Money and inflation

Donald Trump says he will reduce the inflation rate by making it easier for energy companies to drill for oil and natural gas. Joe Biden claimed that he already reduced the inflation rate by putting price controls on medicines. Both of these politicians overstate how much their policies can (or did) influence inflation. What matters is money – the quantity of it.

Joe McGarrity

When there is more money, the inflation rate increases. When there is less money, the inflation rate decreases. Here is how that second scenario works. As a starting point, assume there is a certain amount of money in the economy. People use this money to buy goods and services. With the available amount of money, people decide how much they want to spend on each product. The people who are willing to pay the most for products get them and the competition among people to make purchases determines the products' prices. Next, suppose the money supply shrinks. With less money in the economy, people will not be willing to pay as much for products, so the competition among consumers to purchase items will result in lower prices. If enough prices decrease, the inflation rate will decrease or even become negative.

So does all this imply that the government can easily reduce the inflation rate by reducing the money supply? No, unfortunately, it does not. Mostly because the government only directly controls a small fraction of the overall money supply. M2, a common measure of money, is made up of currency, bank-created money and a small amount of investments that can be quickly liquidated for currency. Certainly, the government creates currency, so it can precisely control this component of the money supply. But, the government obviously does not create bank-created money, so it cannot directly control this component of money.

So how do banks create money? An example will make this clear. Suppose I am the only one with money in a small town. If I have $1,000 in currency, the money supply is $1,000. If I deposit my currency at a bank, the money supply is still $1,000 – it is just that now the money is in the bank's vault. If the bank loans Beth $1,000 and she put the money in a checking account, the money supply is now $2,000. This includes the $1,000 of currency in the bank vault as well as the $1,000 in Beth's account. The money in Beth's account is not backed by currency. Instead, it is backed by Beth's promise to repay her loan. At this point, currency and bank-created money each contribute $1,000 to M2. If the bank makes more loans, and people deposit these loans into the bank, the bank will create even more money and the percentage of money that is made up of currency will decrease.

In fact, according to the Federal Reserve in May 2024, in the U.S. economy, M2 was 27 percent currency and 64 percent bank-created money. So the federal government only directly controls a relatively small fraction of the overall money supply. The government can influence the biggest component of the money supply (bank-created money) but this influence is imprecise. Some economists have argued that this indirect influence is as effective as pushing on a string. In this analogy, if the government is trying to influence bank-created money, it is pushing on a string, which is often ineffective. Pushing on a string is ineffective because the string can bend and fail to accomplish the goal of the string pusher. Similarly, the government's attempt to change the quantity of bank-created money is often ineffective because banks can act on their own and ignore the government's wishes. I should mention that the government does not attempt to manipulate the amount of currency in an attempt to alter economic outcomes. Rather it attempts to alter bank-created money – that is, it pushes on the string.

While economists argue about how effectively the government can influence bank-created money to reduce the inflation rate, at least economists are focused on the correct variable. To continue with the analogy, they are looking at the correct thing – the string. Biden and Trump do not appear to even see the string. They want to push something else that will not affect the inflation rate very much.

Joe McGarrity is a Professor of Economics at UCA. He can be reached at joem@uca.edu.