M.A. ECONOMICS : SEM-II

CC-8 , MODULE -3

E-CONTENT BY –SHALU SINGH , ASSISTANT PROFESSOR (GUEST FACULTY)

E-MAIL ID: shalusinghpatna1@gmail.com

MONETARIST THEORY OF INFLATION

MONETARIST APPROACH TO INFLATION IS AN IMPROVED VERSION OF CLASSICAL THEORY OF INFLATION OR FISHER'S QUANTITY THEORY OF MONEY. I.e.,

$$M V = P Y$$

ACCORDING TO MONETARIST , WITH REFRENCE TO MILTON FRIEDMAN, "INFLATION IS ALWAYS AND EVERYWHERE A PURELY MONETARY PHENOMENON THAT ARISES FROM RAPID EXPANSION IN QUANTITY OF MONEY THAN IN TOTAL OUTPUT".

BY MONEY MARKET EQUILIBRIUM i.e,

$$M_d = M_S$$

NOW ,

THEY ASSUME DEMAND FOR MONEY REMAINS STABLE, SO NOW EXCESS SPENDING ARISES OUT OF INCREASE IN MONEY SUPPLY.

$$M V = P Y$$

Or $$P = M V / Y \text{.......}(A)$$

As per assumption, V remains stable so, eqn (A) can be written as,

$$P = M/Y \text{..........}(B)$$

e.g., if M=Y----P remains same, if M>Y----p will increase

or can be written as—

$$\frac{\Delta P}{P} = \frac{\Delta M}{M} - \frac{\Delta Y}{Y}$$

Here $\frac{\Delta P}{P} = rate\ of\ change\ in\ price\ level$

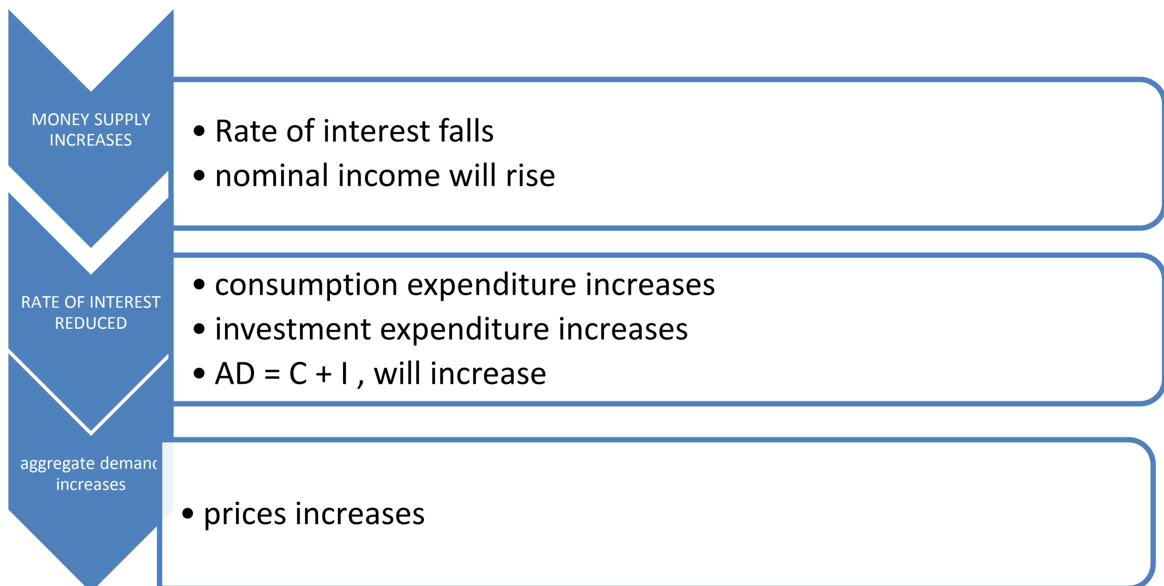
$\frac{\Delta M}{M} = rate\ of\ change\ in\ money\ supply\Delta$

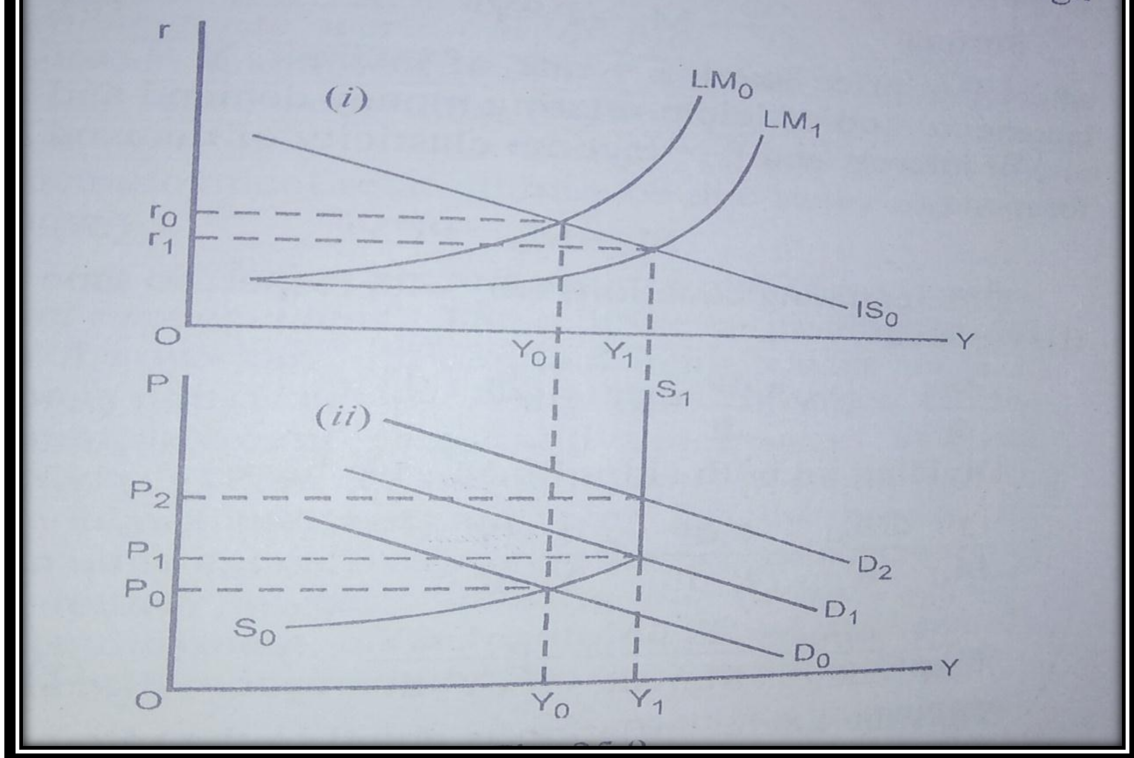
$\frac{\Delta Y}{Y} = rate\ of\ change\ in\ output$

So the rate of change in price level or inflation depends on the gap between money supply and the output i.e, larger the gap larger will be the price rise, smaller the gap smaller will be the price rise.

NOW, THE QUESTION ARISES----- THE EXPANSION OF MONEY SUPPLY WILL AFFECT FIRSTLY THE INCOME OR THE PRICES ?…….

So the answer is……income….it is explained by mechanism below





M_s (increases)-----ROI falls and income increases-----consequently aggregate demand rises this will push up the prices.

NOTE—before full employment, expansion of money supply increases the price level but less than proportionately, but after full employment, price level increases in the same proportion of increase in money supply…as shown in figure.

<u>FEATURES OF MONETARIST THEORY OF INFLATION</u>

1. ***THEY ALSO EMPHASISED ON INCREASE IN AGGREGATE DEMAND FOR INFLATION BUT THIS INCREASED DEMAND WAS AN OUTCOME OF INCREASE IN MONEY SUPPLY***

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2. LEVEL OF INFLATION DEPENDS ON THE DIFFERENCE BETWEEN THE RATE OF GROWTH OF MONEY SUPPLY AND REAL OUTPUT

3. BEFORE FULL- EMPLOYMENT, PRICE LEVEL INCREASES LESS THAN PROPORTIONATLY TO THE INCREASE IN MONEY SUPPLY.

4. AFTER FULL- EMPLOYMENT, PRICE LEVEL RISES IN THE SAME PROPORTION OF INCREASE IN MONEY SUPPLY.

THANK YOU