EC201 Intermediate Macroeconomics

Lecture 3: Money and Inflation

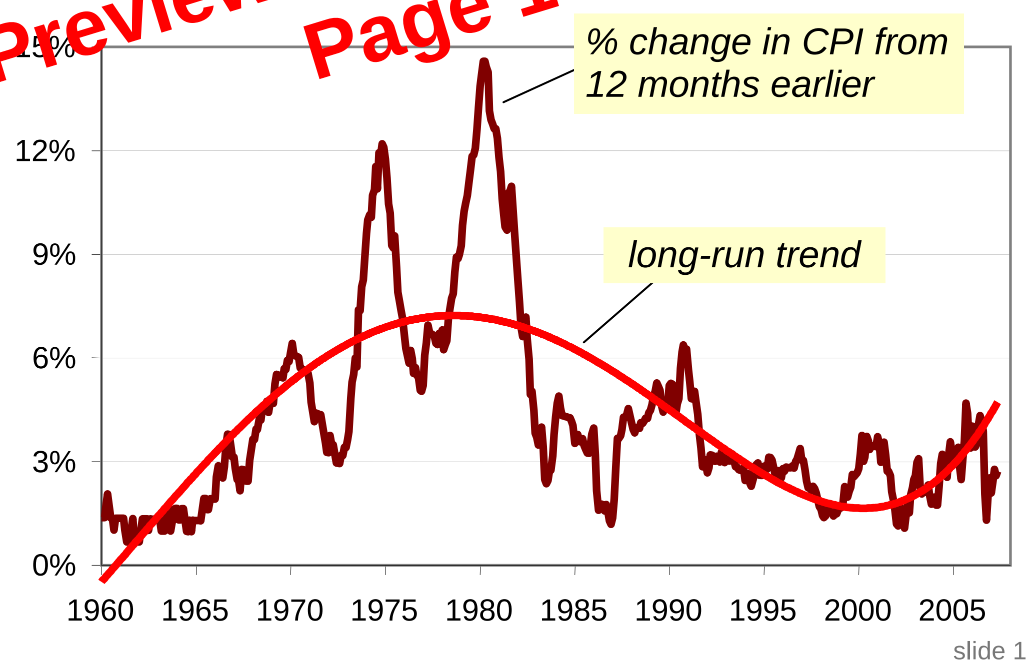
<u>Lecture Outline:</u>

- Money: definition and functions
- The quantity theory of money
- The classical theory of inflation

<u>Essential reading:</u>
Mankiw: Ch. 4 and Ch. 5

1) <u>Classical Theory of Inflation</u>

What causes inflation? According to Milton Friedman (Nobel Prize in economics 1976): "*inflation is always and everywhere a monetary phenomenon*"



Money: Types

1) *Fiat* money:

- Has no intrinsic value. Example: the paper currency we use. This is controlled directly by the Central bank that can print paper currency.

2) *Commodity* money

- Has intrinsic value. Examples: gold coins.

Question: why fiat money that is just a piece of paper with no intrinsic value has value for transactions? Why a good that has intrinsic value of £10 can be exchanged with a piece of paper where there is written £10 on it?

The money supply and monetary policy definitions

The **money supply** is the quantity of money available in the economy.

Monetary policy is the control over the money supply. Monetary policy is conducted by a country's **central bank**. Nowadays you may say that monetary policy is the control of the **price of money** that is the **interest rate** more than the control over the quantity of money in the system (= money supply). However, the previous definition is still a good one, since indeed the central bank controls the money supply and furthermore, there is a close link between money supply and the interest rate.

Usually, the primary way in which a central bank controls the supply of money is through **open-market operations**: the purchase and sale of government bonds.

If the central bank wants to increase the money supply in the country: it buys government bonds from the public therefore the money leaves the central bank and go to the public, this increases the total supply of money.

If the central bank wants to decrease money supply: it sells some of the bonds in its portfolio to the public. The money leaves the hands of the public and therefore money supply is reduced. **Quantitative Easing**: you may have heard about this expression that has been used extensively over the credit crunch period. Quantitative easing simply means printing money. What is the difference between quantitative easing and open market operations? They are very similar indeed; in both cases the central bank affects the total quantity of money in the system. However, while open market operations are conducted regularly by a central bank in order to affects the interest rate, quantitative easing is used as an ultimate tool when the interest rate is already very low (possibly zero, as it was in many cases during the credit crunch crisis). Furthermore, while open market operations will affect the balance sheet of the central bank only temporarily, quantitative easing will affect it permanently.