Money neutrality a central issue in monetary economics

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This essay discusses neutrality of money as a central premise in monetary economics. It conceptualizes and looks at how neutrality of money has influenced various macroeconomic schools of thought. More specifically, the essay focuses on how money supply and demand has continually influenced the major macroeconomic schools of thought. Monetary economics is a subset of macroeconomics and the former is best discussed with emphasis on specific macroeconomic policy(s). In a larger perspective this essay tries conceive the position taken by the major macroeconomic schools of thought in relation to money supply, demand, growth and money neutrality.

Neutrality of Money

Monetary economics is a branch of economics that studies, evaluates, and analyzes the functions and roles of money in the economy. It explains how money supply and demand affects the macro-economy. Shaw and Greenway point out that monetary economics has its central premise in the supply, demand and distribution of money in an economy, arguing that monetary economics provides relevant solutions related to monetary systems, regulation of financial institutions and inflation of a country.[1]Lewis and Mizzen observe that monetary economics examines monetary relationship between supply and demand as well as the rate of growth of output. They are of the opinion that monetary economics scholars focus on money supply and demand in order to understand inflation and price fluctuations among other factors.[2]Many monetary economists today are often faced with the challenge of explaining whether money is neutral or not as different schools of thought in macroeconomics take varied view points on the matter, with some agreeing that money is neutral and others disagreeing.

According to Lewis and Mizzen, neutrality of money refers to a situation where the stock of money affects only nominal variables of an economy. These nominal variables may include among others; actual consumption, employment, and real GDP.[3]Lewis and Mizzen further observe that money neutrality is a fundamental issue in monetary economics that explains and analyzes the relationship between a country's central bank and the economy.[4]They observe that money neutrality also explains ways in which supply, demand and circulation of money can be regulated.[5]For example, printing money and circulating it does not affect the real economy because it has no influence on variables like quantity and number of jobs available in a country, the size of real GDP, and the specific amount of investments. In explaining this phenomenon most macroeconomic schools of thought argue that any increase in the supply of money to an economy would be counteracted by an equivalent increase in wages, salaries, and prices.

In an attempt to explain the neutrality of money, modern monetary economic theorists have come up with the term super neutrality of money, which they use to explain the fact that the economy is so neutral and independent, even to the level of money supply and also that the rate of money growth has no effects on real variables.[6]Drawing from these theoretical frameworks, it can be observed that money supply and money growth rate only influence the nominal variables such as prices and inflation rates in the short run. However, super neutrality of money has faced criticism, where monetary economists have argued that money cannot be supernatural because its growth rate affects real variables despite the fact that its supply has no influence on real amounts, hence the term " neutrality

of money” has gained more prominence than the term “ super neutrality” of money.[7]Money economists have embraced neutrality of money as a tool for predicting future wages, inflation rates, and price levels. This has made it possible for macroeconomists to predict the future economy of a given country.[8]

Keynesian, neoclassical economics, monetarist school of thought, New-Keynesians, and

Post-Keynesian schools of thought have taken varied views on neutrality of money. These different schools of thought have hypothesized varying opinions on the neutrality of money, although their variations are minimal with differences only arising in views over applicability of money neutrality in the dynamics of the monetary systems[9].

Keynesian Economics

Keynesian economists argue that the concept of money neutrality overlooks the microeconomic time arrangement of production process. They are of the opinion that money supply can only influence nominal variables of the economy while the real variables remain relatively unaffected.[10]The Keynesians concur with Shaw and Greenway that money neutrality has no effect on real economic variables such as employment and employment rate as well as national consumption and the actual GDP. In view of Keynesian school of thought, money neutrality has no effect on economic policies that are directly connected to real variables of the economy.[11]

Monetarist School of Thought

The monetarist school of thought postulates that continued money growth rate increase leads to a high output that produces inflation. In their opinion, monetarists point out that money is not neutral to the economy and real variables of the economy can be affected by supply of money.[12]In their opinion, monetarists argue that inflation in any country can only be ended by regulating the supply of money must be regulated, such that money growth rate falls below the growth of output. They further argue that the central banks and governments can improve on stabilization of their economies by regulating the amount of money supplied to their economy, hence in their view, minting of money is harmful to the economy.[13]Monetarism economics focus on role of money in the economy as opposed to Keynesian economics which emphasizes on the government’s role in economy through expenditure instead of focusing on the role of changes in monetary policy.

New Keynesians and Post Keynesians

According to the New Keynesians School of thought, supply of money is neutral and has no effect on real variables of any given economy. This school emphasizes on the role of monetary policy and is of the opinion that policy can have adverse effects on either real or nominal variables of economy regardless of money neutrality.[14]Furthermore, the school proposes that central banks and governments should design proper monetary and fiscal policies in order to achieve positive economic growth rate.[15]

On the other hand, the Post Keynesians reject the idea of money being neutral and oppose the neutrality of money. They stress on the important role played by credit money in an economy by embracing the need to

empower commercial banks to create credit money and essentially improve the economy.[16]Lewis and Mizzen observe that the Post Keynesians School of thought emphasize on the role played by nominal debt. They are of the opinion that nominal amount held in debt is not directly connected to inflation, although inflation erodes the real value of debts.[17]It is therefore a Keynesian belief that money supply and growth cannot be divorced from monetary systems and economic variables.

Neoclassical Economics

The neoclassical school of thought is founded on belief that supply and demand forces shape the markets. The school holds that money is neutral to monetary systems. Furthermore, supply and growth of money output is only as a result of rational demand. Neoclassical economists believe that money neutrality has no effects on either the real or nominal variables of the monetary system. Neoclassical economists maintain that demand for money, no matter how little it is, and will always result to a corresponding increase for money output.[18]

The Austrian School

According to Austrians, money is not neutral. The Austrian school of thought advocates for an ultra free market system in which government should not play any role. The school points out that individual human actions are necessary to bring optimal solutions to economic problems.[19]The Austrians criticize Keynesian economics as fundamentally collectivists and economic analysis based on economic aggregates as fallacies. In Austrian macroeconomics, time and money and the institutions surrounding them are

taken seriously. Austrians recognize the role of money as a medium of exchange arguing that its perfect liquidity gives it an influence over economic activity qualitatively different from any other.[20]Austrian's reject for neutrality of money is based on the idea that purchasing power of money is decided upon during the moment of an exchange and it depends on the amount of money following that particular good or service during that particular period of time.[21]They argue that a change in supply of money does not affect all prices proportionally but it only influences certain prices, depending on what the new money is spent on.[22]

Real Business Cycle Theory

According to real business cycle theory, demand and supply are factions of real variables only, which also include relative prices. The real business cycle theorists are of the opinion that equilibrium found at some set relative prices is not affected by any change in absolute prices. The real business cycle theory highlights that based on equilibrium, price level can only be determined if the excess demand functions for goods contain real money balances as an argument.[23]This builds an economic mechanism which transmits monetary impulses to real sector. If money increases, real balance grows larger, consequently stimulating demand, a situation that causes monetary impulses to work towards higher prices.[24]Neutrality of money in this theory is used in the weaker sense to refer to the level of output but not its composition. This The real business theory agrees that money is neutral and further points out that even if changes in money supply were neutral, changes in growth rate may not be neutral.[25]According to this theory, money supply is endogenous and the central bank can reduce the money

supply in order to respond to an expected fall in money demand. The real business theorists argue that money has no real effects production because when the production rises, the prices must fall to counter the effect.[26]

Conclusion

In conclusion different schools of macroeconomic thought conceptualize money neutrality as one the basic tenets of monetary economic theories and perspectives. The schools exhibit different perspectives and perceptions on neutrality of money, with some like the Keynesian economics, and real business cycle theory agreeing to the idea of money being neutral while others like others like the Monetarist School of thought and Austrian School of thought strongly opposing the idea of money being neutral. Based on the arguments of these macroeconomic schools of thought, the neutrality or non- neutrality of money depends on critic’s perception and factors under consideration.