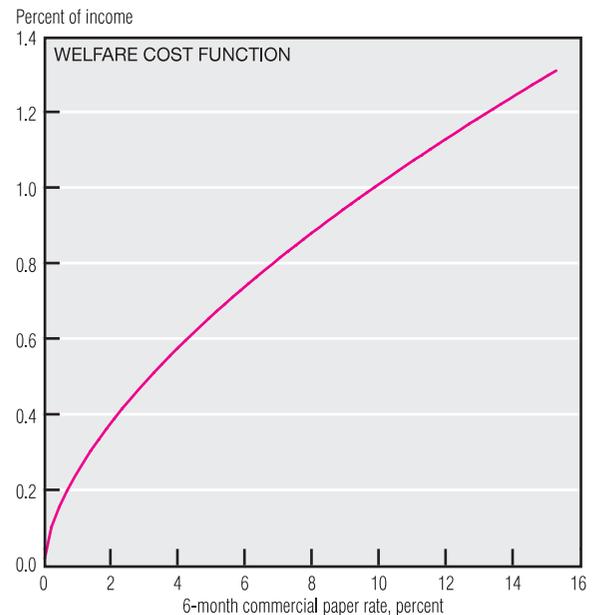
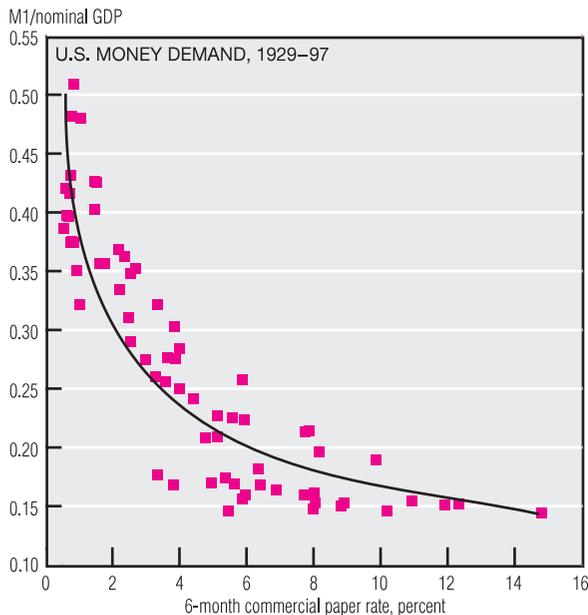
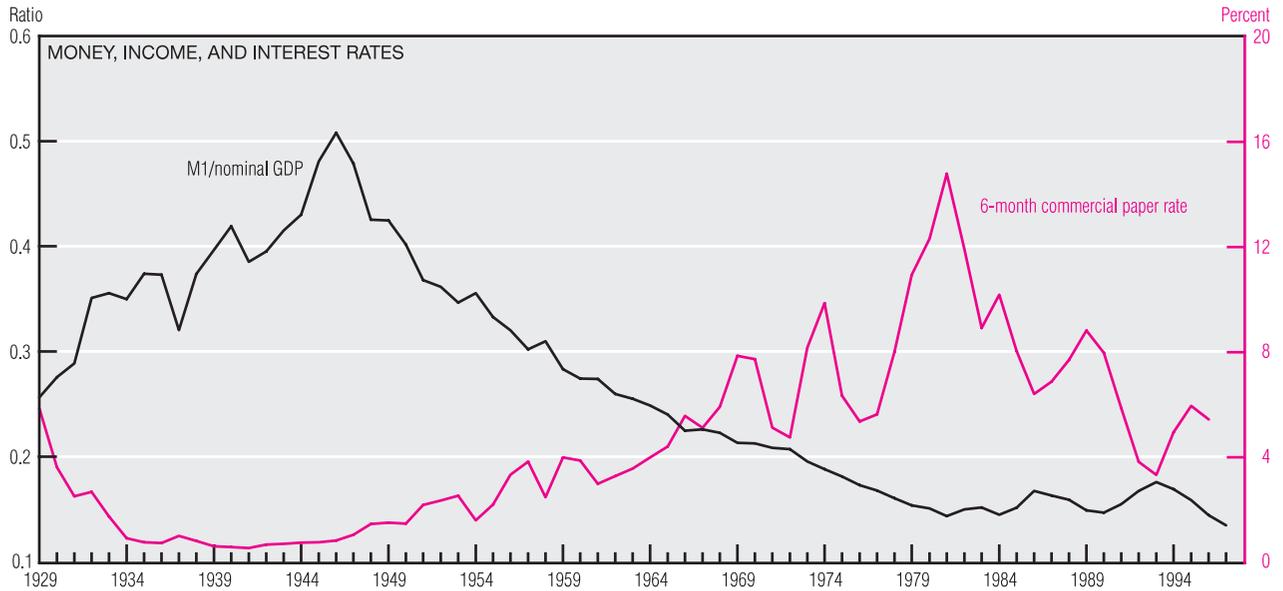


# The Cost of Inflation



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Robert E. Lucas, "Inflation and Welfare," *Econometrica* (forthcoming); and Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960*, Princeton, N.J.: Princeton University Press, 1963, pp. 708-22.

Historically, there has been a negative relationship between interest rates and the ratio of money to nominal GDP. This means that during periods of high interest rates, like the early 1980s, individuals attempt to shed money balances that are not earning interest. The opportunity cost of money is the interest forgone by not holding funds in an interest-bearing account. It is not surprising, therefore, that between the mid-1940s, when interest rates averaged less than 1%, and the early 1980s, when they approached 15%,

the ratio of M1 to GDP dropped approximately threefold.

Because lenders seek compensation for any erosion in the purchasing power of the funds they provide, inflation rates eventually become fully reflected in interest rates. When inflation rises, interest rates and the opportunity cost of maintaining cash balances also increase, so people attempt to economize on their cash holdings. The time and resources devoted to this pursuit—a cost that society pays for higher inflation—are wasted in the sense that they

produce no consumable output. As a nation, we spend millions of hours and employ thousands of people in this endeavor.

According to a standard estimation technique, a one-time, 1% increase in inflation from its current level translates into a 0.7% loss in annual output, or approximately \$6.1 billion per year. A permanent 1% increase in inflation is thus equivalent to society throwing away \$203.3 billion over time. Clearly, vigilance against rising inflation is a policy with obvious and tangible results.