Lecture 3: Money and inflation

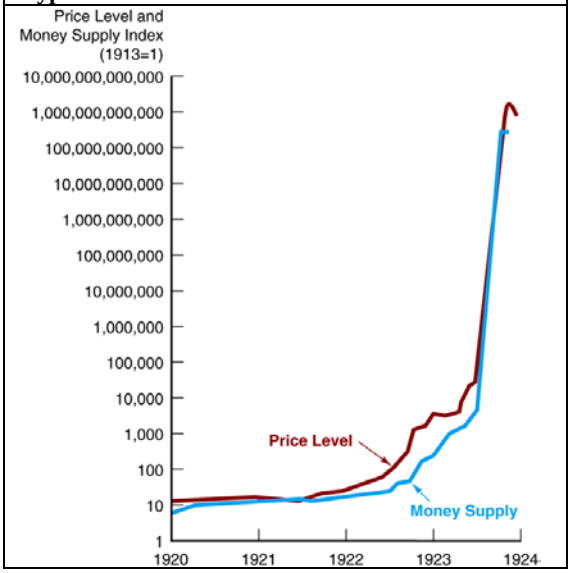
- Friedman 'inflation is always and everywhere a monetary phenomenon'

Reduced-form evidence: whenever a country's inflation rate was extremely high for a sustained period of time, its rate of money supply growth is also extremely high
Specific examples: German hyperinflation (1921-1923), Argentina, Brazil and Peru (1980s-1990s)

- German hyperinflation

In 1921, reconstruction after WW I caused the German government's expenditure to greatly exceed revenues. Raising taxes was politically unpopular, the amount needed far exceeded the capacity to borrow. The government then decided to print money to finance its expenditure and pay striking workers. Money creation led to an inflation rate of exceeding 1 million percent in 1923.

Money Supply and Price Level in the German Hyperinflation



- Latin American countries

They governments were unwilling to finance government expenditures by raising taxes, which then led to large budget deficits, financed by money creation.

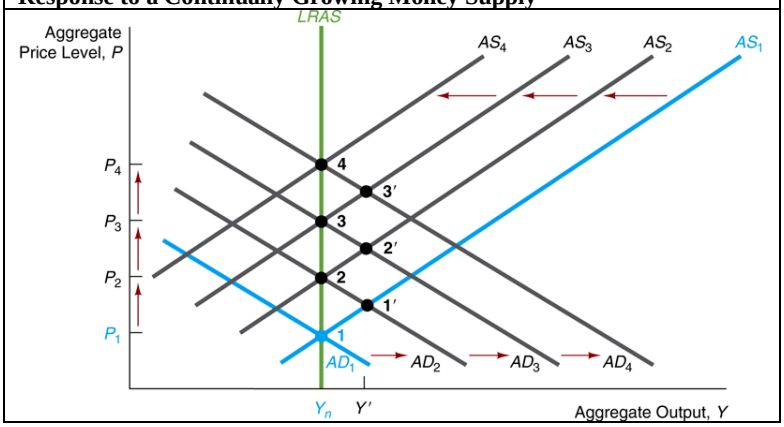
Friedman's proposition: upward movements in the price level are a monetary phenomenon only if this is a sustained process

- Monetarist and Keynesian views on inflation

Monetarists: shifts in aggregate demand curve could only be caused by changes in the money supply. Therefore, rapid inflation must be driven by high money growth.

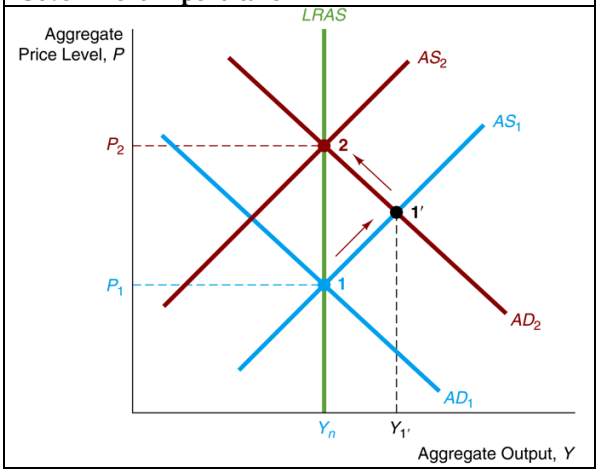
Keynesians: shifts in aggregate demand could be caused by other factors besides money supply growth. However, high inflation could only be caused by changes in money supply.

Response to a Continually Growing Money Supply



Fiscal policies only caused temporary increase in the inflation rate unless government spending increased continually.

Response to a One-Shot Permanent Increase in Government Expenditure



A supply shock (oil price shock) leads to a temporary increase in the inflation rate.

- Two types of inflation

Cost-push: negative supply shock or a push by workers to get higher wages (shift in aggregate supply)
Demand-pull : when policymakers pursue policies that shift the aggregate demand curve to the right

- Budget deficits and inflation

Government budget constraint
Budget deficit = G – T = ΔMB (monetary base) + ΔB (government bonds)

- Activist/Nonactivist policy

1. The lags involved in policy implementation

- data lag
- recognition lag
- legislative lag
- implementation lag
- effectiveness lag

2. Case for an activist policy: wage and price adjustment process is extremely slow
Case for a nonactivist policy: rapid wage and price adjustment.
Case for a nonactivist policy is stronger when expectations play an important role.

3. Ruls vs discretion

- activists believe in the use of discretionary policy to eliminate excessive unemployment because they view the wage and price adjustment process as sluggish and unresponsive to expectations about policy.
- Nonactivists believe that discretionary policy is counter-productive because expectations about policy can matter to wage-setting process. They advocate the use of a policy rule to keep the aggregate demand curve from fluctuating away from the trend rate of growth of the natural rate level of output.