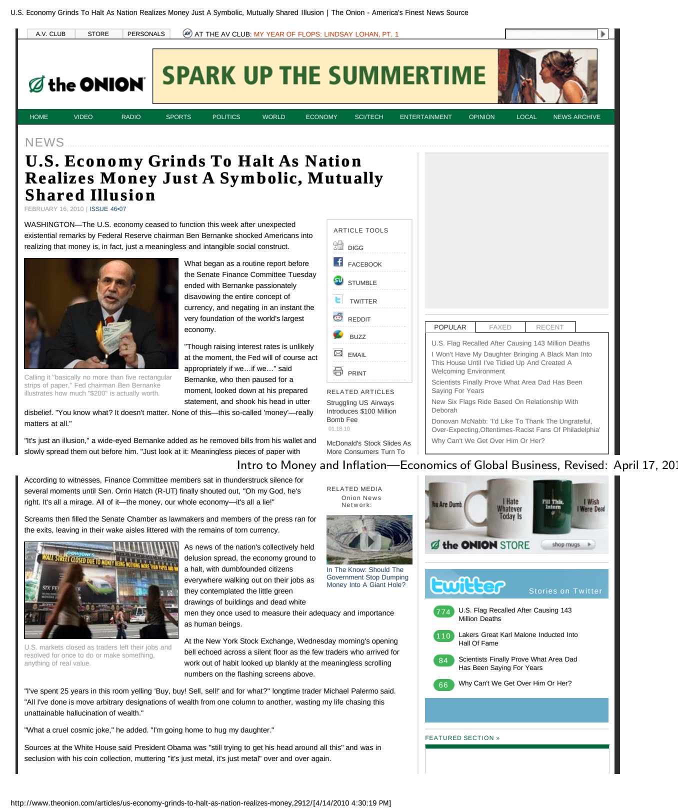
Intro to Money and Inflation

A Laugh. . .



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NEWS

U.S. Economy Grinds To Halt As Nation Realizes Money Just A Symbolic, Mutually Shared Illusion

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WASHINGTON—The U.S. economy ceased to function this week after unexpected existential remarks by Federal Reserve chairman Ben Bernanke shocked Americans into realizing that money is, in fact, just a meaningless and intangible social construct.

Calling it "basically no more than five rectangular strips of paper," Fed chairman Ben Bernanke illustrates how much "$200" is actually worth.

What began as a routine report before the Senate Finance Committee Tuesday ended with Bernanke passionately disavowing the entire concept of currency, and negating in an instant the very foundation of the world's largest economy.

"Though raising interest rates is unlikely at the moment, the Fed will of course act appropriately if we…if we…" said Bernanke, who then paused for a moment, looked down at his prepared statement, and shook his head in utter disbelief. "You know what? It doesn't matter. None of this—this so-called 'money'—really matters at all."

"It's just an illusion," a wide-eyed Bernanke added as he removed bills from his wallet and slowly spread them out before him. "Just look at it: Meaningless pieces of paper with

According to witnesses, Finance Committee members sat in thunderstruck silence for several moments until Sen. Orrin Hatch (R-UT) finally shouted out, "Oh my God, he's right. It's all a mirage. All of it—the money, our whole economy—it's all a lie!"

Screams then filled the Senate Chamber as lawmakers and members of the press ran for the exits, leaving in their wake aisles littered with the remains of torn currency.

U.S. markets closed as traders left their jobs and resolved for once to do or make something, anything of real value.

As news of the nation's collectively held delusion spread, the economy ground to a halt, with dumbfounded citizens everywhere walking out on their jobs as they contemplated the little green drawings of buildings and dead white men they once used to measure their adequacy and importance as human beings.

At the New York Stock Exchange, Wednesday morning's opening bell echoed across a silent floor as the few traders who arrived for work out of habit looked up blankly at the meaningless scrolling numbers on the flashing screens above.

"I've spent 25 years in this room yelling 'Buy, buy! Sell, sell!' and for what?" longtime trader Michael Palermo said. "All I've done is move arbitrary designations of wealth from one column to another, wasting my life chasing this unattainable hallucination of wealth."

"What a cruel cosmic joke," he added. "I'm going home to hug my daughter."

Sources at the White House said President Obama was "still trying to get his head around all this" and was in seclusion with his coin collection, muttering "it's just metal, it's just metal" over and over again.

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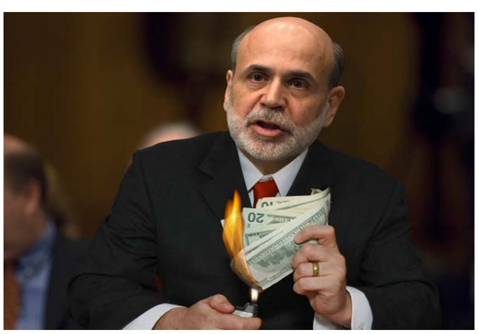
A Laugh. . .



What is Money?

- Medium of exchange.
  - we use it to buy stuff
- Store of value.
  - transfers purchasing power from the present to the future
- Unit of account
  - the common unit by which everyone measures prices and values

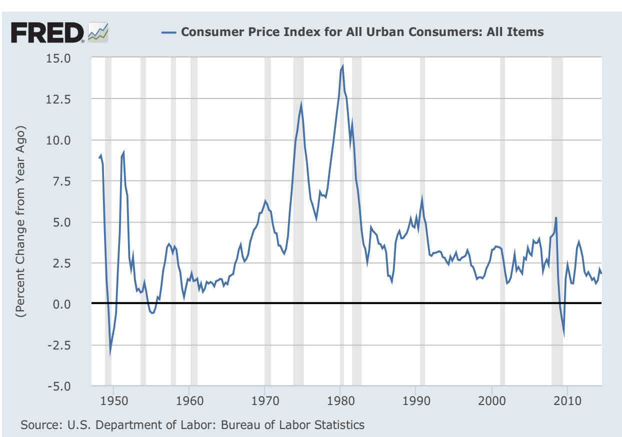
Types of Money

- Commodity Money
  - Has intrinsic value
  - Examples: Gold, cigarettes in P.O.W. camps
- Fiat money
  - Has no intrinsic value
  - Examples: paper currency, bit-coin

Monetary Policy Terminology

- The money supply is the quantity of money in the economy.
  - Various definitions of money supply (example M1 is currency + demand deposits).
  - Monetary base is an important measure, it is currency + banking reserves.
- Monetary policy is the control over the money supply.
  - Monetary policy is conducted by a country's central bank.
  - The U.S. central bank is called the Federal Reserve ("the Fed").
  - To control the money supply, the Fed uses open market operations, the purchase and sale of government bonds.
  - "Tight" monetary policy is to facilitate a slow down in the economy. "Loose" monetary policy is to facilitate a speed up.

Inflation in the US



Velocity

- Basic concept: the rate at which money circulates
- Definition: the number of times the average dollar bill changes hands in a given time period
- Example:
  - In 2012, \$500 billion in transactions
  - money supply = \$100 billion
  - The average dollar is used in five transactions in 2012
  - So, velocity = 5

Velocity

- Use nominal GDP as a proxy for total transactions.
- Then

$$V = \frac{P \times Y}{M} \tag{1}$$

  - P = Price of output (GDP Deflator)
  - Y = Quantity of output (Real GDP)
  - $P \times Y$ = value of output (nominal GDP)

Quantity Theory

- One equation

$$M \times V = P \times Y$$

- Several ways to look at this. . .
  - An identity, that is hold by definition (specifically V).
  - A theory of the demand for money (later in course).

Quantity Theory

- In growth rates

$$\gamma_m + \gamma_v = \pi + \gamma_y$$

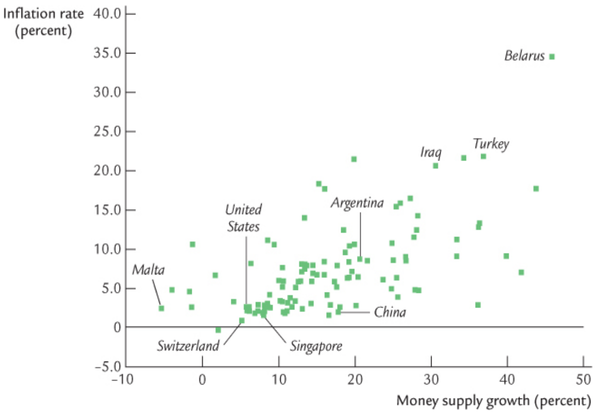
  - γ_m = growth of money supply
  - γ_v = growth of velocity
  - π = growth of price level (inflation)
  - γ_y = growth of real GDP

Classical Dichotomy

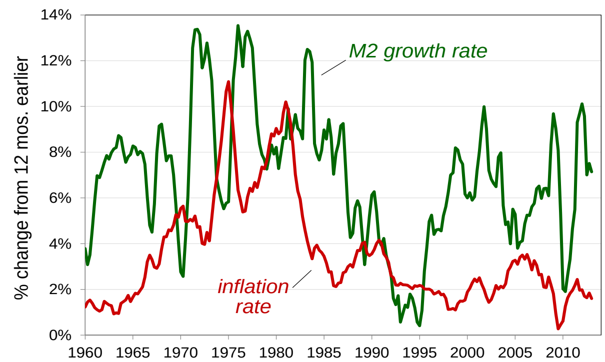
- Two assumptions
  - V is constant
  - Y not affected by changes in M (Chapter 3 of Mankiw)
    - This is the classical dichotomy, money has no affect on real variables.
    - We will loosen this idea later in course for the short run.
- One conclusion:
  - money growth causes inflation

$$\pi = \gamma_m - \gamma_y$$

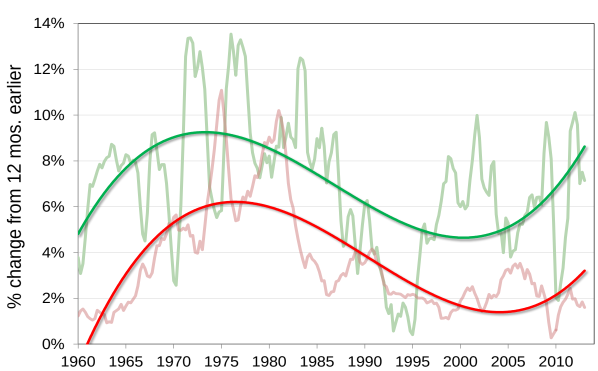
Quantity Theory, Across Countries



Quantity Theory, US Short-Run



Quantity Theory, US Long-Run



Zimbabwe

- Dec 06: inflation over 1000 percent
- Feb 07: inflation ruled "illegal"
- Oct 08: inflation over 200 million percent (!)
- Jan 09: transactions allowed in foreign currencies
  - Soldiers and teachers to be paid in USD
- Feb 09: 12 zeros knocked off currency

Buying Lunch in Zimbabwe