



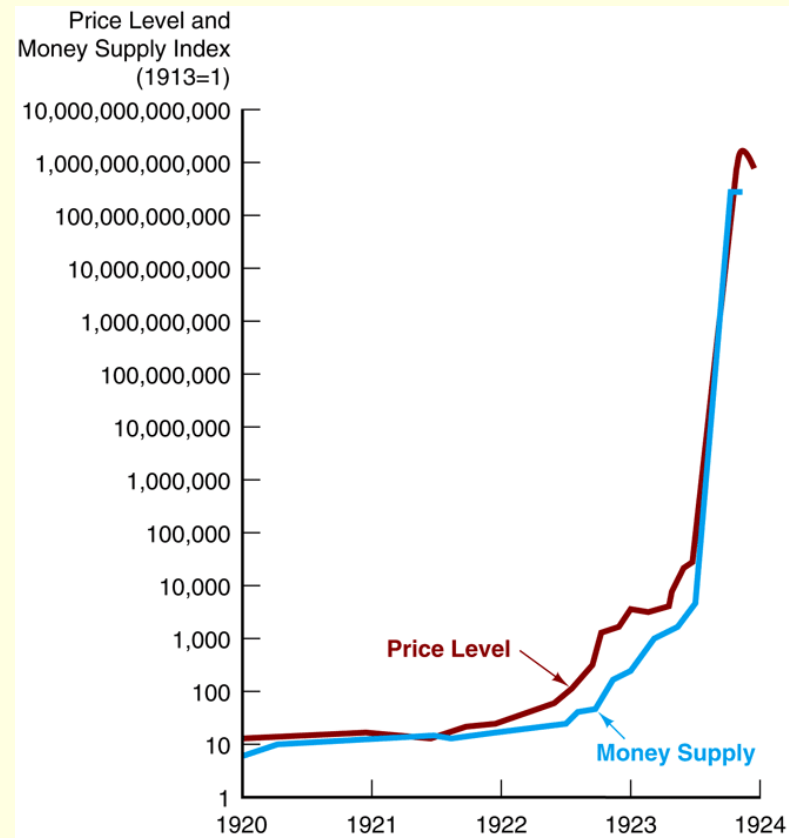
Lecture 3: Money and Inflation

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18 January 2012

Money and Inflation: Evidence

- Inflation is always and everywhere a monetary phenomenon
- Whenever a country's inflation rate is extremely high for a sustained period of time, its rate of money supply growth is also extremely high
- Reduced-form evidence

FIGURE 1 Money Supply and Price Level in the German Hyperinflation



Source: Frank D. Graham, *Exchange, Prices and Production in Hyperinflation: Germany, 1920–25* (Princeton, NJ: Princeton University Press, 1930), pp. 105–106.

Views of Inflation

- Money Growth
 - High money growth produces high inflation
- Fiscal Policy
 - Persistent high inflation cannot be driven by fiscal policy alone
- Supply Shocks
 - Supply-side phenomena cannot be the source of persistent high inflation
- Conclusion: always a monetary phenomenon

FIGURE 2 Response to a Continually Growing Money Supply

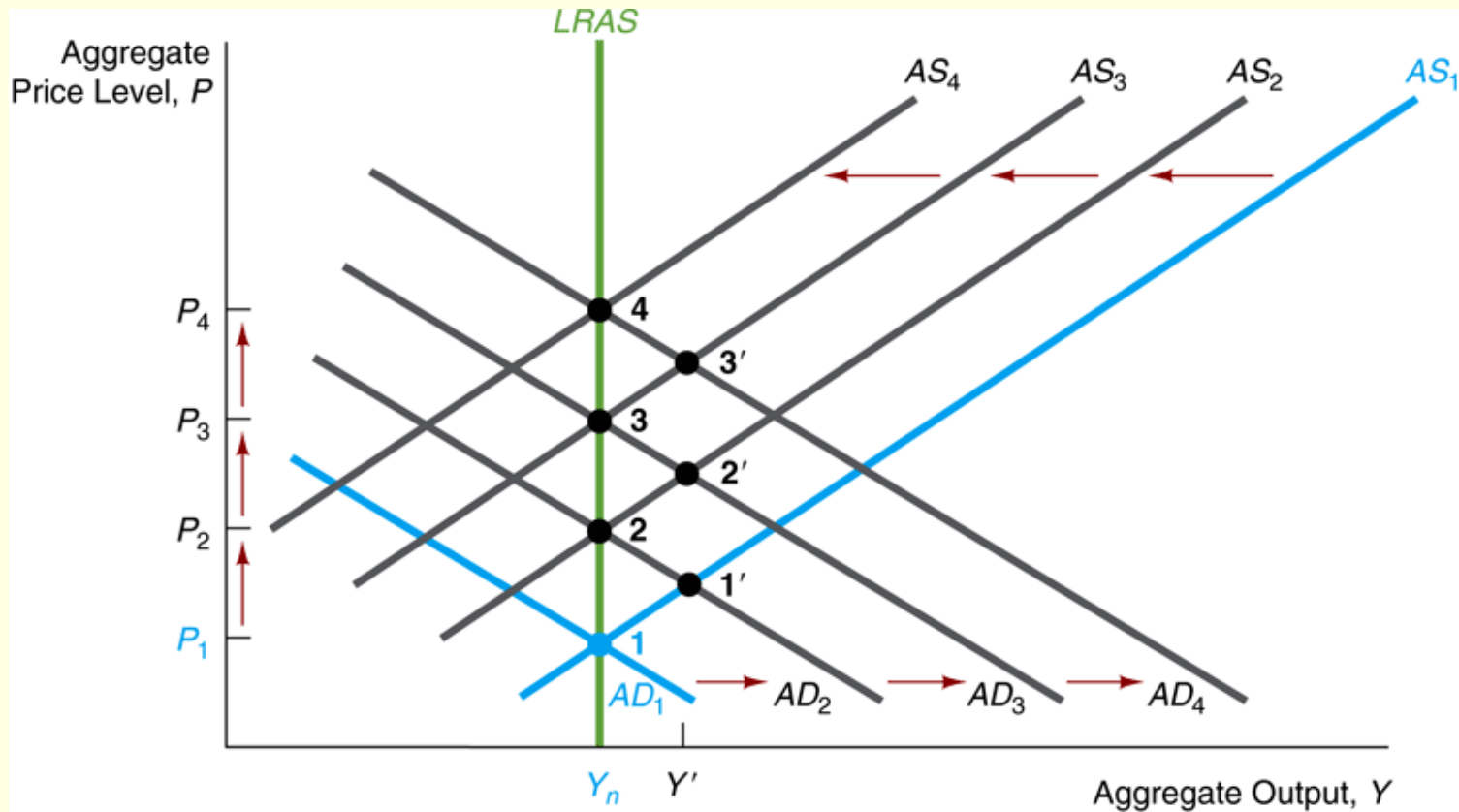


FIGURE 3 Response to a One-Shot Permanent Increase in Government Expenditure

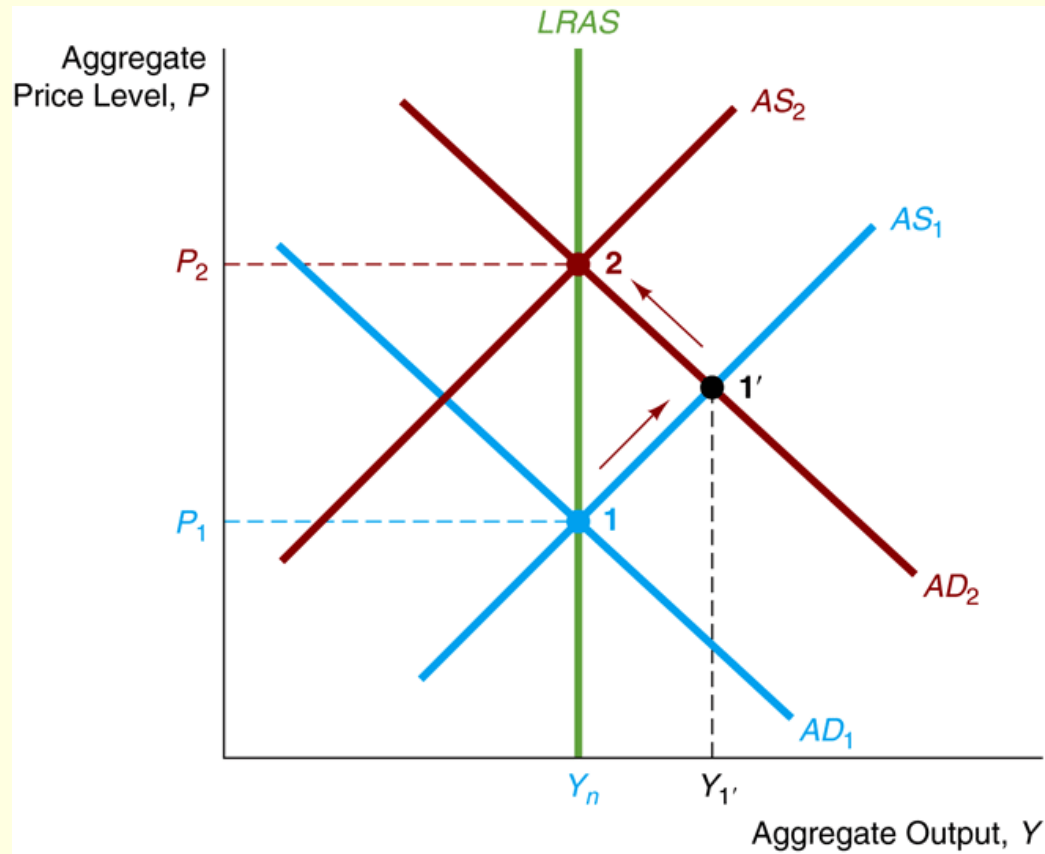
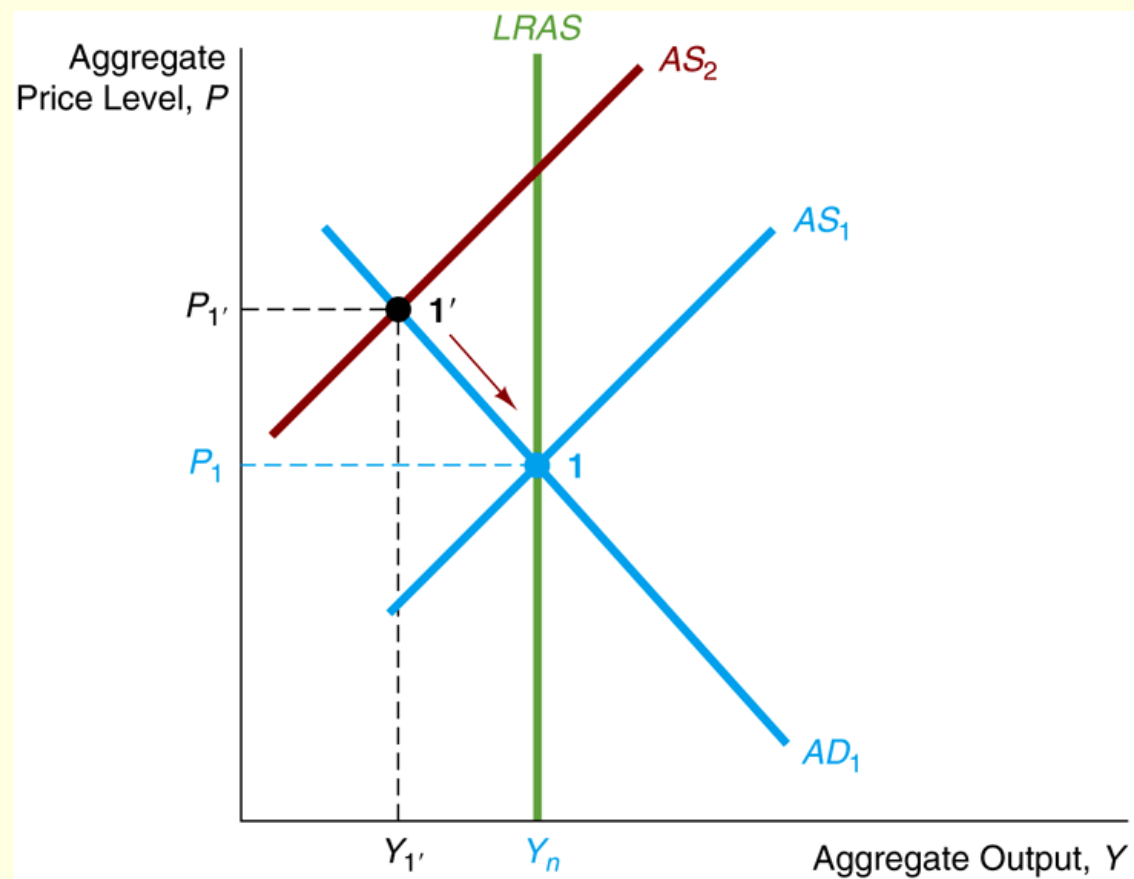


FIGURE 4 Response to a Supply Shock



Origins of Inflationary Monetary Policy

- Cost-push inflation
 - Cannot occur without monetary authorities pursuing an accommodating policy
- Demand-pull inflation
- Budget deficits
 - Can be the source only if the deficit is persistent and is financed by creating money rather than by issuing bonds

Origins of Inflationary Monetary Policy (cont'd)

- Two underlying reasons
 - Adherence of policymakers to a high employment target
 - Presence of persistent government budget deficits

FIGURE 5 Cost-Push Inflation with an Activist Policy to Promote High Employment

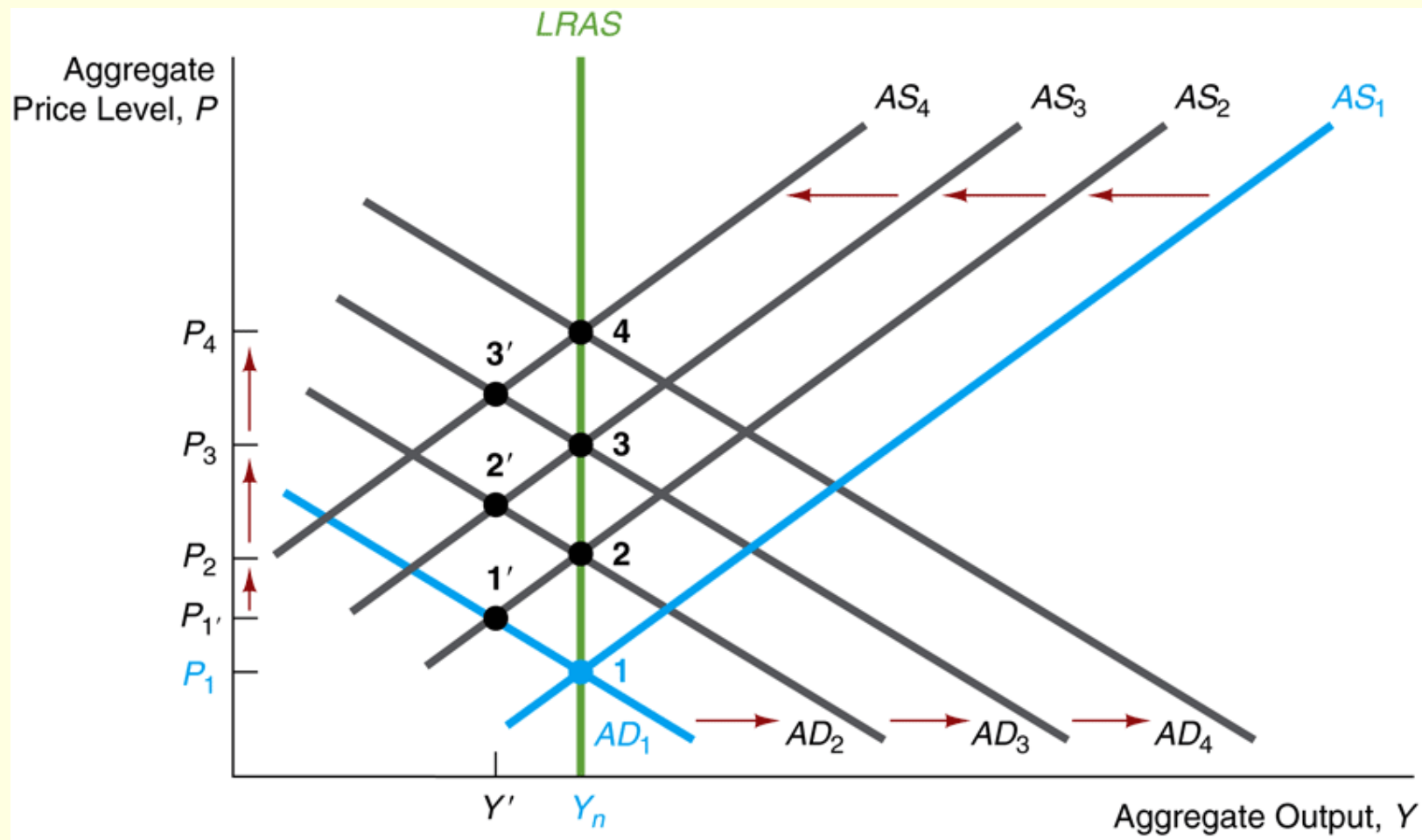


FIGURE 6 Demand-Pull Inflation: The Consequence of Setting Too Low an Unemployment Target

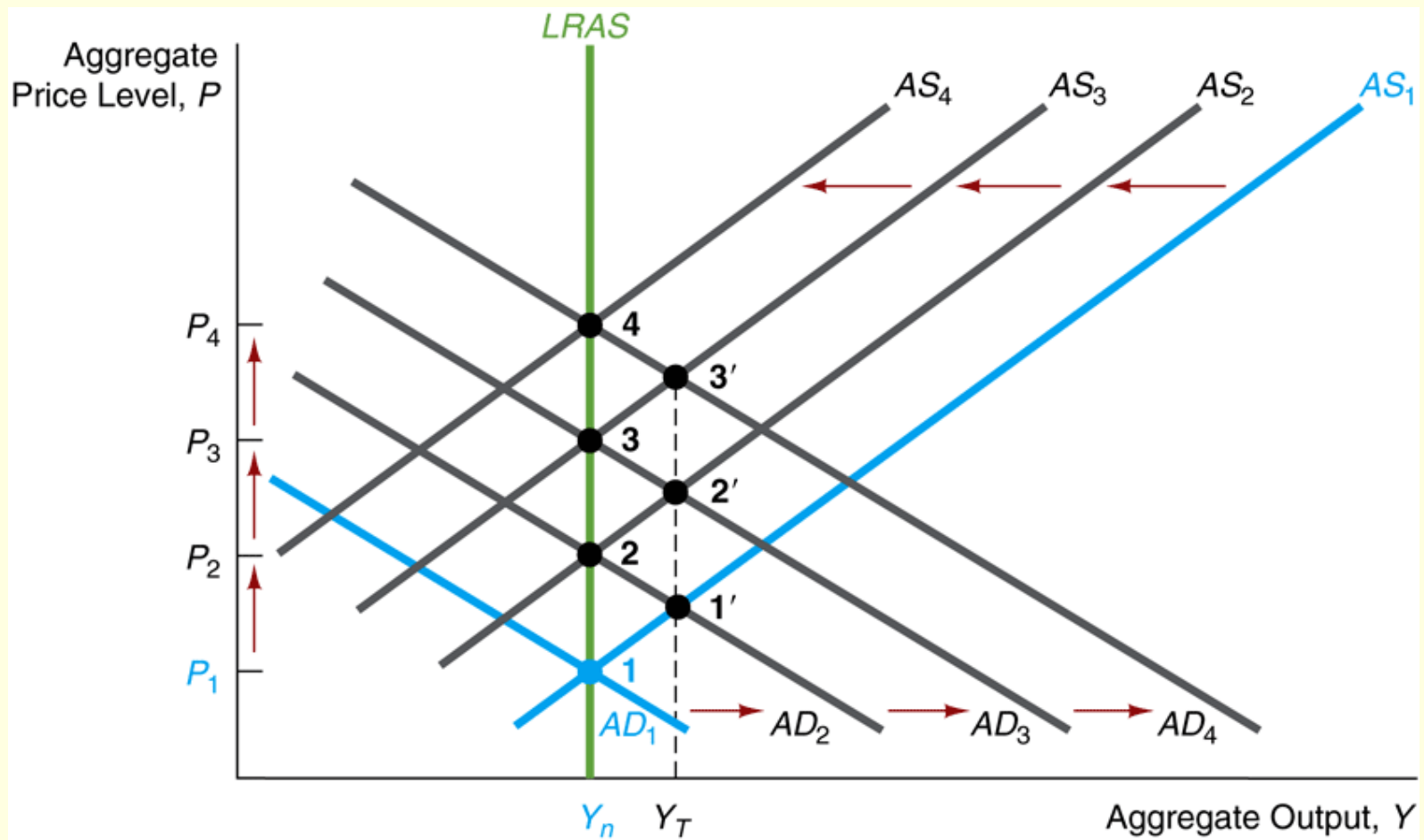


FIGURE 7 Interest Rates and the Government Budget Deficit

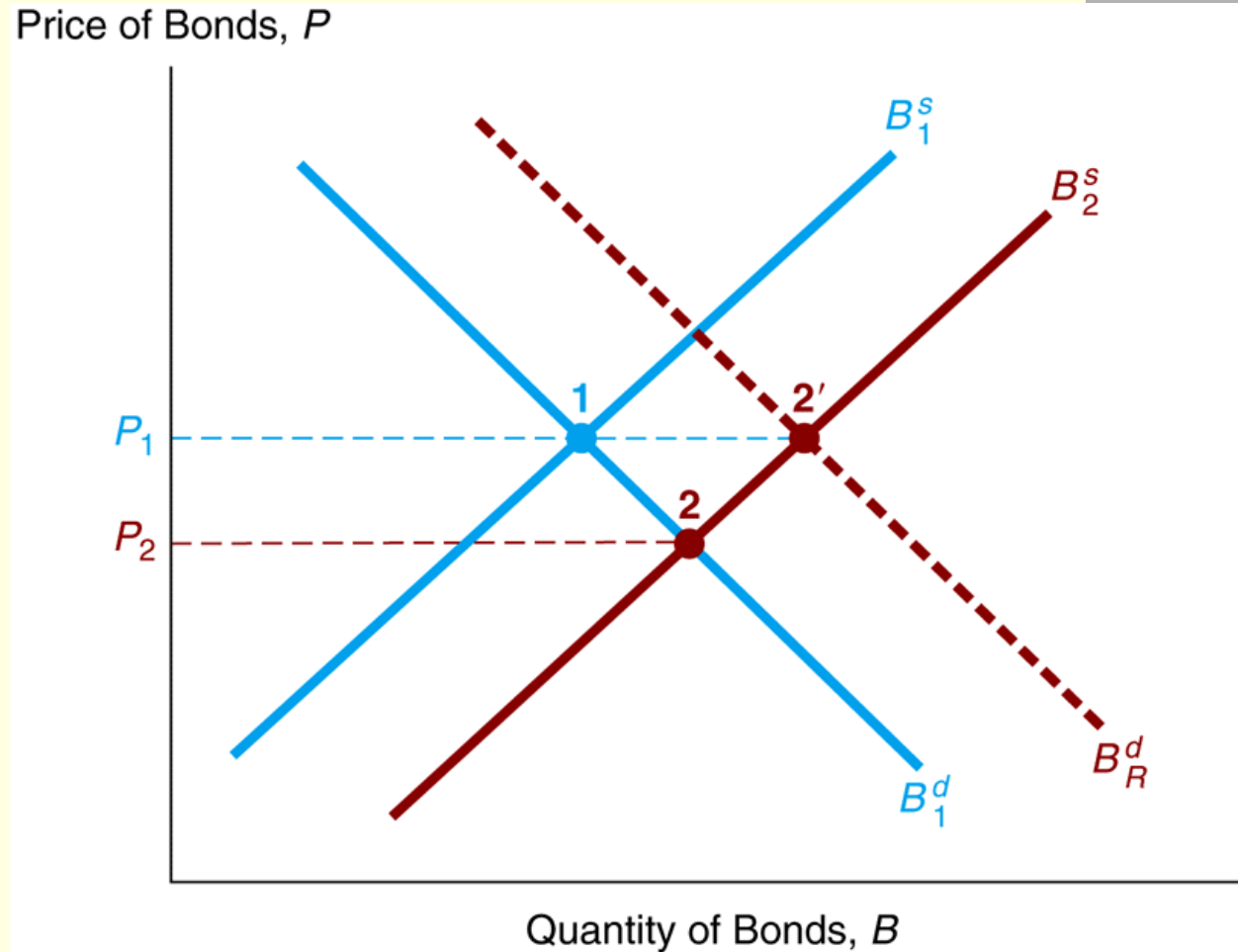
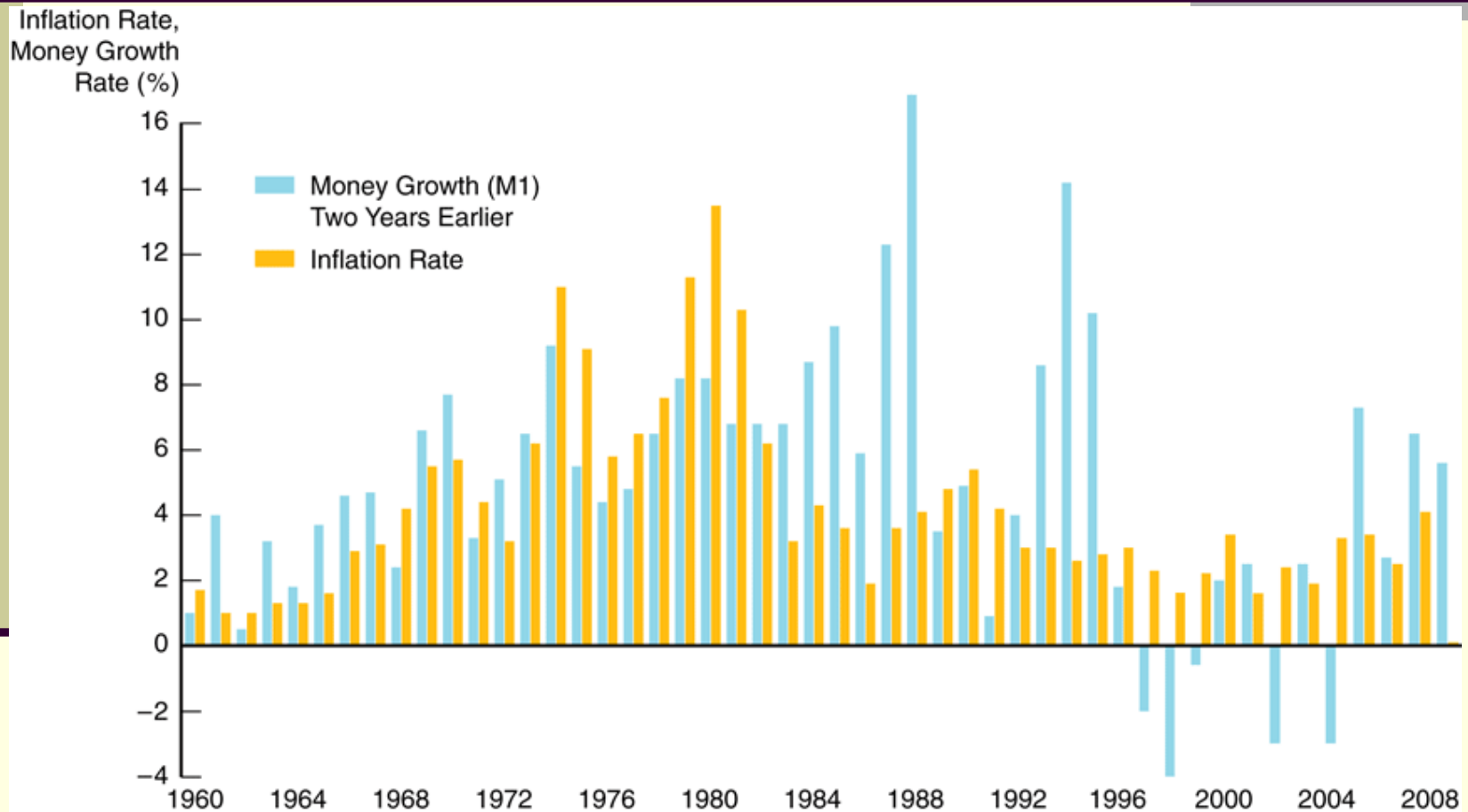
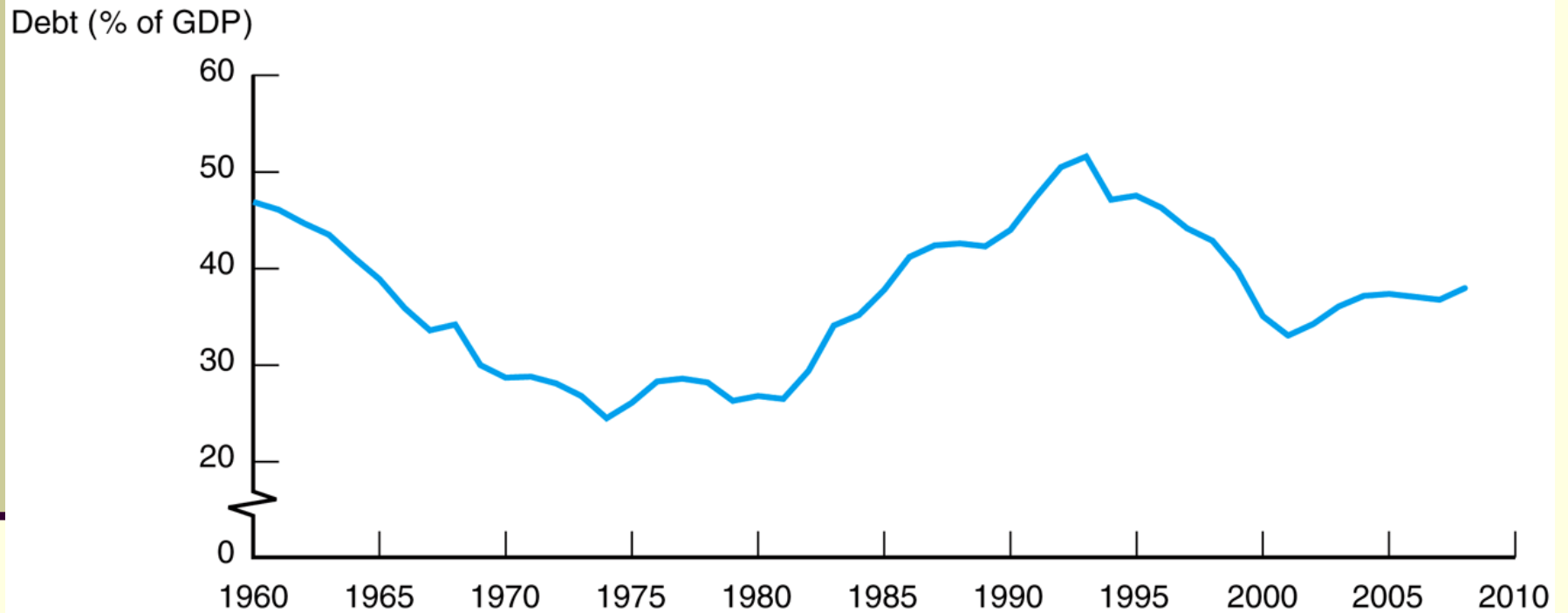


FIGURE 8 Inflation and Money Growth, 1960–2008



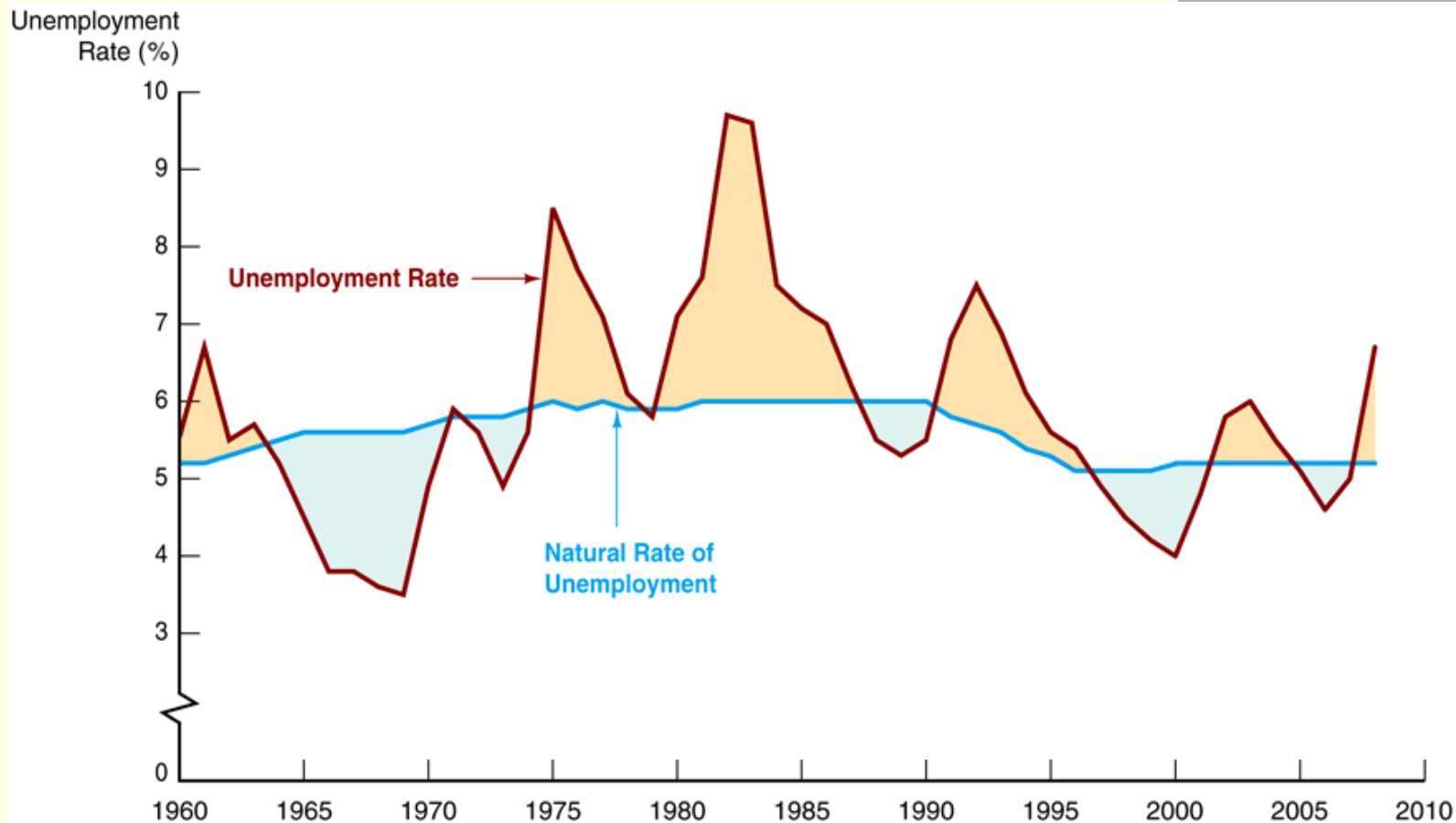
Source: *Economic Report of the President*; www.federalreserve.gov/releases/h6/hist/h6hist1.txt.

FIGURE 9 Government Debt-to-GDP Ratio, 1960–2008



Source: *Economic Report of the President*.

FIGURE 10 Unemployment and the Natural Rate of Unemployment, 1960–2008



Sources: *Economic Report of the President and Congressional Budget Office.*

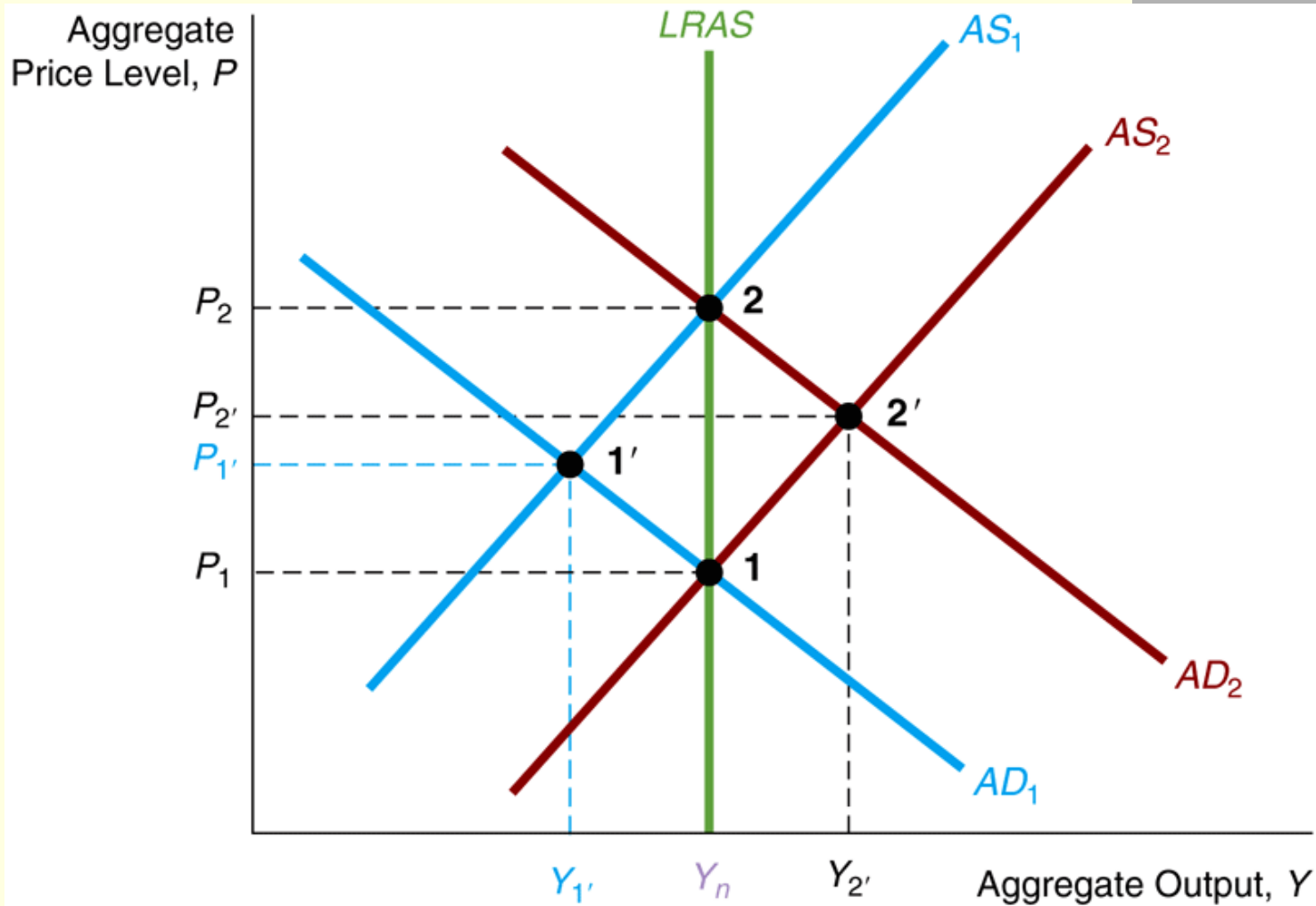
The Discretionary/Nondiscretionary Policy Debate

- Advocates of discretionary policy regard the self-correcting mechanism as slow
- Policy lags slow activist policy
 - Data lag
 - Recognition lag
 - Legislative lag
 - Implementation lag
 - Effectiveness lag

The Discretionary/Nondiscretionary Policy Debate (cont'd)

- Advocates of nondiscretionary policy believe government should not get involved
 - Discretionary policy produces volatility in both the price level and output

FIGURE 11 The Choice Between Discretionary and Nondiscretionary Policy



Expectations and the Discretionary/Nondiscretionary Debate

- If expectations about policy matter, discretionary policy with high employment targets may lead to inflation
- Nondiscretionary policy may prevent inflation and discourage leftward shifts in short-run aggregate supply that lead to excessive unemployment
 - Must be credible
- Constant-money-growth-rate rule