Economic Growth without Inflation
by Robert McTeer

Can the economy grow faster without causing inflation to accelerate? Some argue that the downside of a rapidly rising gross domestic product (GDP) is more inflation, and that you can’t have more of the former without more of the latter. But both logic and history suggest otherwise. There are periods in recent U.S. history when growth rates were higher, but prices were level or falling. And there have been periods with less real growth, but with rapidly rising prices — and rising unemployment. While slower GDP growth might reduce inflation, it is not a necessary condition. Faster real growth can also reduce inflation.

The Supply Side of Growth. Economic growth does not have to be inflationary, nor does growth have to flat line in order keep inflation in check. Consider the equation of exchange, MV = PQ, where the demand for goods and services (measured by the quantity and velocity of money in the economy) is equal to the supply of goods and services (measured by the quantity of goods produced times their price):

\[ M = \text{the quantity of money}; \]
\[ V = \text{velocity or turnover of money in generating income}; \]
\[ P = \text{price per unit of goods and services produced}; \]
\[ Q = \text{quantity of goods and services produced}. \]

For a simple example of money velocity, suppose the value of goods sold is $300 (PQ = $300), but the value of the money supply is only $100. This means the velocity of money (V = PQ/M) is equal to 3. In other words, a dollar must turn over three times to finance the sale of $300 worth of goods and services.

The Effects of Tinkering with the Money Supply. The two sides of the equation always balance by the way its components are defined. But consider inflation, which would show up in P in the equation of exchange. By rearranging the equation to \( P = MV/Q \), the only way price can increase is if the numerator (the money supply or velocity) grows, or the denominator (quantity of goods produced) shrinks.

There are several options for balancing the equation. Lowering interest rates stimulates the economy by reducing the cost of borrowing for consumer goods and capital investment and, hence, increasing the demand for goods. But pushing interest rates down involves expanding the money supply, which occurs through three mechanisms:

- The Federal Reserve purchases bonds to directly create more money and bank reserves.
- The Federal Reserve lowers the required reserve ratio — increasing the amount of deposit money that a given level of reserves in the banking system can support.
- The Federal Reserve lowers the discount rate at which banks borrow reserves, enabling the reserves to support more deposit money.

All of these mechanisms serve to increase the quantity of money in the economy, lower the cost of borrowing and increase the demand for loans to purchase goods and capital. So, other things constant, increasing the money supply (an increase in M in the equation) increases aggregate demand, resulting in price increases if there is insufficient slack in the economy to allow for greater production of goods and services.

On the other hand, shrinking the money supply (a decrease in M in the equation) by selling bonds, increasing

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the discount rate or increasing reserve ratios may keep inflation in check, but it increases the cost of borrowing. This will deter some consumers from purchasing big-ticket items or firms from investing in capital expansions and hiring workers.

**The Demand Side and the Phillips Curve.** Though the Phillips curve is rarely mentioned explicitly anymore, it still pervades the common view that inflation can only be tamed by reducing aggregate demand and accepting lower output and higher unemployment. In the 1950s, economist A.W. Phillips noted an inverse relationship between wages and unemployment in the British economy. When unemployment was low, wages were higher, and vice versa. Phillips’ observations led to the conclusion that there is a trade-off between employment and inflation. As the unemployment rate falls, the demand for goods increases, causing prices to rise.

However, the Phillips curve has not always held under empirical scrutiny, particularly over the past 40 years. In fact, during the 1970s and 1980s, oil supply shocks pushed up both prices and unemployment. The result — high prices and unemployment accompanied by slow economic growth — was called “stagflation.” Adding the rate of inflation to the unemployment rate yielded what some, including President Reagan, termed the “misery index”:

- In 1974, at about the time of the first oil crisis, inflation was at 11 percent and unemployment at 5.6 percent; adding them together produced a misery index number of 16.6.
- By 1979, however, inflation had crept up to 11.3 percent and unemployment rose to 5.9 percent; the misery index stood at 17.2.
- By 1980, inflation rose to a remarkably 13.5 percent, while unemployment rose to 7.2 percent, for a misery index of 20.7.

The Federal Reserve’s decision to target inflation directly by slowing money supply growth drove up interest rates, making it more costly for consumers to borrow and for firms to invest in capital and job growth. By 1982, inflation dropped to 6.2 percent, but not without unemployment peaking at 9.7 percent. This was consistent with the pervasive view that controlling inflation comes at the expense of GDP growth.

**How to Grow the Economy without Growing Inflation.** Simply put, however, it is possible to grow the economy without any drastic manipulation of the money supply. Supply-side factors may stimulate output independent of aggregate demand through:

- Increases in labor productivity (output per worker), through investments in education, capital goods and technological advances.
- Shifts in investment as a result of lower prices for capital and higher expected future returns.
- Increases in globalization and free trade, which makes imports more affordable while increasing the demand for U.S. exports.
- Cutting taxes on capital investment, which stimulates job creation.

Hence, the quantity and quality of goods can be increased without expanding the money supply to raise aggregate demand. In a tight labor market, increased production can raise labor costs. But, accelerating productivity per worker allows wages to rise without comparable increases in the cost per unit of labor.

In fact, GDP growth rates have been higher in many years with lower-than-average inflation rates. [See the figure.]

**Conclusion.** The economy can grow at the 3.5 percent average of the past several decades, with low and stable inflation. Supply-side economics is out of favor, but that is largely because its bar for success has been raised too high. Supply-side policies, such as tax rate cuts, may not fully pay for themselves at current tax rates, but they certainly have gone a long way in that direction, as indicated by the recent sharp decline in the budget deficit. Recent monetary policy has been about right, and it is being helped in the fight against inflation by globalization, productivity gains and other factors.

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