

Money and Inflation

FIN 204 Lecture 14.2.

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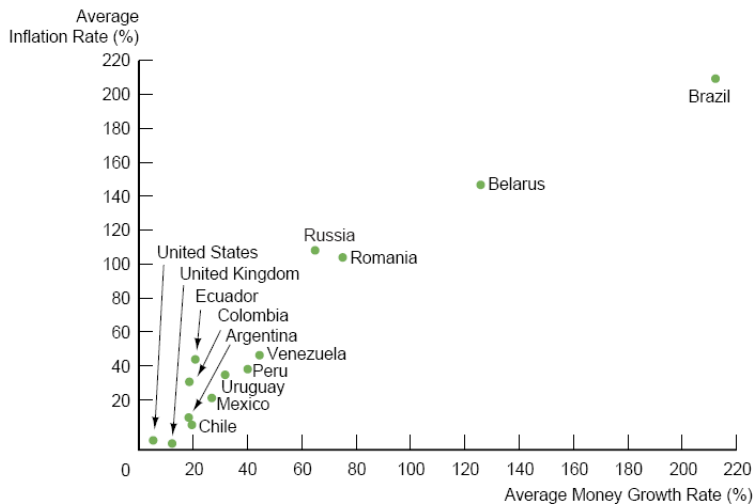
13 May 2010

Outline

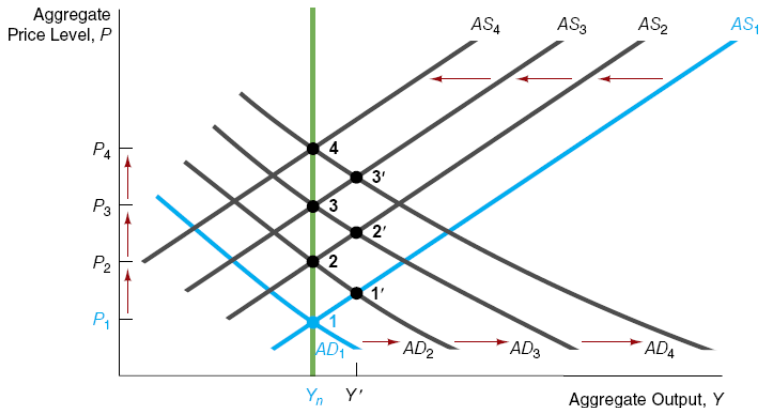
- 1 Money Supply and Inflation: Theory and Evidence
- 2 What Causes Money to Grow?

Money, Money Supply and Inflation

Money creates business cycles and inflation (M. Friedman):
Money Supply Growth and Inflation, 1992 – 2002



Money Supply and Inflation: Theoretical Arguments

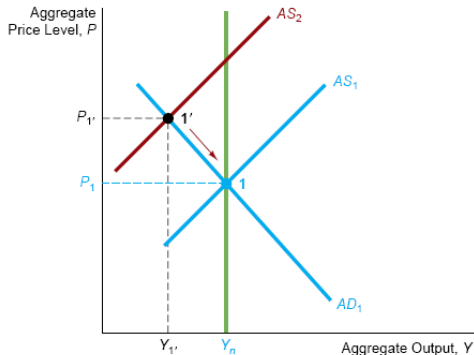


One-shot increase in money supply or government spending does NOT lead to continuous overall price-level increase.

Continuous increase in M_s or G spending can cause inflation.

What Causes Money to Grow?

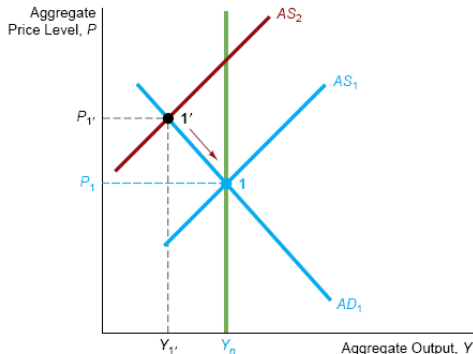
The case of a weak government



After a negative supply shock, workers want higher wages, government accomodates their wants.

What Causes Money to Grow?

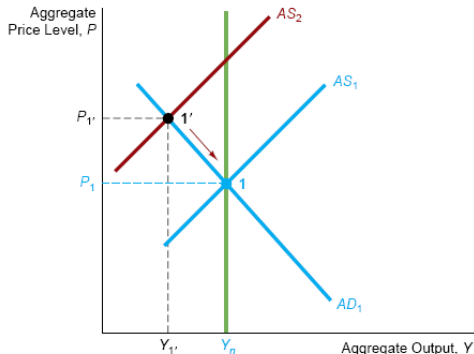
The case of a weak government



After a negative supply shock, workers want higher wages, government accomodates their wants. What is a better strategy for the government?

What Causes Money to Grow?

The case of a weak government



After a negative supply shock, workers want higher wages, government accomodates their wants. What is a better strategy for the government?

Answer: Supply side stimuli.

What Causes Money to Grow?

The case of PERSISTENT budget deficits

What is the budget deficit?

$$\begin{aligned} DEF &= G - T = Bonds = \\ &= \Delta MB + \Delta B \end{aligned}$$

What Causes Money to Grow?

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If $G - T > 0$, the
Government should issue
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What Causes Money to Grow?

The case of PERSISTENT budget deficits

What is the budget deficit?

$$DEF = G - T = Bonds =$$

$$= \Delta MB + \Delta B$$

If $G - T > 0$, the
Government should issue
bonds.

If the public does not want
the bonds, the Central bank
buys them by issuing new
money.

