

# CHAPTER 27

## Money and Inflation

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## Money and Inflation: The Evidence

**“Inflation is Always and Everywhere a Monetary Phenomenon”** (*M. Friedman*)

**Evidence**

In every case when  $\pi$  high for *sustained period*,  $M$  growth is high

**Examples:**

1. Latin American inflations
2. German Hyperinflation, 1921–23

Controlled experiment, particularly after 1923 invasion of Ruhr—government prints money to pay strikers,  $\pi > 1$  million %

**Meaning of “inflation”**

Friedman’s statement uses definition of  $\pi$  as continuing, rapidly rising price level: Only then does evidence support it

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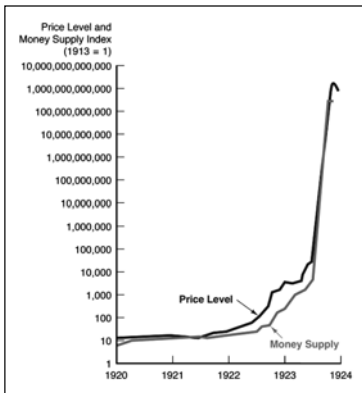
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## German Hyperinflation: 1921–23



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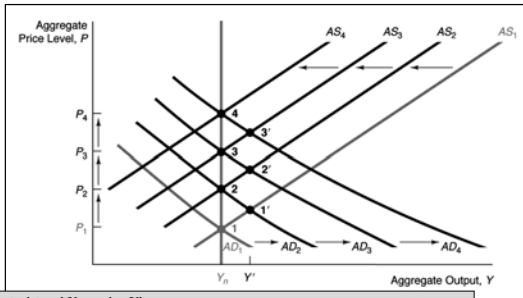
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## Response to Continually Rising $M^S$



**Monetarist and Keynesian View**

1.  $M \uparrow$  continually, shifts  $AD$  to right from  $AD_1$  to  $AD_2$  to  $AD_3$ , etc.
2.  $Y > Y_n$ , wages  $\uparrow$ ,  $AS$  shifts to left from  $AS_1$  to  $AS_2$  to  $AS_3$ , etc.
3.  $P$  continually rises from  $P_1$  to  $P_2$  to  $P_3$ , etc.: i.e., have inflation

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## Monetarist and Keynesian Views of $\pi$

### Monetarist View

Only source of  $AD$  shifts and  $\pi$  in Figure 2 can be  $M^s$  growth

### Keynesian View

Allows for other sources of  $AD$  shifts, but comes to same conclusion that only source of *sustained* high  $\pi$  is  $M^s$  growth

1. Figure 3 shows that fiscal policy without  $M^s$  growth only causes  $P \uparrow$ , but not sustained  $\pi$
2. Figure 4 shows that supply shock does not lead to sustained  $\pi$

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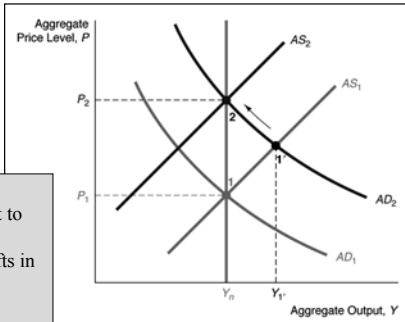
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## Response to One-Shot Increase in $G$



$G \uparrow$  permanently

1.  $AD$  shifts right to  $AD_2$
2.  $Y > Y_n$ ,  $AS$  shifts in to  $AS_2$
3.  $P \uparrow$  to  $P_2$ , but doesn't keep rising

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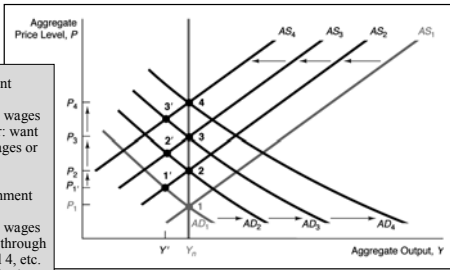
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## Cost-Push Inflation

- High Employment Target at  $Y_n$
- Workers raise wages because either: want higher real wages or  $\pi^e$  high
  - AS shifts in
  - $Y < Y_n$ , government shifts AD out
  - Workers raise wages again, and go through steps 2, 3, and 4, etc.
  - $P \uparrow$  continually: i.e., get  $\pi$




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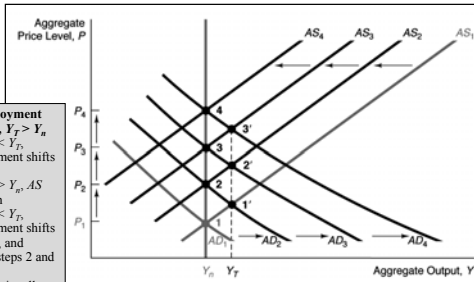
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## Demand-Pull Inflation

- High Employment Target,  $Y_T > Y_n$
- $Y = Y_n < Y_T$ , government shifts AD out
  - $Y = Y_T > Y_n$ , AS shifts in
  - $Y = Y_n < Y_T$ , government shifts AD out, and repeat steps 2 and 3, etc.
  - $P \uparrow$  continually: i.e., get  $\pi$




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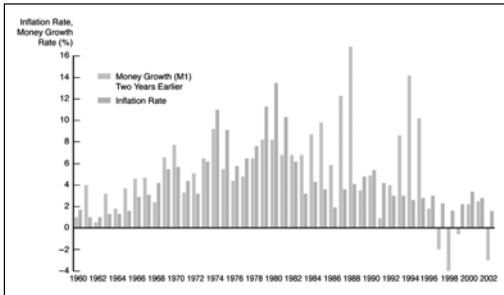
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## Inflation and Money Growth



- Money and inflation relationship close until 1980
- After 1980 relationship breaks down

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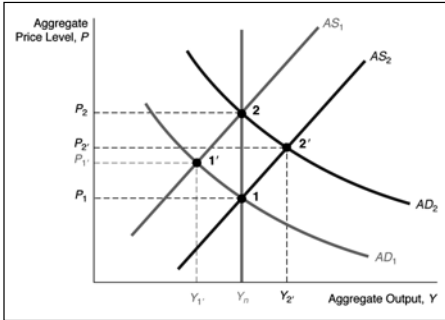
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# Choice Between Activist and Nonactivist Policy



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