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Headline: Impact of money supply on inflation
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Impact of money supply on inflation

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Does a decrease in money supply always lead to an increase in interest rates? How long will the current loose monetary policy in the United States continue?

GENERALLY, a decrease in money supply should lead to an increase in interest rates. When a central bank raises bank reserve requirements, or sells Treasury bills or other government securities, banks will have less cash to lend, and the reduction in loan supply tends to cause interest rates to increase.

However, there are possible exceptions to this general tendency. If prices of goods and services adjust gradually over time to the monetary tightening, the latter can induce a decline in expected future inflation. Since nominal interest rates are the sum of real interest rates and expected inflation rates, the reduction in inflationary expectations can induce a decline in nominal interest rates (though real interest rate increase).

This effect may persist over time if a tightening of money supply induces expectations of further tightening in the future, which will affect current nominal interest rates on securities with longer maturities.

In an open economy, lower expected future inflation would also tend to cause market participants to expect the country's exchange rate against other currencies to strengthen, and such an expectation would cause domestic nominal interest rates to decline against foreign nominal interest rates.

Another possible scenario is that of an economy hit by an adverse terms-of-trade shock, such as an increase in the price of imported oil. This would lead to stagflation: higher prices as well as a fall in real economic activity. If the central bank is mainly concerned about price stability, it would tighten money supply. But the fall in real economic activity would tend to reduce loan demand by businesses and households, and this could outweigh the monetary tightening to bring about a fall in interest rates.

The US Federal Reserve has maintained the target range for the federal funds rate (the overnight interbank lending rate) at 0.25 per cent since December 2008, and is not likely to change it at its Federal Open Market Committee meeting this month. The US economic recovery has been weak lately, which warrants a continuation of the current relaxed monetary policy stance.

Scotia Economics, a Canadian research group, in its Global Forecast Update of Sept 2, says it expects the Fed to keep its overnight rate unchanged at 0.25 per cent through the end of the third quarter of next year. It adds: "We have also flattened the trajectory of the cyclical upswing in US government bond yields, reflecting the extended period of Fed accommodation and muted inflation, as well as a slower revival in private sector credit demands."

With these factors likely to persist well into next year, we now expect the yield on the 10-year US Treasury bond to end 2011 at 3.6 per cent. Indeed, recent 10-year US Treasury bond yields have been well below the historical average from 1971 to this year, which, according to economic research firm Trading Economics, was 7.18 per cent.

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