WEEKLY OUTLOOK
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CONTROLLING THE MONEY SUPPLY MAY LOWER INFLATION

THE FEDERAL RESERVE BOARD HAS, over the last year or so, stated that its current policy is to control the nation's money supply to reduce inflation. This policy creates a paradoxical situation in which the control of the money supply initially raises interest rates and contributes to an increase in inflation. As with any commodity, when the supply of money is restricted and demand grows, the price of money has to rise. In other words, lenders, who have less money to supply as a result of the Federal Reserve's action, will charge higher interest to borrowers. That is what has occurred during the last year and a half.

Since May, one measure of the money supply has actually been declining, resulting in a rise in the prime interest rate to over 20 percent. This increase contributes to a higher inflation rate as measured by the Consumer Price Index (CPI). Components of the CPI include measures of interest costs to consumers. The strength of the relationship between interest rates and the CPI exists because one of the interest costs included in the CPI is the interest paid for a mortgage, a significant part of the consumer's monthly budget.

Part of the solution to high inflation begins with high interest rates. High interest rates reduce borrowing, which reduces consumer spending. In other words, there is less money to spend on a limited supply of goods so manufacturers' price increases should be minimal. In addition, consumers with extra money may find the higher interest rates offered by banks and other investment services attractive, so they may save or invest their money instead of spending it. In the long run, as savings increase, interest rates should fall and businesses can borrow to expand their production capacity to meet growing consumer demands. The supply of goods should then expand enough to further limit the price increases charged by a manufacturer.

These long-run changes reflect the overall solution to the economy's problems. Behind this solution is a theory that relates the money supply to the economy's general price level and the gross national product (GNP). In brief, this theory states that if the money supply expands at a faster rate than the real gross national product, then the general price level (inflation) must increase. Evidence of this relationship can be seen by reviewing relevant economic data from 1961 to 1980. During the 1960's, the average annual change in the money supply was 4.1 percent, only slightly more than the average change in the GNP of 3.7 percent. The inflation rate during that same time was 2.8 percent per year. During the 1970's, the money supply grew at the more rapid rate of 6.6 percent per year with an average increase in the GNP of 3.2 percent. The inflation rate more than doubled to an average of 7.9 percent per year.

At present, the Federal Reserve's targets for monetary growth are in the range of 3.5 to 6 percent. If these targets are met for an extended period of time, it is possible that consumers will see inflation fall to a level below 5 percent per year within the next few years.

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