When the new nation won its independence, there was a natural skepticism about fiat money. Upon the recommendation of the first Secretary of Treasury, Alexander Hamilton, the Congress passed the Mint Act of 1792, which established gold and silver as the basis for a new system of commodity money.

4-4 Inflation and Interest Rates

As we first discussed in Chapter 3, interest rates are among the most important macroeconomic variables. In essence, they are the prices that link the present and the future. Here we discuss the relationship between inflation and interest rates.

Two Interest Rates: Real and Nominal

Suppose you deposit your savings in a bank account that pays 8 percent interest annually. Next year, you withdraw your savings and the accumulated interest. Are you 8 percent richer than you were when you made the deposit a year earlier?

The answer depends on what "richer" means. Certainly, you have 8 percent more dollars than you had before. But if prices have risen, each dollar buys less, and your purchasing power has not risen by 8 percent. If the inflation rate was 5 percent over the year, then the amount of goods you can buy has increased by only 3 percent. And if the inflation rate was 10 percent, then your purchasing power has fallen by 2 percent.

Economists call the interest rate that the bank pays the **nominal interest rate** and the increase in your purchasing power the **real interest rate**. If i denotes the nominal interest rate, r the real interest rate, and π the rate of inflation, then the relationship among these three variables can be written as

$$r = i - \pi.$$

The real interest rate is the difference between the nominal interest rate and the rate of inflation.[5]

The Fisher Effect

Rearranging terms in our equation for the real interest rate, we can show that the nominal interest rate is the sum of the real interest rate and the inflation rate:

$$i = r + \pi.$$

The equation written in this way is called the **Fisher equation**, after economist Irving Fisher (1867–1947). It shows that the nominal interest rate can change for two reasons: because the real interest rate changes or because the inflation rate changes.

[5] *Mathematical note:* This equation relating the real interest rate, nominal interest rate, and inflation rate is only an approximation. The exact formula is $(1 + r) = (1 + i)/(1 + \pi)$. The approximation in the text is reasonably accurate as long as r, i, and π are relatively small (say, less than 20 percent per year).

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Once we separate the nominal interest rate into these two parts, we can use this equation to develop a theory that explains the nominal interest rate. Chapter 3 showed that the real interest rate adjusts to equilibrate saving and investment. The quantity theory of money shows that the rate of money growth determines the rate of inflation. The Fisher equation then tells us to add the real interest rate and the inflation rate together to determine the nominal interest rate.

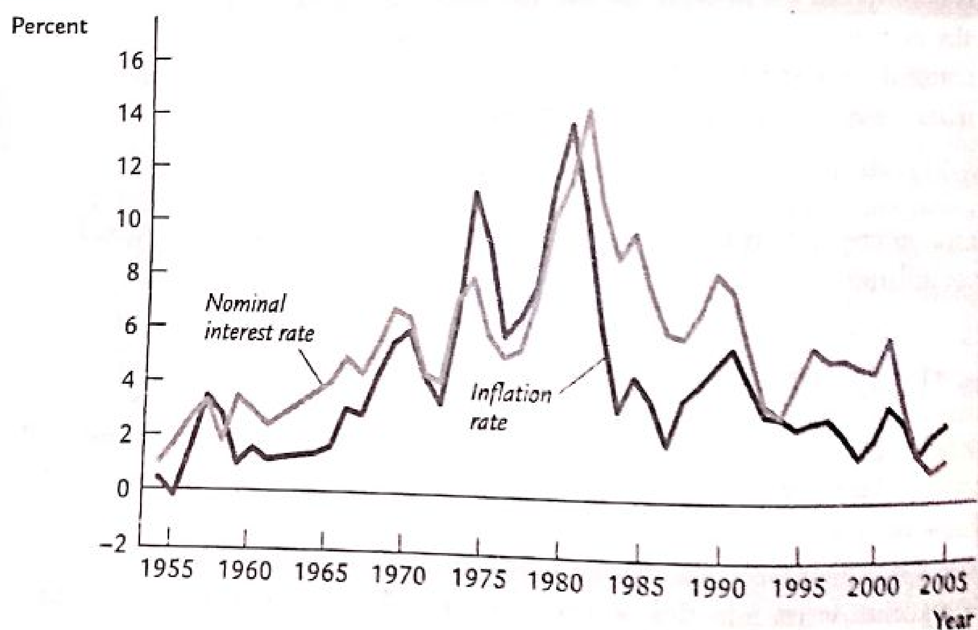
The quantity theory and the Fisher equation together tell us how money growth affects the nominal interest rate. *According to the quantity theory, an increase in the rate of money growth of 1 percent causes a 1 percent increase in the rate of inflation. According to the Fisher equation, a 1 percent increase in the rate of inflation in turn causes a 1 percent increase in the nominal interest rate.* The one-for-one relation between the inflation rate and the nominal interest rate is called the **Fisher effect.**

CASE STUDY

Inflation and Nominal Interest Rates

How useful is the Fisher effect in explaining interest rates? To answer this question we look at two types of data on inflation and nominal interest rates.

FIGURE 4-3



Inflation and Nominal Interest Rates Over Time This figure plots the nominal interest rate (on three-month Treasury bills) and the inflation rate (as measured by the CPI) in the United States since 1954. It shows the Fisher effect: higher inflation leads to a higher nominal interest rate.

Source: Federal Reserve and U.S. Department of Labor.

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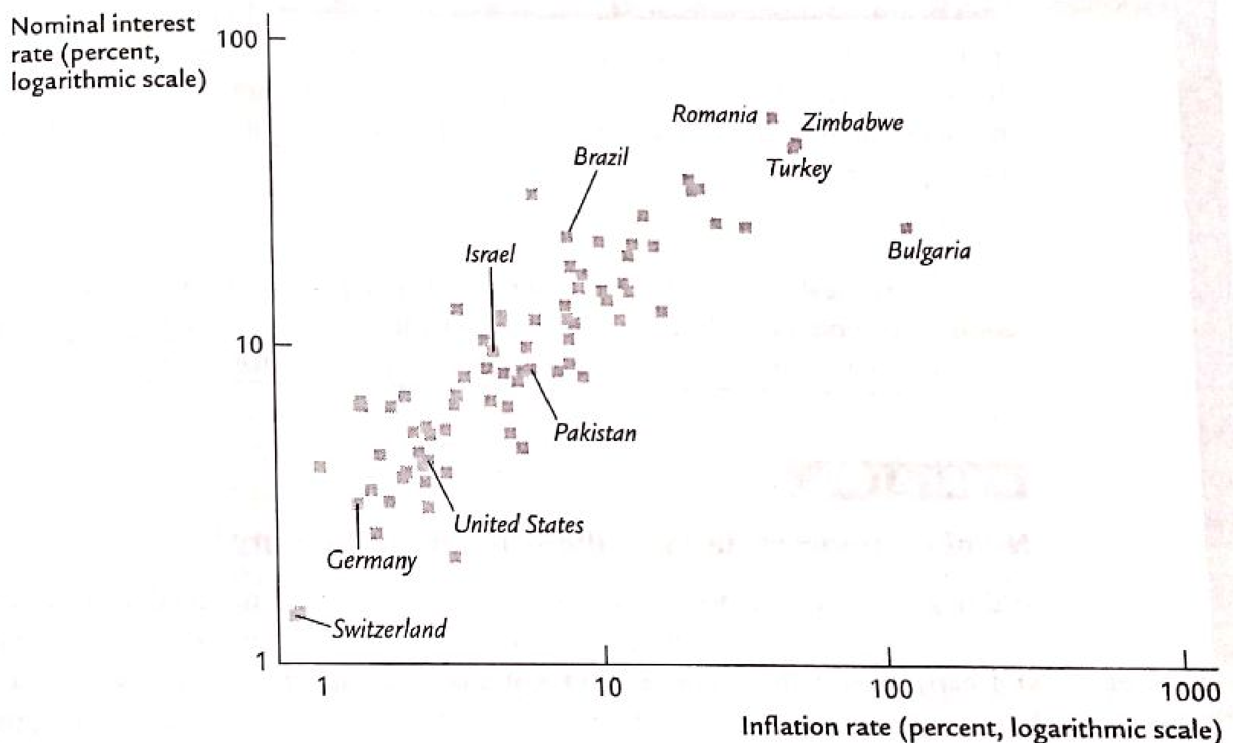
Figure 4-3 shows the variation over time in the nominal interest rate and the inflation rate in the United States. You can see that the Fisher effect has done a good job explaining fluctuations in the nominal interest rate over the past 50 years. When inflation is high, nominal interest rates are typically high, and when inflation is low, nominal interest rates are typically low as well.

Similar support for the Fisher effect comes from examining the variation across countries. As Figure 4-4 shows, a nation's inflation rate and its nominal interest rate are related. Countries with high inflation tend to have high nominal interest rates as well, and countries with low inflation tend to have low nominal interest rates.

FIGURE 4-4



Inflation and Nominal Interest Rates Across Countries This scatterplot shows the average nominal interest rate on short-term Treasury bills and the average inflation rate in 77 countries during the period 1996 to 2004. The positive correlation between the inflation rate and the nominal interest rate is evidence for the Fisher effect.

Source: International Financial Statistics.

The link between inflation and interest rates is well known to Wall Street investment firms. Because bond prices move inversely with interest rates, one can get rich by predicting correctly the direction in which interest rates will move. Many Wall Street firms hire *Fed watchers* to monitor monetary policy and news about inflation to anticipate changes in interest rates.

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Two Real Interest Rates: *Ex Ante* and *Ex Post*

When a borrower and lender agree on a nominal interest rate, they do not know what the inflation rate over the term of the loan will be. Therefore, we must distinguish between two concepts of the real interest rate: the real interest rate the borrower and lender expect when the loan is made, called the ***ex ante* real interest rate**, and the real interest rate actually realized, called the ***ex post* real interest rate**.

Although borrowers and lenders cannot predict future inflation with certainty, they do have some expectation about what the inflation rate will be. Let π denote actual future inflation and π^e the expectation of future inflation. The *ex ante* real interest rate is $i - \pi^e$, and the *ex post* real interest rate is $i - \pi$. The two real interest rates differ when actual inflation π differs from expected inflation π^e.

How does this distinction between actual and expected inflation modify the Fisher effect? Clearly, the nominal interest rate cannot adjust to actual inflation, because actual inflation is not known when the nominal interest rate is set. The nominal interest rate can adjust only to expected inflation. The Fisher effect is more precisely written as

$$i = r + \pi^e.$$

The *ex ante* real interest rate r is determined by equilibrium in the market for goods and services, as described by the model in Chapter 3. The nominal interest rate i moves one-for-one with changes in expected inflation π^e.

CASE STUDY

Nominal Interest Rates in the Nineteenth Century

Although recent data show a positive relationship between nominal interest rates and inflation rates, this finding is not universal. In data from the late nineteenth and early twentieth centuries, high nominal interest rates did not accompany high inflation. The apparent absence of any Fisher effect during this time puzzled Irving Fisher. He suggested that inflation "caught merchants napping."

How should we interpret the absence of an apparent Fisher effect in nineteenth-century data? Does this period of history provide evidence against the adjustment of nominal interest rates to inflation? Recent research suggests that this period has little to tell us about the validity of the Fisher effect. The reason is that the Fisher effect relates the nominal interest rate to *expected* inflation and, according to this research, inflation at this time was largely unexpected.

Although expectations are not observable, we can draw inferences about them by examining the persistence of inflation. In recent experience, inflation has been very persistent: when it is high one year, it tends to be high the next year as well. Therefore, when people have observed high inflation, it has been rational for them to expect high inflation in the future. By contrast, during the nineteenth century, when the gold standard was in effect, inflation had little persistence.

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Future Money and Current Prices

Money, prices, and interest rates are now related in several ways. Figure 4-5 illustrates the linkages we have discussed. As the quantity theory of money explains, money supply and money demand together determine the equilibrium price level. Changes in the price level are, by definition, the rate of inflation. Inflation, in turn, affects the nominal interest rate through the Fisher effect. But now, because the nominal interest rate is the cost of holding money, the nominal interest rate feeds back to affect the demand for money.

Consider how the introduction of this last link affects our theory of the price level. First, equate the supply of real money balances M/P to the demand $L(i, Y)$:

$$M/P = L(i, Y).$$

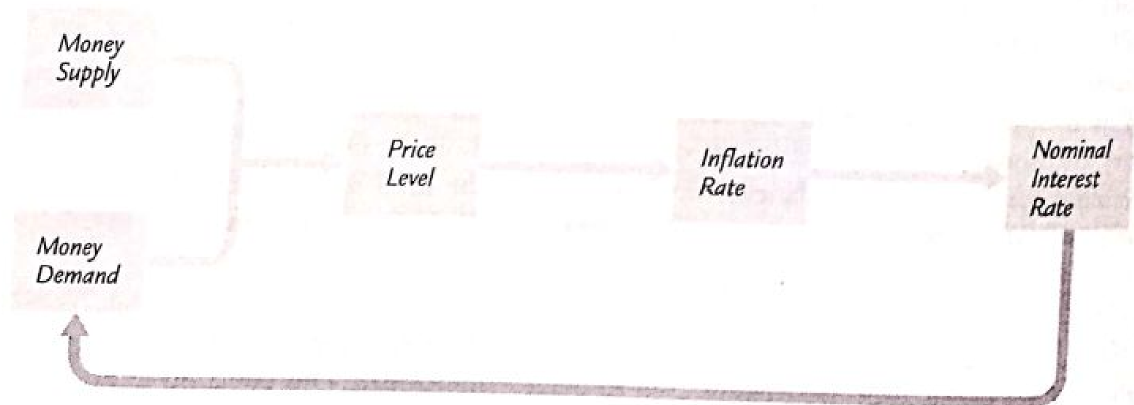
Next, use the Fisher equation to write the nominal interest rate as the sum of the real interest rate and expected inflation:

$$M/P = L(r + \pi^e, Y).$$

This equation states that the level of real money balances depends on the expected rate of inflation.

The last equation tells a more sophisticated story about the determination of the price level than does the quantity theory. The quantity theory of money says that today's money supply determines today's price level. This conclusion remains partly true: if the nominal interest rate and the level of output are held constant, the price level moves proportionately with the money supply. Yet the nominal

FIGURE 4-5



The Linkages Among Money, Prices, and Interest Rates This figure illustrates the relationships among money, prices, and interest rates. Money supply and money demand determine the price level. Changes in the price level determine the inflation rate. The inflation rate influences the nominal interest rate. Because the nominal interest rate is the cost of holding money, it may affect money demand. This last link (shown as a blue line) is omitted from the basic quantity theory of money.

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interest rate is not constant; it depends on expected inflation, which in turn depends on growth in the money supply. The presence of the nominal interest rate in the money demand function yields an additional channel through which money supply affects the price level.

This general money-demand equation implies that the price level depends not only on today's money supply but also on the money supply expected in the future. To see why, suppose the Fed announces that it will increase the money supply in the future, but it does not change the money supply today. This announcement causes people to expect higher money growth and higher inflation. Through the Fisher effect, this increase in expected inflation raises the nominal interest rate. The higher nominal interest rate increases the cost of holding money and therefore reduces the demand for real money balances. Because the Fed has not changed the quantity of money available today, the reduced demand for real money balances leads to a higher price level. Hence, higher expected money growth in the future leads to a higher price level today.

The effect of money on prices is complex. The appendix to this chapter presents the *Cagan model*, which shows how the price level is related to current and future money. The conclusion of the analysis is that the price level depends on a weighted average of the current money supply and the money supply expected to prevail in the future.

4-6 The Social Costs of Inflation

Our discussion of the causes and effects of inflation does not tell us much about the social problems that result from inflation. We turn to those problems now.

The Layman's View and the Classical Response

If you ask the average person why inflation is a social problem, he will probably answer that inflation makes him poorer. "Each year my boss gives me a raise, but prices go up and that takes some of my raise away from me." The implicit assumption in this statement is that if there were no inflation, he would get the same raise and be able to buy more goods.

This complaint about inflation is a common fallacy. As we know from Chapter 3, the purchasing power of labor—the real wage—depends on the marginal productivity of labor, not on how much money the government chooses to print. If the central bank reduces inflation by slowing the rate of money growth, workers will not see their real wage increasing more rapidly. Instead, when inflation slows, firms will increase the prices of their products less each year and, as a result, will give their workers smaller raises.

According to the classical theory of money, a change in the overall price level is like a change in the units of measurement. It is as if we switched from

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measuring distances in feet to measuring them in inches: numbers get larger, but nothing really changes. Imagine that tomorrow morning you wake up and find that, for some reason, all dollar figures in the economy have been multiplied by ten. The price of everything you buy has increased tenfold, but so have your wage and the value of your savings. What difference would such a price increase make to your life? All numbers would have an extra zero at the end, but nothing else would change. Your economic well-being depends on relative prices, not the overall price level.

Why, then, is a persistent increase in the price level a social problem? It turns out that the costs of inflation are subtle. Indeed, economists disagree about the size of the social costs. To the surprise of many laymen, some economists argue that the costs of inflation are small—at least for the moderate rates of inflation that most countries have experienced in recent years.[7]

CASE STUDY

What Economists and the Public Say About Inflation

As we have been discussing, laymen and economists hold very different views about the costs of inflation. Economist Robert Shiller has documented this difference of opinion in a survey of the two groups. The survey results are striking, for they show how the study of economics changes a person's attitudes.

In one question, Shiller asked people whether their "biggest gripe about inflation" was that "inflation hurts my real buying power, it makes me poorer." Of the general public, 77 percent agreed with this statement, compared to only 12 percent of economists. Shiller also asked people whether they agreed with the following statement: "When I see projections about how many times more a college education will cost, or how many times more the cost of living will be in coming decades, I feel a sense of uneasiness; these inflation projections really make me worry that my own income will not rise as much as such costs will." Among the general public, 66 percent said they fully agreed with this statement, whereas only 5 percent of economists agreed with it.

Survey respondents were asked to judge the seriousness of inflation as a policy problem: "Do you agree that preventing high inflation is an important national priority, as important as preventing drug abuse or preventing deterioration in the quality of our schools?" Fifty-two percent of laymen, but only 18 percent of economists, fully agreed with this view. Apparently, inflation worries the public much more than it does the economics profession.

The public's distaste for inflation may be psychological. Shiller asked those surveyed if they agreed with the following statement: "I think that if my pay went up I would feel more satisfaction in my job, more sense of fulfillment, even if prices went up just as much." Of the public, 49 percent fully or partly agreed with this statement, compared to 8 percent of economists.

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[7] See, for example, Chapter 2 of Alan Blinder, *Hard Heads, Soft Hearts: Tough-Minded Economics for a Just Society* (Reading, MA: Addison Wesley, 1987).

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Do these survey results mean that laymen are wrong and economists are right about the costs of inflation? Not necessarily. But economists do have the advantage of having given the issue more thought. So let's now consider what some of the costs of inflation might be.[8]

The Costs of Expected Inflation

Consider first the case of expected inflation. Suppose that every month the price level rose by 1 percent. What would be the social costs of such a steady and predictable 12 percent annual inflation?

One cost is the distortion of the inflation tax on the amount of money people hold. As we have already discussed, a higher inflation rate leads to a higher nominal interest rate, which in turn leads to lower real money balances. If people are to hold lower money balances on average, they must make more frequent trips to the bank to withdraw money—for example, they might withdraw $50 twice a week rather than $100 once a week. The inconvenience of reducing money holding is metaphorically called the **shoeleather cost** of inflation, because walking to the bank more often causes one's shoes to wear out more quickly.

A second cost of inflation arises because high inflation induces firms to change their posted prices more often. Changing prices is sometimes costly: for example, it may require printing and distributing a new catalog. These costs are called **menu costs**, because the higher the rate of inflation, the more often restaurants have to print new menus.

A third cost of inflation arises because firms facing menu costs change prices infrequently; therefore, the higher the rate of inflation, the greater the variability in relative prices. For example, suppose a firm issues a new catalog every January. If there is no inflation, then the firm's prices relative to the overall price level are constant over the year. Yet if inflation is 1 percent per month, then from the beginning to the end of the year the firm's relative prices fall by 12 percent. Sales from this catalog will tend to be low early in the year (when its prices are relatively high) and high later in the year (when its prices are relatively low). Hence, when inflation induces variability in relative prices, it leads to microeconomic inefficiencies in the allocation of resources.

A fourth cost of inflation results from the tax laws. Many provisions of the tax code do not take into account the effects of inflation. Inflation can alter individuals' tax liability, often in ways that lawmakers did not intend.

One example of the failure of the tax code to deal with inflation is the tax treatment of capital gains. Suppose you buy some stock today and sell it a year from now at the same real price. It would seem reasonable for the government not to levy a tax, because you have earned no real income from this investment. Indeed, if there is no inflation, a zero tax liability would be the outcome. But

[8] Robert J. Shiller, "Why Do People Dislike Inflation?" in Christina D. Romer and David H. Romer, eds., *Reducing Inflation: Motivation and Strategy* (Chicago: University of Chicago Press, 1997).

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suppose the rate of inflation is 12 percent and you initially paid $100 per share for the stock; for the real price to be the same a year later, you must sell the stock for $112 per share. In this case the tax code, which ignores the effects of inflation, says that you have earned $12 per share in income, and the government taxes you on this capital gain. The problem, of course, is that the tax code measures income as the nominal rather than the real capital gain. In this example, and in many others, inflation distorts how taxes are levied.

A fifth cost of inflation is the inconvenience of living in a world with a changing price level. Money is the yardstick with which we measure economic transactions. When there is inflation, that yardstick is changing in length. To continue the analogy, suppose that Congress passed a law specifying that a yard would equal 36 inches in 2006, 35 inches in 2007, 34 inches in 2008, and so on. Although the law would result in no ambiguity, it would be highly inconvenient. When someone measured a distance in yards, it would be necessary to specify whether the measurement was in 2006 yards or 2007 yards; to compare distances measured in different years, one would need to make an "inflation" correction. Similarly, the dollar is a less useful measure when its value is always changing. The changing value of the dollar requires that we correct for inflation when comparing dollar figures from different times.

For example, a changing price level complicates personal financial planning. One important decision that all households face is how much of their income to consume today and how much to save for retirement. A dollar saved today and invested at a fixed nominal interest rate will yield a fixed dollar amount in the future. Yet the real value of that dollar amount—which will determine the retiree's living standard—depends on the future price level. Deciding how much to save would be much simpler if people could count on the price level in 30 years being similar to its level today.

The Costs of Unexpected Inflation

Unexpected inflation has an effect that is more pernicious than any of the costs of steady, anticipated inflation: it arbitrarily redistributes wealth among individuals. You can see how this works by examining long-term loans. Most loan agreements specify a nominal interest rate, which is based on the rate of inflation expected at the time of the agreement. If inflation turns out differently from what was expected, the *ex post* real return that the debtor pays to the creditor differs from what both parties anticipated. On the one hand, if inflation turns out to be higher than expected, the debtor wins and the creditor loses because the debtor repays the loan with less valuable dollars. On the other hand, if inflation turns out to be lower than expected, the creditor wins and the debtor loses because the repayment is worth more than the two parties anticipated.

Consider, for example, a person taking out a mortgage in 1960. At the time, a 30-year mortgage had an interest rate of about 6 percent per year. This rate was based on a low rate of expected inflation—inflation over the previous decade had averaged only 2.5 percent. The creditor probably expected to receive a real return of about 3.5 percent, and the debtor expected to pay this real return. In fact, over

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the life of the mortgage, the inflation rate averaged 5 percent, so the *ex post* real return was only 1 percent. This unanticipated inflation benefited the debtor at the expense of the creditor.

Unanticipated inflation also hurts individuals on fixed pensions. Workers and firms often agree on a fixed nominal pension when the worker retires (or even earlier). Because the pension is deferred earnings, the worker is essentially providing the firm a loan: the worker provides labor services to the firm while young but does not get fully paid until old age. Like any creditor, the worker is hurt when inflation is higher than anticipated. Like any debtor, the firm is hurt when inflation is lower than anticipated.

These situations provide a clear argument against variable inflation. The more variable the rate of inflation, the greater the uncertainty that both debtors and creditors face. Because most people are *risk averse*—they dislike uncertainty—the unpredictability caused by highly variable inflation hurts almost everyone.

Given these effects of uncertain inflation, it is puzzling that nominal contracts are so prevalent. One might expect debtors and creditors to protect themselves from this uncertainty by writing contracts in real terms—that is, by indexing to some measure of the price level. In economies with high and variable inflation, indexation is often widespread; sometimes this indexation takes the form of writing contracts using a more stable foreign currency. In economies with moderate inflation, such as the United States, indexation is less common. Yet even in the United States, some long-term obligations are indexed. For example, Social Security benefits for the elderly are adjusted annually in response to changes in the consumer price index. And in 1997, the U.S. federal government issued inflation-indexed bonds for the first time.

Finally, in thinking about the costs of inflation, it is important to note a widely documented but little understood fact: high inflation is variable inflation. That is, countries with high average inflation also tend to have inflation rates that change greatly from year to year. The implication is that if a country decides to pursue a high-inflation monetary policy, it will likely have to accept highly variable inflation as well. As we have just discussed, highly variable inflation increases uncertainty for both creditors and debtors by subjecting them to arbitrary and potentially large redistributions of wealth.

CASE STUDY

The Free Silver Movement, the Election of 1896, and the Wizard of Oz

The redistributions of wealth caused by unexpected changes in the price level are often a source of political turmoil, as evidenced by the Free Silver movement in the late nineteenth century. From 1880 to 1896 the price level in the United States fell 23 percent. This deflation was good for creditors, primarily the bankers of the Northeast, but it was bad for debtors, primarily the farmers of the South and West. One proposed solution to this problem was to replace the gold standard with a bimetallic standard, under which both gold and silver could

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One Benefit of Inflation

So far, we have discussed the many costs of inflation. These costs lead many econ-omists to conclude that monetary policymakers should aim for zero inflation. Yet there is another side to the story. Some economists believe that a little bit of infla-tion—say, 2 or 3 percent per year—can be a good thing.

The argument for moderate inflation starts with the observation that cuts in nominal wages are rare: firms are reluctant to cut their workers' nominal wages.

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[9] The movie made forty years later hid much of the allegory by changing Dorothy's slippers from silver to ruby. For more on this topic, see Henry M. Littlefield, "The Wizard of Oz: Parable on Pop-ulism," *American Quarterly* 16 (Spring 1964): 47–58; and Hugh Rockoff, "The Wizard of Oz as a Monetary Allegory," *Journal of Political Economy* 98 (August 1990): 739–760. It should be noted that there is no direct evidence that Baum intended his work as a monetary allegory, so some people believe that the parallels are the work of economic historians' overactive imaginations.

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and workers are reluctant to accept such cuts. A 2-percent wage cut in a zero-inflation world is, in real terms, the same as a 3-percent raise with 5-percent inflation, but workers do not always see it that way. The 2-percent wage cut may seem like an insult, whereas the 3-percent raise is, after all, still a raise. Empirical studies confirm that nominal wages rarely fall.

This finding suggests that some inflation may make labor markets work better. The supply and demand for different kinds of labor are always changing. Sometimes an increase in supply or decrease in demand leads to a fall in the equilibrium real wage for a group of workers. If nominal wages can't be cut, then the only way to cut real wages is to allow inflation to do the job. Without inflation, the real wage will be stuck above the equilibrium level, resulting in higher unemployment.

For this reason, some economists argue that inflation "greases the wheels" of labor markets. Only a little inflation is needed: an inflation rate of 2 percent lets real wages fall by 2 percent per year, or 20 percent per decade, without cuts in nominal wages. Such automatic reductions in real wages are impossible with zero inflation.[10]

4-7 Hyperinflation

Hyperinflation is often defined as inflation that exceeds 50 percent per month, which is just over 1 percent per day. Compounded over many months, this rate of inflation leads to very large increases in the price level. An inflation rate of 50 percent per month implies a more than 100-fold increase in the price level over a year, and a more than 2-million-fold increase over three years. Here we consider the costs and causes of such extreme inflation.

The Costs of Hyperinflation

Although economists debate whether the costs of moderate inflation are large or small, no one doubts that hyperinflation extracts a high toll on society. The costs are qualitatively the same as those we discussed earlier. When inflation reaches extreme levels, however, these costs are more apparent because they are so severe.

The shoeleather costs associated with reduced money holding, for instance, are serious under hyperinflation. Business executives devote much time and energy to cash management when cash loses its value quickly. By diverting this time and energy from more socially valuable activities, such as production and investment decisions, hyperinflation makes the economy run less efficiently.

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[10] For a recent paper examining this benefit of inflation, see George A. Akerlof, William T. Dickens, and George L. Perry, "The Macroeconomics of Low Inflation," *Brookings Papers on Economic Activity*, 1996:1, pp. 1–76.

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Menu costs also become larger under hyperinflation. Firms have to change prices so often that normal business practices, such as printing and distributing catalogs with fixed prices, become impossible. In one restaurant during the German hyperinflation of the 1920s, a waiter would stand up on a table every 30 minutes to call out the new prices.

Similarly, relative prices do not do a good job of reflecting true scarcity during hyperinflations. When prices change frequently by large amounts, it is hard for customers to shop around for the best price. Highly volatile and rapidly rising prices can alter behavior in many ways. According to one report, when patrons entered a pub during the German hyperinflation, they would often buy two pitchers of beer. Although the second pitcher would lose value by getting warm over time, it would lose value less rapidly than the money left sitting in the patron's wallet.

Tax systems are also distorted by hyperinflation—but in ways that are different from the distortions of moderate inflation. In most tax systems there is a delay between the time a tax is levied and the time the tax is paid to the government. In the United States, for example, taxpayers are required to make estimated income tax payments every three months. This short delay does not matter much under low inflation. By contrast, during hyperinflation, even a short delay greatly reduces real tax revenue. By the time the government gets the money it is due, the money has fallen in value. As a result, once hyperinflations start, the real tax revenue of the government often falls substantially.

Finally, no one should underestimate the sheer inconvenience of living with hyperinflation. When carrying money to the grocery store is as burdensome as carrying the groceries back home, the monetary system is not doing its best to facilitate exchange. The government tries to overcome this problem by adding more and more zeros to the paper currency, but often it cannot keep up with the exploding price level.

Eventually, these costs of hyperinflation become intolerable. Over time, money loses its role as a store of value, unit of account, and medium of exchange. Barter becomes more common. And more stable unofficial monies—cigarettes or the U.S. dollar—start to replace the official money.

CASE STUDY

Life During the Bolivian Hyperinflation

The following article from the *Wall Street Journal* shows what life was like during the Bolivian hyperinflation of 1985. What costs of inflation does this article emphasize?

Precarious Peso – Amid Wild Inflation, Bolivians Concentrate on Swapping Currency

LA PAZ, Bolivia—When Edgar Miranda gets his monthly teacher's pay of 25 million pesos, he hasn't a moment to lose. Every hour, pesos drop in value. So, while his wife rushes to market to lay in a month's supply of rice and noodles, he is off with the rest of the pesos to change them into black-market dollars.

Mr. Miranda is practicing the First Rule of Survival amid the most out-of-control inflation in the world today. Bolivia is a case study of how runaway infla-

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The Causes of Hyperinflation

Why do hyperinflations start, and how do they end? This question can be answered at different levels.

The most obvious answer is that hyperinflations are due to excessive growth in the supply of money. When the central bank prints money, the price level rises. When it prints money rapidly enough, the result is hyperinflation. To stop the hyperinflation, the central bank must reduce the rate of money growth.

This answer is incomplete, however, for it leaves open the question of why central banks in hyperinflating economies choose to print so much money. To address this deeper question, we must turn our attention from monetary to fiscal policy. Most hyperinflations begin when the government has inadequate tax revenue to pay for its spending. Although the government might prefer to

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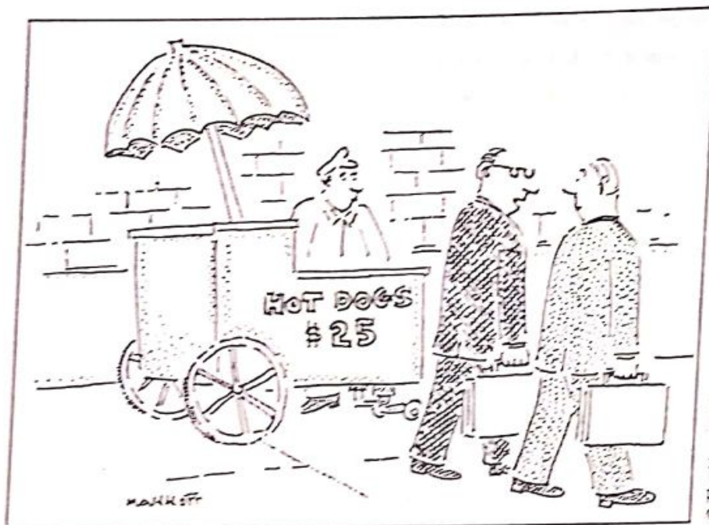

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"I told you the Fed should have tightened."

finance this budget deficit by issuing debt, it may find itself unable to borrow, perhaps because lenders view the government as a bad credit risk. To cover the deficit, the government turns to the only mechanism at its disposal—the printing press. The result is rapid money growth and hyperinflation.

Once the hyperinflation is under way, the fiscal problems become even more severe. Because of the delay in collecting tax payments, real tax revenue falls as inflation rises. Thus, the government's need to rely on seigniorage is self-reinforcing. Rapid money creation leads to hyperinflation, which leads to a larger budget deficit, which leads to even more rapid money creation.

The ends of hyperinflations almost always coincide with fiscal reforms. Once the magnitude of the problem becomes apparent, the government musters the political will to reduce government spending and increase taxes. These fiscal reforms reduce the need for seigniorage, which allows a reduction in money growth. Hence, even if inflation is always and everywhere a monetary phenomenon, the end of hyperinflation is often a fiscal phenomenon as well.[11]

CASE STUDY

4-8 Conclusion: The Classical Dichotomy

We have finished our discussion of money and inflation. Let's now step back and examine a key assumption that has been implicit in our discussion.

In Chapter 3, we explained many macroeconomic variables. Some of these variables were *quantities,* such as real GDP and the capital stock; others were *relative prices,* such as the real wage and the real interest rate. But all of these variables had one thing in common—they measured a physical (rather than a monetary) quantity. Real GDP is the quantity of goods and services produced in a given year, and the capital stock is the quantity of machines and structures available at a given time. The real wage is the quantity of output a worker earns for each hour of work, and the real interest rate is the quantity of output a person earns in the future by lending one unit of output today. All variables measured in physical units, such as quantities and relative prices, are called **real variables**.

In this chapter we examined **nominal variables**—variables expressed in terms of money. The economy has many nominal variables, such as the price level, the inflation rate, and the dollar wage a person earns.

At first it may seem surprising that we were able to explain real variables without introducing nominal variables or the existence of money. In Chapter 3 we

[12] The data on newspaper prices are from Michael Mussa, "Sticky Individual Prices and the Dynamics of the General Price Level," *Carnegie-Rochester Conference on Public Policy* 15 (Autumn 1981): 261-296.

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studied the level and allocation of the economy's output without mentioning the price level or the rate of inflation. Our theory of the labor market explained the real wage without explaining the nominal wage.

Economists call this theoretical separation of real and nominal variables the **classical dichotomy**. It is the hallmark of classical macroeconomic theory. The classical dichotomy is an important insight because it simplifies economic theory. In particular, it allows us to examine real variables, as we have done, while ignoring nominal variables. The classical dichotomy arises because, in classical economic theory, changes in the money supply do not influence real variables. This irrelevance of money for real variables is called **monetary neutrality**. For many purposes—in particular for studying long-run issues—monetary neutrality is approximately correct.

Yet monetary neutrality does not fully describe the world in which we live. Beginning in Chapter 9, we discuss departures from the classical model and monetary neutrality. These departures are crucial for understanding many macroeconomic phenomena, such as short-run economic fluctuations.

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