



M2 and “Reigniting” Inflation

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On April 7, 2005, the *Wall Street Journal* (WSJ) published a letter from Milton Friedman in response to a March 21, 2005, editorial that criticized the Federal Reserve’s monetary policy as being too easy for too long. Friedman defended the Federal Reserve’s actions, chastising the WSJ editor for failing to notice that M2 growth had been slowing during the period in which they claimed that the Fed was reigniting inflation. Friedman wrote, “On the contrary, since 2000, the rate of growth in the quantity of money has been trending downward and in the past year has consistently been in the range of 4% to 6%, just about the rate required for a rapidly growing non-inflationary economy.”

More than any other single economist, Milton Friedman gets credit for teaching the world that central banks are responsible for inflation through their control over the money supply. This letter is not significant so much because of what it said, but because of who said it. The letter marked 70 years of publications by the prolific Professor Friedman. His first article, “Professor Pigou’s Method for Measuring Elasticities of Demand from Budgetary Data,” was published in the *Quarterly Journal of Economics* in November 1935.

What about the message? Should slowing M2 growth give us comfort about the future of price stability? As Friedman notes, M2 growth in the range of 4 to 6 percent is consistent with healthy economic growth. Over the past 15 years, M2 has grown at an average annual rate of 4.8 percent while nominal GDP has advanced at a 5.0 percent rate.

The accompanying chart shows the four-quarter growth rates in M2 and nominal GDP since 1991, including the recent slowdown in M2 growth to the 4 to 6 percent range noted by Friedman. It also shows that the 15-year averages are approximately equal. Low M2 growth between 1991 and 1996 was offset by relatively high growth between 1998 and 2003.

But the chart also shows that M2 and nominal GDP appear to be moving in opposite directions most of the time. The measured correlation between these

two series is mildly negative whether we look at the contemporaneous relationship (-0.3), a one-year lead for M2 (-0.11), or a two-year lead (-0.19). Therefore, we have little reason to think that slowing M2 growth today means slowing GDP growth over the next year or two.

The short-run correlation between M2 growth and nominal GDP growth depends importantly on the nature of monetary policy and money demand. If variation in M2 is driven mainly by destabilizing monetary policy (as in the 1970s, or in the case of a hyperinflation), then we expect to see a close correlation between M2 and GDP growth. If we are in an era of relative price stability, then we expect to see the effects of shifts in money demand. We should not be surprised to see M2 and GDP growing in different directions much of the time.

The recent moderation in M2 growth is confirmation that we continue to live in a regime of relative price stability. There is no reason to think that inflation will become a major problem for the U.S. economy unless one believes that there is going to be a major regime change in Federal Reserve policymaking. This caveat helps to explain the high degree of interest in who Chairman Greenspan’s successor will be. ■

