Money and Inflation

There are many historical illustrations of the positive correlation between money and inflation.

Historical Episodes

- Price Revolution
- American Revolution
- Europe in the 1800s
- Latin America, post-World War II
- German hyperinflation after World War I

Long-Run Relationship

The relationship between money and inflation is a long-run relationship. For annual data for the United States, the correlation of money growth and inflation is positive, but not near one.

The strong positive correlation between money and inflation across the centuries and across countries suggests that the relationship is basic.

Causality

Proponents of the monetary theory of inflation contend that the increase in money is exogenous, not a reaction to economic events. This exogenous increase causes prices to rise.

Reverse Causality?

A few economists see money as endogenous.

For example, consider the gold discoveries of the 1800s. They contend that the rising price of gold (the falling price of goods in terms of gold) induced prospecting for gold, which led to discoveries. There exists a natural price of gold in terms of goods, and a deviation of the current price from this natural price affects behavior.

Paper Money

Since World War I, the world has used paper money. Consistently the use of paper money has been associated with money growth and inflation.

Fluctuating Inflation

Countries with high inflation on average tend to have high fluctuation of the rate of inflation.