

# THE WALL STREET JOURNAL.

$$P=MV/Q$$

By **ROBERT D. MCTEER**  
*January 23, 2007; Page A19*

The main question on financial TV lately has been whether the economy will continue to weaken and possibly slip into recession, but allow inflation to decelerate, or whether it will pick up and cause inflation to accelerate. More slack in the economy, or a larger output gap, would reduce inflation; more output, it is presumed, would make inflation worse. While a weaker economy might well reduce inflation, that isn't a necessary condition. Faster growth can also reduce inflation.

While inflation may respond to a reduction in aggregate demand, it would also logically respond to an increase in aggregate supply. In the simple equation of exchange,  $MV=PQ$ , so  $P=MV/Q$ . In other words, other things equal, prices respond positively to an increase in  $MV$ , or aggregate demand, and negatively to an increase in  $Q$ , or aggregate supply. This is not rocket science.

But it is a truism rarely articulated. The Phillips Curve is rarely mentioned anymore, but it still pervades the common view that inflation can be tamed only through a weaker economy. Disinflationary growth is not considered an option, probably because we think of output as responding only

passively to changes in aggregate demand, so that they rise together or fall together.

That may be the usual case, but it doesn't have to be. Supply-side factors may stimulate output independent of aggregate demand, through shifts in investment, exports or shifts from imports to domestically produced goods. Or animal spirits.

Monetary policy is currently in pause mode as far as interest rates are concerned, but moderate increases in the monetary base must be considered anti-inflationary whether output remains weak, or strengthens, as I expect.

Supply-side economics is out of favor at universities that don't have good football teams. But that's largely because its bar for success has been raised too high. Tax-rate cuts may not fully pay for themselves at current rate levels, but they certainly have gone a long way in that direction, as the recent sharp decline in the budget deficit despite rapid spending growth clearly indicates. Tax-rate cuts that substantially pay for themselves in higher tax revenue are clearly a good thing.

Our economy is remarkably healthy. Inflation has crept above our comfort zone, but

current policies are bringing it down without a recession. Monetary policy is just about right, and is being helped in its fight against inflation by other factors: the Internet, globalization, China, India and other new players. Let's not be afraid of growth.

*Mr. McTeer is a distinguished fellow of the National Center for Policy Analysis and former president of the Federal Reserve Bank of Dallas.*