures had a positive impact on the dynamics of inflationary processes in Ukraine. Inflation rates in 1994 reached 400%, in 1997 they were only 10.1%; production decline rates

considerably decreased as well — from 22.9 to 3.2%.

However, even this stage of the NBU's monetary policy can be considered monetarist only conventionally. The above aspects of this policy were directed primarily at restricting money supply. General rates of money supply growth M2 decreased from 7 times in 1994 to 1,38 times in 1997. Thus, the NBU's monetary policy can be considered monetarist only to the extent of its anti-inflationary orientation.

Monetarism in its classical understanding also envisions money demand stability which is not inherent in the Ukrainian economy since its real sector has not been subject to qualitative changes directed at its structural reformation. Under such circumstances the deficiency of working capital at enterprises is explained by their noncompetitiveness in conditions of the flexible price system, inability to act in the market situation or work in competitive environment rather than by the strict NBU policy or by monetarism. Without proper institutional transformations and changes in the taxation and financial systems (primarily in the sphere of budgetary expenses) it is too early to speak about achievements of macroeconomic stabilization.

Thus, the estimation of the monetary policy in transitional Ukraine from the scientific point of view at a conceptual level makes it clear that Ukraine does not answer the main postulates of monetarism. Even despite the fact that the NBU's policy is oriented towards stabilization — this is not monetarism in the proper meaning of the word. Actually, as it was mentioned above, monetarism was not used in its pure form in developed countries either. However, corresponding measures of the monetary policy were accompanied there by necessary structural changes in the real sector of the economy and financial sphere. In addition they did not need to create all the market institutes anew.

So, if the monetary policy as a means of reforming the economy is considered one-sidedly, without taking into account the interrelation of all components of the economic reform, it will continue to be estimated from the extreme points of view: as a panacea for overcoming all crisis phenomena, or as a reason of the reforms failure. Both the first and the second estimates will be as far from the truth as the identification of the current monetary policy in Ukraine with monetarism. □