

Economics Chapter 14 – Money and the Economy

1. **Velocity** – the average number of times a dollar is spent to buy final goods and services in a year
2. **Equation of Exchange** – an identity stating that the **money supply \* velocity = price level \* Real GDP**
  - a. **Another way to state it: Money supply \* velocity = nominal GDP (not adjusted for inflation)**
3. **Simple Quantity Theory of Money** – the velocity and real GDP are constant and predicts that the changes in the money supply lead to strictly proportional changes in the price level
4. If the money supply goes up, then nominal GDP goes up. If nominal GDP goes up but real GDP stays the same, then inflation must have went up. In other words, if real GDP stays the same, the price level (aka GDP deflator) must have gone up
5. **Derived from above: Money growth + velocity growth = inflation (price level growth) + real GDP growth**
  - a. If you want to prove this equation, take the derivative of the Equation of Exchange
6. **Generally, an increase in the money supply will cause inflation**
  - a. More money chasing the same number of goods and services, so everything costs more
7. An increase in the money supply or velocity will increase AD and shift the AD curve to the right
8. Monetarists believe that velocity changes in a predictable way, and is a function of other variables
9. According to the simple quantity theory of money, the short run AS curve is vertical. However, monetarists believe that it is upward sloping, since it can change
10. Monetarists also believe that the economy is self regulating, and that prices and wages are flexible
11. **One Shot Inflation** – a one time increase in the price level. An increase in the price level that does not continue
  - a. Can be caused by the increased demand or decreased supply
12. **Continued Inflation** – a continued increase in price level, caused by constant increases in AD or money supply
13. **Liquidity Effect** – the change in the interest rate due to a change in the supply of loanable funds
14. **Income Effect** – the change in the interest rate due to a change in Real GDP
15. **Price Level Effect** – the change in the interest rate due to a change in the price level
16. **Expectations Effect** – the change in the interest rate due to a change in the expected inflation rate
17. **Nominal Interest Rate** – the interest rate actually charged or paid in the market
  - a.  $\text{Nominal Interest Rate} = \text{Real Interest Rate} + \text{Expected Inflation Rate}$
18. **Real Interest Rate** – the nominal interest rate minus the expected inflation rate