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December 8, 2005

Professor Milton Friedman
Hoover Institution

Dear Professor Friedman:

I wrote a single-spaced letter to you (forwarded through your secretary Gloria) along with some attachments two days ago. <u>This double-spaced letter in bigger font</u> is, hopefully, more readable.

I am writing a textbook in macroeconomics with an India focus. The stress is on the Fisher effect and your **monetarist paradox** ("<u>An easy money policy leads to high interest rates.</u>") The analytical framework used is based on a 2000 study I did for the Reserve Bank of India on bond financing of the deficit (attached page). The inspiration for this phrase 'monetarist paradox' derives from your December 1967 Presidential Address, "Paradoxically, the monetary authority could assure low nominal rates of interest - but to do so it would have to start out in what seems like the opposite direction,…."

By contrast, most textbooks, <u>even when they adequately cover the natural rate hypothesis and Fisher equation, do not stress the monetarist paradox</u>, let alone treat it as a corollary to the natural rate and Fisher equation, which I do. A student of mine pointed out that, under Google, there is no reference to the phrase "monetarist paradox" other than my 2000 study, and my 2003 paper on India's debt projections.   I see the monetarist paradox as the most profound, useful and non-trivial conlcusion in macroeconomics and monetary policy.   Under Google, by contrast, there are 17,600 references to Keynes paradox of thrift. The imbalance needs to be redressed!

May I take the liberty of requesting you to consider taking a look at Chapter 9 of the draft of my text which explains, labels and emphasises the monetarist paradox?   If you find the content noteworthy, would you be willing to consider writing a jacket blurb for the book? I hope this request is not too much of a bother.

I also use a cartoon to illustrate the impact of easy money and explain the monetarist paradox, drawing upon and citing your memorable passage in Money Mischief,

"When the alcoholic starts drinking, the good effects come first; the bad effects come only the next morning, when he wakes up with a hangover…..In both cases, it takes a larger and larger amount of alcohol, or money, to give the alcoholic, or the economy, the same kick."

In this context, I have a Working Paper "The Stability of Bond Financed Deficits.."in 1998 (not yet sent out for publication) that deals with your debate with Solow-Blinder (1973,1974) and Tobin-Buiter (1976) on this issue. This paper evolved out of a debate I had with a former Governor of Reserve Bank of India who was advocating monetization of the deficit along Sargent-Wallace lines to prevent a debt trap.

The critical portion of the abstract of the paper reads as follows:

"It argues that conclusions about a debt trap under bond finance stem from unrealistic conclusions about the interest rate, and not from the assumption of budget balance in the

Blinder-Solow model as commonly believed. An adaptive expectations Fisher-equation specification for how interest rates respond to the mode of financing and to inflation, implies that, in a growth framework, stability under bond finance can be easily achieved.(Moorthy)"

More specifically, in your rejoinder (Comments on Tobin & Buiter in Monetarism ed. by Jerome Stein, 1976) you list four differences in approach between monetarists and Keynesians: "Money versus credit, build up or down, stocks and flows, substitution versus wealth effects". You state that "I have tried to present monetarist analysis in IS/LM terms, even though recognizing that this was a cumbrous theoretical structure for the purpose." (pp. 315-317). I can also send you a copy of this paper if you wish.

However, the problem with Solow-Blinder and Tobin-Buiter analysis, as I argue, is more than mere cumbrousnness. Their analysis is based on IS/LM and lacks a Fisher effect, although they allow for flexible prices. Hence they arrive at the counter factual implication that the debt cannot stabilize under bond financing.

It has been a great educational experience to read much of your work, and I learn more as I re read some classic pieces, in particular "Should There be an Independent Monetary Authority?

With regards,
Yours sincerely,

Vivek Moorthy
Professor and Chairperson
Economics and Social Sciences Area, IIM Bangalore.