

ABSTRACT:

We study an monetary in which final goods sell on spot markets, while labor and dividends sell through contracts. Firms and workers confuse absolute and relative price changes: A positive price-level shock makes sellers think they are producing better goods than they really are. They split this apparent windfall with workers who get a higher real wage. Hence, unexpected inflation shifts real income from firms (the principals) to workers (the agents), and thereby lowers stock-returns. A predictable money-supply rule *strictly* Pareto-dominates random money-supply rules.

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