"Money and Inflation"

by Milton Friedman

Newsweek, 20 September 1976, p. 77

In 1863, a famous British economist, W. Stanley Jevons, published a pamphlet analyzing the effect of the California and Australian gold discoveries. One conclusion was that "an expansion of currency occurs one or two years prior to a rise of prices."

On July 13, 1976, *The Times of London* published an article by its editor, William Rees-Mogg, with the provocative heading HOW A 9.4% EXCESS MONEY SUPPLY GAVE BRITAIN 9.4% INFLATION. In his article, Rees-Mogg erroneously attributes to me rather than to Jevons the demonstration that "there was a time lag, normally of about two years, between changes in the money supply and consequential changes in prices." Accordingly, he compares the increase in money supply each year in excess of the increase in output with the increase in prices two years later. For individual years, there is wide variation. But for 1964 to 1973 as a whole, the excess money supply rose at the average rate of 9.4 per cent per year; and for 1966 to 1975, prices rose at the average rate of 9.4 per cent.

Of course, the identity of these two numbers is a coincidence. Many factors other than changes in money supply affect the precise rate of inflation. But rough agreement between the two numbers—and even more important, their tendency to rise and fall together—is no coincidence. For example, the corresponding numbers for the U.S, are 4.2 per cent for money and 5.8 per cent for prices. For the prior decade, 1954 to 1964, they are 0.6 per cent for money and 1.8 per cent for prices, so both went up together by roughly the same amount.

For the U.S., as for Britain, this relationship is of long standing. Our own money-supply estimates go back to 1867. Throughout that period, changes in prices have tended to follow changes in money supply by roughly two years.

More recently, Congressman Stephen Neal, chairman of a House subcommittee on domestic monetary policy, reported that staff studies indicate that "the rate of inflation rises and falls in the wake of increases and decreases in the supply of money," with the peak effect taking place after a lag of 23 months.

A lag of two years is *not* a natural constant that will prevail under all circumstances. It has characterized countries that, like the U.S. and Britain, have generally experienced only moderate rates of inflation during peacetime. In countries like Israel, Brazil, Chile or Argentina that have experienced much higher and more variable rates of inflation, the lag is only a few months.

The close relation between money and prices has persisted despite major changes in the determinants of the supply of money. When Jevons wrote, and for the next half-century, changes in the supply of money were produced mainly by gold discoveries or improvements in the methods of extracting gold from ore or developments in private banking. Today, gold no longer plays any monetary role and banking developments only a minor one. The money supply is controlled by the government—through the Federal Reserve in the U.S., the Bank of England in the U.K.

Rees-Mogg's article aroused a storm of controversy. In the ten days after it was published, the Times printed some 25 letters denouncing, praising or amplifying the article. The controversy is understandable. As Rees-Mogg wrote, "These figures have changed further my own attitude to incomes policy [i.e., wage and price control]. If the Excess Money Supply determines the rate of inflation equally closely in years subject to incomes policy and in years without, there seems to be no evidence left that incomes policy has any significant influence on inflation." Yet the current British Labor government is pinning most of its hopes for curbing inflation on a form of incomes policy—the so-called "social contract" with the unions whereby they agree to accept a low limit on wage increases.

The old chestnut goes: "What is a share of Penn Central worth?" Answer: "Together with a quarter, it will get you a cup of coffee." Similarly, the social contract, together with low monetary growth, will curb inflation. With rapid monetary growth, it will be another unsuccessful experiment.

Reprinted in Milton Friedman, *Bright Promises, Dismal Performance*, pp. 198-200. Edited by William R. Allen. New York: Harcourt Brace Jovanovich, 1983.

Compiled by Robert Leeson and Charles Palm as part of their "Collected Works of Milton Friedman" project.

Reformatted for the Web.

10/26/12