cent surtax believe consumption spending will rise substantially and greatly aggravate the current inflation unless Congress passes the surtax.

But where does monetary policy fit into the picture? The answer is that monetary developments affect consumption and investment spending. But this is a purely formal answer. We want to identify the links that relate monetary policy to consumption and investment, and also we want to identify the role monetary policy has played in the current inflation.

How does monetary policy affect consumption and investment? A fullblown answer to this question requires at least a full year of study. Moreover, we do not know all of the details of the transmission process. But the main elements of the chain of causation are known and can be set forth in a few minutes. Let me take the time to do so by sketching the adjustments of the economy to a policy of monetary expansion.

Monetary expansion is a two-pronged policy. One prong is defined by decreases in interest rates and the other by increases in the nation's money stock. The interest rate effects of monetary expansion are well-known. To illustrate, with a 5 per cent interest rate a corporation can raise $100 million by selling (for simplicity) a default free bond with a coupon yield in perpetuity of $5 million per year. At 4 per cent $100 million can be raised by selling a default free bond with a coupon yield of $4 million per year in perpetuity. Clearly, corporations are more likely to invest in a $100 million project when their future annual interest obligations are $4 million than when they are $5 million. Thus decreases in interest rates act to increase investment.

By the same line of reasoning decreases in interest rates also tend to increase consumption. For consumers buy durable goods and, for example, a 1 per cent interest rate reduction reduces the cost of financing a $5,000 consumption loan by $50 per year where (for simplicity) interest is computed and paid annually on the initial loan for the full term of the loan and the principal is paid in full at the end of the term.

Money supply increases, the second prong of monetary expansion, affect consumption and investment because the public cannot be forced to hold larger money balances, than it desires to hold in view of its total wealth and the structure of returns to different assets including money. If the nominal stock of money therefore increases, or, in the context of a growing economy, grows more rapidly than warranted by the growth of the nation's wealth and the structure of yields, the public will try to reach the desired level of cash balances by reordering its spending patterns. Households will increase their spending on consumers' goods. Producers, who demand and hold the overwhelming bulk of the economy's money balances, finding that they have excess working capital, will increase inventories and other new investment commitments such as new orders for consumers' goods and plant and equipment expenditures.

In summary, monetary policy affects consumption and investment, and thereby prices, via intervention of interest rates and money balances. We turn now to assessing the role played by monetary policy in the current inflation. This is not an easy task. For we arrive at one conclusion if we look at interest rate trends and another if we judge the thrust of monetary policy by changes in the money stock.

The trend of interest rates has been up, up and up and almost without pause since the last trough in business activity back in February, 1961. To illustrate the trend, in February, 1961 the daily average of yields on 91 day Treasury bills was 2.42 percent and the daily average of yields on Treasury bonds maturing or callable in 10 or more years was 3.81 per cent. In January, 1963 the same variables were respectively 2.91 per cent and 3.89 per cent. In January, 1965 they were 3.83 per cent and 4.15 per cent. In January, 1966 they were 4.58 per cent and 4.43 per cent. In January, 1967 they were 4.72 per cent and 4.40 per cent. In January, 1968 they were 4.99 per cent and 5.18 per cent. And last week the bill rate was 5.46 per cent and the long term rate was 5.27 per cent. Recalling that economic theory asserts that investment and purchases of consumer durables are stimulated by low and falling interest rates, the trend of interest rates in recent years makes one wonder whether there is something wrong with that part of our theory that links monetary policy to investment and consumption (and thereby to prices) via intervention of interest rates.

In fact there is something wrong with that part of our model. It is incomplete. It ignores the feedback effects of money supply changes. Increases in the quantity of money have far reaching repercussions on the economy's real variables and there is feedback from these variables to interest rates. Initially, in-