EC1B5 Winter Term 2023-24
Answer Key to Discussion Question 6 (Week 8 Class)

Week 8 class: We have learnt about economic growth, money and inflation since the beginning of the course. The quantity theory of money is one theory that links them together.

a. What does this theory predict about the relationship between economic growth and inflation?

b. What is the key assumption behind the theory?

c. Explain whether the assumption always holds.

Answer key:

a. The quantity theory of money predicts that inflation is equal to the growth rate of money supply minus growth rate of real GDP (a measure of economic growth), i.e. the economic growth rate.

b. It assumes the ratio of money to nominal GDP is constant.

c. This relationship tends to hold in the long run as shown in the data for U.S.. The key reason why it might not hold in the short run is that prices and nominal wages might not adjust immediately.