



FIGURE 10.2 The effects of an increase in money growth

A corollary is that a reduction in inflation can be accompanied by a temporary period of unusually high money growth. Suppose that policymakers want to reduce inflation and that they do not want the price level to change discontinuously. What path of M is needed to do this? The decline in inflation will reduce expected inflation, and thus lower the nominal interest rate and raise the quantity of real balances demanded. Writing the money market equilibrium condition as $M = PL(i, Y)$, it follows that—since $L(i, Y)$ increases discontinuously and P does not jump— M must jump up.

Of course, to keep inflation from this higher level.

Thus, the monetary policy response to inflation is a sudden upward jump in money growth. And, in fact, the clear cause of hyperinflations—are accompanied by a period of high money growth that continue for a time after

The Case of Incomplete

In the preceding analysis, a central bank can raise interest rates. In practice, however, a monetary expansion is to lower short-term interest rates. Monetary expansions on nominal

The conventional explanation is that monetary expansions reduce real rates. A decline in the money stock raises the nominal interest rate. In terms of the money market, the economy moves down along the money demand curve. If enough, it more than offsets the

If prices are fully flexible, the economy returns to normal following the real-rate effect dominates the monetary shift depresses the nominal interest rate. As Friedman (1968) provides a description of the effects of a central bank's expansionary policy, the nominal interest rate for several years longer term.

10.2 Monetary Policy and Structure

In many situations, we are concerned with interest rates, but also of the effect of monetary policy affects long-term real interest rates and short-term and long-term

² This analysis raises the question of whether the price level is exploding. We return to this issue in a later section.

³ See Problem 10.2. In addition, for any interval of time, then expected inflation in this case short-term nominal real