ment securities, because it pays for the debt by increasing bank reserves. This in turn can lead to more bank lending, more money in circulation, higher demands for goods and services, and an accelerating inflation rate at both private and public sectors compete for the same resources.

This problem is complicated, because all of this takes time. If inflation followed immediately on an excessive increase in bank reserves, interest rates would rise immediately to reflect the higher inflation rates, and it would not be possible for the Federal Reserve to prevent interest rates from rising by purchasing government debt. However, it takes time for an increase in bank reserves to work its way through to a higher inflation rate. During that transition period interest rates will be below their long-run market-clearing levels.

The opposite happens when the trend in money-supply growth is lowered. Bank reserves are reduced immediately, shrinking the supply of credit available. Lower growth in bank reserves will lead to less lending, less money in circulation, a lower demand for goods and services, and a decelerating inflation rate. But this also takes time. During the transition period interest rates will be above their long-run market-clearing levels.

Today's high interest rates reflect a reduction in the growth of bank reserves with an attendant reduction in the underlying inflation rate. Interest rates are high, and the existence of large deficits makes it more difficult to reduce interest-bearing debt outstanding can have an effect on inflation (the inverse of the value of money) if it is perceived that the taxing potential of the government is being strained and that interest-bearing debt is likely to be redeemed by inflating the money supply. In this case, deficits will raise inflation expectations and slow the adjustment process needed to end inflation.

The Federal Reserve has adopted a monetary-growth rule intended to guarantee that deficits will not be financed. Most economists would agree that the steady growth rule is a reasonable if not optimal long-run policy. On the other hand, there is no well-accepted economic theory ensuring that it is reasonable or optimal to force the money supply to grow at the long-run constant rate in the short run, i.e., week-to-week or even month-to-month. But to maintain credibility and change expectations, the Federal Reserve must convince the public that it will not overshoot its long-run targets. One way to do this is to adhere to the long-run targets even in the short run. The presence of large deficits makes it more difficult to convince the public that the Federal Reserve System will not finance those deficits and places pressure on the System to adhere even more closely to its long-run targets in the short run.

From a technical point of view, this is a relatively simple task. It becomes complicated, however, because the central bank is the largest trader in the money market and appears to have control over interest rates. During periods of disinflation policy, all the adjustment costs will be attributed to high interest rates and the central bank.

Political coalitions will be formed by sectors in the economy that are most sensitive to high interest rates. These coalitions will often be strong, having benefited from the inflationary policies of the past. They will put pressure on the Federal Reserve to re-verify an inflationary policy—although it will be called a low interest-rate or a low-unemployment policy.

Conclusion: Deficits can cause inflation when they are financed by excessive growth of the money supply. However, the Federal Reserve sets growth-rate targets for the money supply that do not depend on the size of the deficit or on interest rates. These targets are intended to be low enough to reduce inflation and interest rates in the long run, although they may require higher interest rates in the short run. Large budget deficits have to be financed in credit markets, because the Federal Reserve cannot buy large amounts of government debt without creating excess bank reserves and above-target money growth. Given the money targets, a larger budget deficit will require higher interest rates to reduce private borrowings enough to float the extra government debt.

NOTE: No issues of the Economic Commentary were published in June.
The deficit is simply the difference between the dollar amount that the federal government collects in taxes and the dollar amount that it spends on goods, services, and transfer payments. Temporary deficits are desirable under some circumstances, because they allow the government to plan a departure from trend. This article examines the relationship among governments are not likely to be a major factor in determining inflation or inflation expectations.

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deficit that year's deficit and no visible impact. Ex post, these deficits appear to have resulted from tax reductions that are meant to reduce the role of the public sector.
The deficits of the federal government in the United States. A trend toward higher government expenditures suggests that the government has been running a temporary departure above its long-run trend, and partial debt issue will be chosen in the optimal finance policy.

Inflation is the result of a slowdown. The deficit is simply the difference between the dollar amount that the federal government collects in taxes and the dollar amount that it spends on goods, services, and transfer payments. Temporary deficits are desirable under some circumstances, because they allow the government to plan a
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