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Original Research Article

Impact of Money Supply on Inflation in the Economic Community of West African States

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Abstract: This research investigates the impact of money supply by central banks on inflation in the Economic Community of West African States (ECOWAS) using broad money and the monetary policy rate as explanatory variables in the analysis of the economic relationship. The study used panel data containing the 15 ECOWAS countries and a time dimension of 7 years (2016 to 2022). The fixed effects model of panel data regression was employed to analyse the data, and the parameters were estimated using the within-groups fixed effects estimation approach. Findings from the results of the analysis show that every unit change in broad money leads to a positive effect of 27.67% on the inflation rate in the ECOWAS countries. The findings also reveal that the monetary policy rate has a positive effect of 16.01% on the inflation rate in the ECOWAS countries, and though the positive effect does not align with theoretical expectations, values in the confidence interval indicate chances of a negative effect, as there is a time lag between policy adoption and the desired policy effect. From the findings, the study recommends that central banks of the ECOWAS countries should reduce the amount of broad money by raising the required reserve ratio so as to reduce the inflation rate, and that the monetary policy rate be increased to decrease the inflation rate.

Keywords: ECOWAS, Money Supply, Inflation

INTRODUCTION

When asked a question about inflation in America, Stanley Fischer said, “no central bank will ever say oh, I don’t worry about *that stuff*. That’s what we get paid to deal with in part and with the employment side of it” (Council on Foreign Relations, 2016). This was at a presentation organised by the Council on Foreign Relations in America. Stanley Fischer is a former governor of the Bank of Israel and a former vice chairman of the board of governors of the Federal Reserve System of the United States of America (the United

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States' central bank). Inflation is *that stuff* every central bank across the globe must worry about and because the business of central banks is a business of economists, economic researchers should worry about it too. Inflation is a situation in which there is a persistent and appreciable (or significant) increase in the general level of prices; in practice, the term "persistent" implies that the price rise exhibits a secular trend or continues to rise over a period of one to two years, and does not respond to anti-inflationary policies (Dwivedi, 2005).

Since the period of the first oil shock (which disrupted oil supply) in the mid-1970s, a considerable amount of inflation had been experienced by African countries. Inflation rates of 20 percent or more were common for many African countries at the time, and a few countries even experienced rates in excess of 50 or even 100 percent a year (International Monetary Fund [IMF], 1989). As inflation persisted, it had consequences for African countries, affecting economic performance in a variety of ways. The purchasing power of currencies in Africa was eroded as the quantity of goods that could be bought with them fell. People and businesses spent more quickly; they were buying in advance to reduce the time they held the depreciating currency, and this led to excess demand, causing more inflation. Notwithstanding the awareness that Africa had an inflation dilemma, IMF (1989) pointed out that there was remarkably little analysis of the dilemma.

Central banks are supposed to stabilise prices, output, the financial system, exchange rates, and interest rates. Central banks occupy a privileged position because they have a monopoly on the issuance of currency. Also, central banks create money and the ability to print currency means that the central banks can control the availability of money and credit in a country's economy and as such can control inflation. Central banks always use monetary policy to stabilise economic growth and inflation. An expansionary or accommodative policy through lower interest rates raises both growth and inflation over the short run, while tighter or restrictive policy reduces them through higher interest rates (Cecchetti & Schoenholtz, 2015). With the efforts of central banks all over the world, one would expect a moderate inflation but yet inflation still remains worrisome in recent times. Stubbornly high inflation across more wealthy economies in the last week of October 2021 incited a shakeout in bond markets as investors began expecting central banks to tighten monetary policy. The Federal Reserve (United States' Central Bank) is expected to start winding down its $120-billion-a-month asset buying programme with an eye toward ending those purchases by June 2022 (Timiraos, 2021). Markets show investors are increasingly betting on the Federal Reserve raising interest rates following recent inflation reports and signals from other major central banks that are moving toward tightening policy. Expectation that the Bank of England (BoE) could be the first major central bank to increase interest rates has intensified after Andrew Bailey, Governor of the BoE warned in October 17, 2021 that the central bank will have to act if surging prices push up Britons' expectations of future inflation (Timiraos, 2021).

In the Economic Community of West African States (ECOWAS), the story is not different. ECOWAS is a union of fifteen (15) countries in West Africa. The countries are: Benin, Burkina Faso, Cape Verde (or Cabo Verde), Côte d'Ivoire (Ivory Coast), The

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Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo (ECOWAS, 2016). In Nigeria, ECOWAS' biggest economy, an inflation of 18.8% was recorded for 2022. In 2020 it was 13.2%, rising by 1.8% from 2019 and in March 2021, inflation hit a four-year peak. Driven by the effects of the corona virus (Covid-19) pandemic, it rose to 18.17% with an increase of 4.85% from February 2021. In October 2021, the inflation rate was 15.99% (Proshare, 2021). Benin in 2020 recorded an average inflation rate of 3.02%. In October 2021, inflation rate in Benin decreased to 2.30% but rose to 5% in December 2021 and in 2022 it stood at 2.5%. Inflation rate in Mali stood at 0.54% in 2020 but increased to 4.70% in September 2021 and in 2022 it came to 10.08%. The annual inflation rate in Senegal rose up to 9.7% in 2022 from 3.2% in October 2021, whereas in 2020 it was 2.55%. The inflation rate in Cape Verde was 0.61% in 2020 but increased to 3.8% in October 2021 and to 7.93% in 2022. 14.3% inflation rate was recorded in 2022 for Burkina Faso. It rose by 9.9% from 4.40% in September 2021(Trading Economics, 2022).

In Niger, inflation rate rose to 4.7% in February 2021 from about 4% in January (Statista, 2021). In 2022, Niger recorded 4.2% inflation. Inflation rate in Cote D'Ivoire for 2020 was 2.4%. It increased consecutively from June 2021 to September 2021 (from 3.5% to 5.2%) and then to 5.3% in 2022. Inflation rate in Togo averaged 1.83% in 2020 but in 2021 it surged to 5.90% in October and rose again to 8% in 2022 (Trading Economics, 2022). In Liberia, the rate was 17% in 2020 but decreased to 7% in August 2021 and increased to 7.59% in 2022. Inflation rate in Gambia was 5.93% in 2020 but rose to 7.34% in October 2021 and then came to 11.5% in 2022 (Macrotrends, 2022). Ghana's inflation rate in 2020 stood at 9.95%, but from 9.7% in August 2021 it increased to 10.6% in September and stood at 31.3% in 2022. Inflation rate in Sierra Leone surged to 27.2% in 2022 from 11.63% in September 2021. In 2020, inflation rate of 13.45% was recorded for Sierra Leone. In Guinea, inflation rate was 10.6% in 2020, rose up to 13.05% in September 2021 and reduced to 10.5% in 2022. In Guinea Bissau, the rate stood at 1.5% in 2020 but increased to 4.3% in September 2021 and then to 9.4% in 2022 (Trading Economics, 2022).

Blanchard and Johnson (2013) stated that a stable inflation rate between 1% and 4% is believed by most macroeconomists to be the best rate. The European Central Bank (ECB) is more specific, with a recommendation of 2% as the acceptable or target rate of inflation (ECB, 2020). So the intention of economists is not to remove inflation totally but rather to reduce it to the acceptable rate. The acceptable rate of inflation is a moderate rate which is important for an economy because it helps to stimulate growth by driving consumption spending. Unfortunately, the ECOWAS inflation is above 2% for all members, some are single-digit rates while some are double digits. Countries with single-digit rates but higher than 2% are: Benin, Senegal, Cape Verde, Niger, Cote D'Ivoire, Togo, Liberia, and Guinea-Bissau. Countries with double-digit inflation rates include Nigeria, Guinea, Sierra Leone, Ghana, Mali, Burkina Faso, and Gambia.

Jumah and Kunst (2007), in an attempt to address the inflation problem in West Africa, verified whether cocoa prices, budget deficits, and migrant remittances could be a source of inflation in five countries of the West African region. They chose five

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cocoa-producing countries in West Africa: Benin, Cameroon, Cote D'Ivoire, Ghana and Togo. Going by the United Nations' subregions of Africa, Cameroon is in Central Africa but some people take it as a West African country because it lies at the junction of Western and Central Africa (Britannica, 2021; University of Pittsburgh Library System [ULS], 2021). After running a multiple regression on the research data using the least squares method, they also did a fixed-effect panel estimation and the results revealed that the influence of cocoa prices on consumer price inflation is strong and statistically significant. The results also showed that the influence of budget deficits and flow of migrant remittances on inflation is weak.

Obi and Uzodigwe (2015) assessed the dynamic linkage between money supply and inflation in eight ECOWAS member countries (five from the West African Economic and Monetary Union [WAEMU] and three from the West African Monetary Zone [WAMZ]) for the period 1980 to 2012 in order to find out whether money supply really leads to inflation. The random effect panel estimation for the ECOWAS member states showed that the impact of money supply on inflation is effective for the WAMZ and WAEMU countries. Balogun (2007) examined the monetary and macroeconomic stability perspective for entering into monetary union, using data on WAMZ countries. The WAMZ countries include Ghana, Gambia, Guinea, Liberia, Nigeria, and Sierra Leone. The study tested the hypothesis that independent monetary policy has been relatively ineffective in influencing domestic activities, especially GDP and inflation. Using the General Least Squares method, the regression result showed that domestic monetary policy, as captured by money supply and credit to government has a negative effect on real domestic output of these countries, and that expansion in domestic output reduced inflation.

Tule, Ajilore, and Ujunwa (2019) utilised quarterly time series data for Nigeria and three selected WAMZ countries for the period, 1980 to 2016, to verify whether monetary policy shocks emanating from Nigeria are an important source of macroeconomic fluctuations in WAMZ economies. The study complemented the Global Vector Autoregressive method with the Diebold-Yilmaz connectedness weights computation for the analysis. Inferences from generalised impulse response function (GIRF) analysis indicated that an unanticipated Nigerian monetary policy shock decelerates inflation for Nigeria and Gambia, but accelerates inflation for Ghana and Sierra Leone.

Famoroti and Tipoy (2019) analysed the impact of external monetary policy shocks to economic growth in fourteen countries of the ECOWAS sub-region (they didn't include Guinea Bissau), using quarterly data from 1980 to 2017. They employed a Panel Structural Vector Autoregressive (SVAR) model for the study. The result showed that the external shocks have significant effects on the economic growth and stability of ECOWAS. The shocks of the federal funds rate (FFR) of the USA significantly impacts economic growth and inflation rates in the ECOWAS economy. Furthermore, money supply has the prime impact on the economic growth, inflation rate and interest rate. It further showed a positive and significant effect on the inflation rate, which is in line with the monetarist school of thought that inflation is a monetary phenomenon. Henry and Sabo (2020) conducted a study to examine the impact of monetary policy management on inflation in the Nigerian

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economy (the largest economy in ECOWAS) during the 1985 – 2019 period. Autoregressive distributed lag analysis was employed on time series data covering the period. It was found that while the monetary policy rate and foreign exchange rate impact inflation negatively, the broad money supply impacts it positively.

From the previous studies cited above, it can be seen that Henry and Sabo (2020) researched on the impact of monetary policy on inflation in Nigeria alone. Jumah and Kunst (2007), Obi and Uzodigwe (2015), Balogun (2007), Famoroti and Tipoy (2019), and Tule et al. (2019) conducted similar studies based on West Africa or ECOWAS but not all countries were included, they selected some countries. The present study cuts across all ECOWAS countries. Famoroti and Tipoy (2019) examined the extent to which economic growth fluctuations in West Africa arise from external monetary policy. It focused on the monetary policy of USA but the present study focuses on the money supply (as determined by monetary policy) of the ECOWAS countries and its impact on inflation in the ECOWAS countries. Jumah and Kunst (2007) selected 5 countries from West Africa (not ECOWAS) and did not use money supply as a predictor variable but rather cocoa prices, budget deficits, and migrant remittances. The present research offers support for the efforts of the ECOWAS' central banks in tackling inflation in the ECOWAS states by evaluating the relationship between money supply and inflation in ECOWAS and making recommendations based on the result of data analysis. The specific objective of the research is to examine the effect of money supply (measured as broad money) and the monetary policy rate on the inflation rate in the ECOWAS economies.

METHOD

This study is modeled after the monetarist theory of inflation which asserts that if money supply rises faster than the rate of growth of national output, then there will be inflation. In other words, it is the growth in money supply that causes inflation (Ahuja, 2012). According to the monetarist theory,

$$P = M/Y \qquad (1)$$

In equation (1), P is price level, M is money supply, and Y is output. If Y remains the same and M increases, P will surely increase. This implies that change in P is caused by change in M. Therefore, equation (1) can be adjusted as follows:

$$P = f(M) \qquad (2)$$

This means that P is a function of M, i.e, the value of P depends on the value of M. Equation (2) is modified based on the variables of this study as follows:

$$INF = f(M) \qquad (3)$$

where INF is inflation and M is money supply. But given that inflation rate (INFR) is used as proxy for inflation and broad money (M2) and monetary policy rate (MPR) are used as proxies for money supply, equation (3) can be rewritten as:

$$INFR = f(M2, MPR) \qquad (4)$$

From the functional form in (4) above comes the mathematical form below:

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$$INFR = a_0 + a_1M2 - a_2MPR \quad (5)$$

From the mathematical form in (5) above, the econometric model follows:

$$INFR = a_0 + a_1M2 - a_2MPR + u \quad (6)$$

In equation (6), INFR is the dependent variable, M2 and MPR are the explanatory variables, and u is the error term. a_0, a_1, and a_2 are parameters to be estimated. a_0 is the intercept, a_1 and a_2 are the slope coefficients. The expected signs of the parameters or theoretical a priori expectations are: $a_0 > 0$; $a_1 > 0$; $a_2 < 0$. Since this study is a panel study, the panel data regression model shall be adopted. Thus, equation (6) becomes:

$$INFR_{it} = a_0 + a_1M2_{it} - a_2MPR_{it} + u_{it} \quad (7)$$

where i stands for each of the cross-sectional units (the ECOWAS countries) and t for the time period. The 15 ECOWAS states are the cross-sectional units and the time period is 7 years, from 2016 to 2022. The data collected for the analysis in this study is secondary data and it is collected for INFR, M2 and MPR. INFR is the annual percentage increase in general price level as measured by the consumer price index in the ECOWAS economies. M2 is a measure of money supply in ECOWAS. M2 here is calculated as a percentage of GDP. M2 is made up of currency held by the public, demand deposits with banks, and time and savings deposits with banks that require advance notice for withdrawal. MPR is a benchmark interest rate given by the central banks of the ECOWAS countries which is used to determine other interest rates in the countries' financial markets. It is measured in percentages.

For INFR, data is collected from the following sources: World Bank (www.worldbank.org), Statista, World Data (www.worlddata.info), Trading Economics (tradingeconomics.com), African Development Bank (Benin economic outlook) and Central Bank of Nigeria Statistical Bulletin. For M2 (broad money), data is collected from World Bank (www.worldbank.org). For MPR, data is gotten from the following sources: Bank of Cape Verde Annual Report, 2017; IMF Country Report (for Cape Verde); BCEAO (French: Banque Centrale des Etat de l'Afrique de l'Ouest, i.e, Central Bank of West African States) Quarterly Statistical Bulletin, 2022; BCEAO 2019 Annual Report; Central Bank of The Gambia's website (www.cbg.gm); Bank of Ghana's website (www.bog.gov.gh); Central Bank of the Republic of Guinea's website (www.bcrg-guinee.org); Central Bank of Liberia's website (www.cbl.org.lr); World Bank (Sierra Leone economic update); Sierra Leone Ministry of Finance Economic Bulletin, 2018; and Central Bank of Nigeria Statistical Bulletin.

The technique that is used in the analysis of data for the study given the model specified depends on the outcome of the Hausman test for panel data model specification. In equation (7), we only specified a general model for panel data regression and such a model fails to recognise the existence of individual characteristics as can be found in panel data. The Hausman test provides an objective way to choose between the fixed effects model (FEM) and random effects model (REM) of panel data regression. To perform the Hausman test, a fixed effects model and a random effects model are first run and then

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choice is made between the two based on the result of the Hausman test. To run the FEM, the within-groups fixed effects estimation technique is employed, and for the REM, the generalised least squares (GLS) technique is used; this means that in the random effects model we obtain GLS estimators for the parameters (Gujarati et al., 2009). The Stata software is used in a computer system to do all the analyses.

Hypotheses development: The hypotheses tested in the study are stated in their null forms as follows:

Ho_1: Broad money (M2) has no significant effect on the inflation rate in ECOWAS countries.

Ho_2: Monetary policy rate (MPR) does not have a significant effect on the inflation rate in ECOWAS countries.

RESULT AND DISCUSSION

Table 1 in this section presents the descriptive statistics and correlation matrix of the variables of the study. The sixteenth row in the table shows the total number of observations or data values for each variable. Skewness (in the tenth row) is a measure of lack of symmetry about the mean; it measures the deviation of the distribution of the variables from a normal distribution. The table shows that all the variables are positively skewed (skewed to the right) meaning that extreme data values in the variables are larger, raising the mean value and making it greater than the median. The kurtosis statistic measures the degree to which the data of each variable cluster at the tails or base of their frequency distribution. While M2 has positive excess kurtosis (1.939), the rest of the variables have negative excess kurtosis (excess kurtosis = kurtosis – 3). This shows that the distribution of M2 has heavy tails, meaning that it has more extreme values (farther from the mean) when compared with the distributions of the other variables.

In the twelfth row is the Shapiro-Wilk test of normality with the probabilities of its statistic for each of the variables in the thirteenth row. Since all the probabilities are less than 0.05, we can reject the Shapiro-Wilk null hypothesis that the variables are normally distributed; this implies that data samples for each variable may not have come from a population whose distribution is normal. The correlation matrix indicates that there is a relationship or association between the dependent variable (INFR) and the explanatory variables (M2 and MPR) as none of the correlation statistics is zero. Values of the correlation statistic that are below ±0.6 indicate a weak association while values that are either ±0.6 or above ±0.6 indicate a strong association (Vohra, 2013).

Table 1: Descriptive Statistics and Correlation Matrix of the Variables

Descriptive Statistics			
	INFR	M2	MPR
mean	6.5115	37.4143	7.3829
median	4.1	30.8	2.5
maximum	31.30	113.70	30.00

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minimum	-3.23	15.80	0.25
variance	47.174	364.823	48.766
std dev.	6.8683	19.1004	6.9833
range	34.53	97.90	29.75
skewness	1.218	2.096	1.041
kurtosis	1.567	4.939	0.239
Shapiro-wilk	0.8925	0.7755	0.7959
probability	0.0000	0.0000	0.0000
sum	683.71	3928.50	775.20
S.E. of mean	0.6703	1.8640	0.6815
observations	105	105	105
Correlation Matrix			
INFR	1.0000		
M2	-0.3121	1.0000	
MPR	0.7474	-0.4290	1.0000

Source: Researcher's computation (2023)

The Hausman test result in Table 4 shows a chi-square value of 20.42 with a probability of 0.0000 which is below 0.05 or 5% (the chosen significance level). This leads to the rejection of the null hypothesis in the Hausman test which says the random effects estimators would be consistent and efficient. This makes the fixed effects model the appropriate model for the study as the fixed effects estimators under the null and alternative hypotheses in the Hausman test would be consistent and efficient.

The fixed effects model regression result in Table 2 shows that the coefficient of M2 is 0.2767. This implies that a unit increase in M2 leads to 0.2767 units or 27.67% increase in INFR and a unit decrease in M2 leads to 0.2767 units or 27.67% decrease in INFR in the ECOWAS countries. The relationship here is positive which conforms to the theoretical expectation of a positive relationship between M2 and INFR; Henry and Sabo (2020) and Famoroti and Tipoy (2019) found same also. When M2 is increased, inflation rate is expected to increase and vice versa.

The result also indicates that the coefficient of MPR is 0.1601. This implies that a unit increase in MPR leads to 0.1601 units or 16.01% increase in INFR and a unit decrease in MPR leads to 0.1601 units or 16.01% decrease in INFR in the ECOWAS countries. The relationship here is positive which does not conform to the theoretical expectation of a negative relationship between MPR and INFR. When MPR is increased, money supply reduces and inflation rate is expected to reduce according to the monetarist theory of inflation. This was confirmed by Henry and Sabo (2020) and Famoroti and Tipoy (2019) in the empirical evidence. In the present study, the opposite seems to be the case, where an increase in MPR leads to an increase in INFR instead of a reduction. But the result also provides a range of values for the coefficient with confidence level of 95%. In the range of values, we have some negative coefficients that support the theoretical a priori expectation,

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for the range begins from -0.2192 and ends at 0.5393. So, the true value of the coefficient (parameter estimate) may be 0.1601 (the expected value) or any of the negative or positive values in the confidence interval. In the long run, the coefficient may turn negative because there is usually a time gap between when a policy is implemented and when the expected effect is realized.

Hypothesis testing: For Ho_1, the p-value of the t-statistic of the coefficient of M2 provided in the FEM regression result is checked. The p-value is 0.003, and because this value is less than 0.05, we reject Ho_1 that M2 has no significant effect on inflation rate in member countries of ECOWAS. For Ho_2, the p-value of the t-statistic of the coefficient of MPR given in the FEM regression result is checked. The p-value is 0.404, and because this value is greater than 0.05, we do not reject Ho_2 that MPR does not have a significant effect on inflation rate in member countries of ECOWAS. However, going by the monetarist theory, MPR should have a significant effect on inflation; this may materialise in the long run.

Table 2: Fixed Effects Model (FEM) Regression Result

INFR	coefficient	std. error	t	p>|t|	95% conf. interval
M2	0.2767	0.0913	3.03	0.003	0.0951 – 0.4582
MPR	0.1601	0.1908	0.84	0.404	-0.2192 – 0.5393
constant	-5.0212	3.9638	-1.27	0.209	-12.8984 – 2.8559
rho = 0.8120 (fraction of variance due to u_i)					
corr (u_i, xb) = -0.7320					
F(2, 88) = 4.62, Prob>F = 0.0124					

Source: Researcher's computation (2023)

Table 3: Random Effects Model (REM) Regression Result

INFR	coefficient	std. error	z	p>|z|	95% conf. interval
M2	0.0077	0.0300	0.26	0.798	-0.0511 – 0.0664
MPR	0.7183	0.0813	8.83	0.000	0.5589 – 0.8776
constant	0.9221	1.5676	0.59	0.556	-2.1504 – 3.9946
rho = 0.0552 (fraction of variance due to u_i)					
corr (u_i, x) = 0 (assumed)					
Wald chi^2 = 92.68, Prob>chi^2 = 0.0000					

Source: Researcher's computation (2023)

Table 4: Hausman Test Result

	FEM coefficients	REM coefficients	difference	std. error
M2	0.2767	0.0077	0.2690	0.0863
MPR	0.1601	0.7183	-0.5582	0.1726
Test: Ho: difference in coefficients not systematic				
chi^2 = 24.02, prob>chi^2 = 0.0000				

Source: Researcher's computation (2023)

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CONCLUSION

The study evaluates the impact of money supply (represented by broad money and the monetary policy rate) on inflation in ECOWAS economies. Conclusions are drawn from the results of the data analysis to satisfy the objectives of the study as stated in the introduction. Given the results, the study concludes thus: broad money has a positive effect of 27.67% on the inflation rate in ECOWAS economies, and the effect is statistically significant. Again, the monetary policy rate has a positive effect of 16.01% on the inflation rate in ECOWAS, and this does not agree with theoretical postulates; however, the range of values in the confidence interval indicates the possibility of a negative effect as implied by the monetarist theory. To reduce inflation rates to an acceptable level, the study recommends that the central banks of ECOWAS should raise the required reserve ratio in order to decrease broad money, and should increase the monetary policy rate in order to reduce the demand for loans or investible funds.

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