Qualifications to the Quantity Theory

The Christmas Eve Caper

The Solution

The Neutrality of Money

Money is Neutral

(A But not always)

A Little Change

Suppose we modify our assumption, so that there are assets denominated in money terms.
Qualifications to the Quantity Theory

Effects on the Y curve

The Y curve still shifts up and to the right.

Effects on the M curve

The M curve still shifts up and to the left.

Qualifications to the Quantity Theory

Equilibrium

The price level will be higher. The effect on the interest rate is uncertain.

The Long Run Solution

Qualifications to the Quantity Theory

Conclusions

This is one case when the quantity theory does not work perfectly. Money is not exactly neutral.

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This is one case when the quantity theory does not work perfectly. Money is not exactly neutral. Given time for things to adjust, it works very well.
Another Exception

- The Christmas Eve Caper becomes permanent
- Distributions no longer in proportion to money holdings.
- There will come a day when people realize this is permanent.

Changes in Expectations

\[
\begin{align*}
Pr & = YM \\
2P_o & = Po \\
r_o & = Y'
\end{align*}
\]

Changed inflationary expectations changes \( \eta^e \) and hence \( r^m \). M curve shifts to \( M'' \).

The Friedman Surge

Thus even higher inflation, the Friedman surge.

What determines inflationary expectations?

\[
\eta^e_t = \eta_{t-1}
\]
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Rational Expectations

\[ \eta_t = \eta_t^e + \epsilon_t \]

Inflationary Expectations Include all Information

End

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