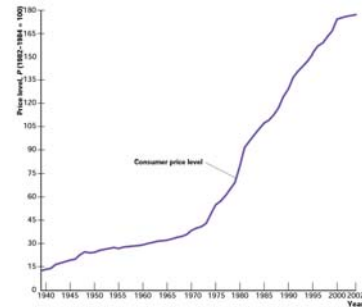


# Chapter 28

## Inflation: Causes and Consequences

1

Figure 28.1 Consumer Price Level in the U.S., 1939-2002

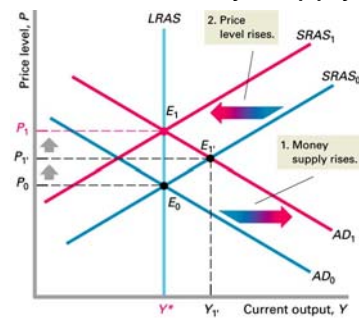


2

### Causes of Short-Term Price Level Fluctuations

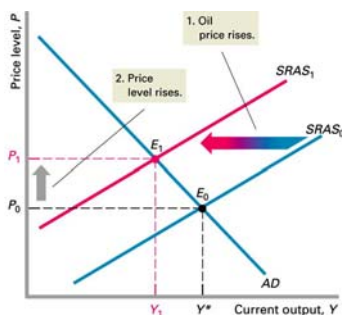
- Nominal aggregate demand could rise due to a nominal money supply increase. (M)
- Nominal aggregate demand could rise due to a short-run increase in velocity. (V)
- A fall in the growth rate of aggregate supply could occur. (Y)

### Price Level Effects of an Increase in the Money Supply



4

### Price Level Effects of an Oil Price Increase

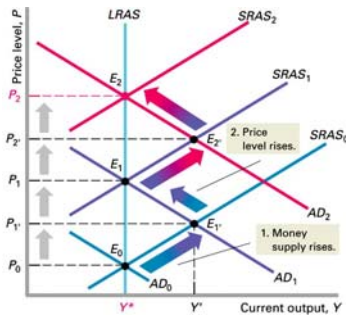


5

### Sustained Changes in the Price Level: Inflation

- Sustained rates of change in the price level constitute inflation.
- Inflation arises when aggregate demand grows faster than aggregate supply.
- One-time shocks cannot by themselves produce inflation.
- Sustained money supply growth causes inflation but does not affect real output.

## Persistent Money Supply Growth and Inflation



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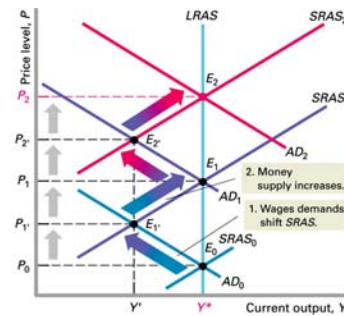
## Costs of Unexpected Inflation

- Because some contracts are set in nominal terms, wealth redistribution can occur.
- When inflation fluctuates significantly, relative prices may change.
- Inflation uncertainty causes distortion of information provided by prices.

## Inflation and Monetary Policy

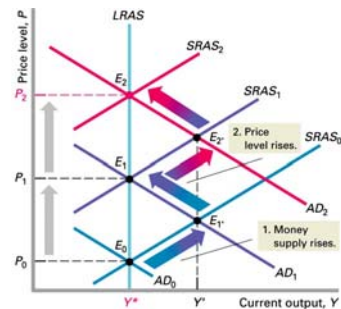
- Cost-push inflation results from workers' pressure for higher wages.
- Demand-pull inflation results from attempts to decrease the unemployment rate too low.

## Demand-Pull Inflation



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## Cost-Push Inflation

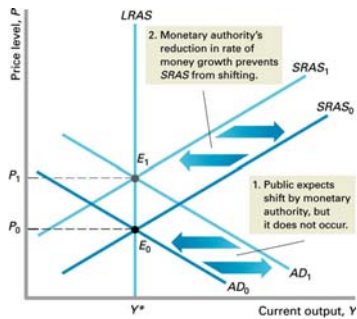


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## Reducing Inflation

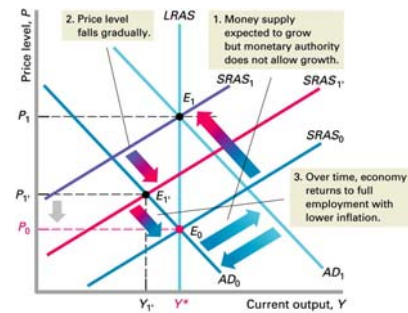
- Disinflation refers to a decline in long-run inflation.
- The new classical view argues for an immediate reduction in money growth.
- New Keynesians advocate slow and steady reduction in money growth.

## New Classical Suggestion: Cold Turkey Disinflation



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## New Keynesian Suggestion: Gradual Disinflation

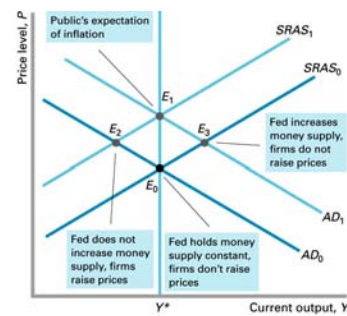


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## Central Bank Credibility

- A crucial factor in disinflationary policy is central bank credibility.
- Appointing a "tough" central banker is likely to increase central bank credibility.
- Some economists argue that the central bank should adopt a rules strategy.
- Other economists support a discretion strategy.

## Strategies for Changing the Economy's Equilibrium



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