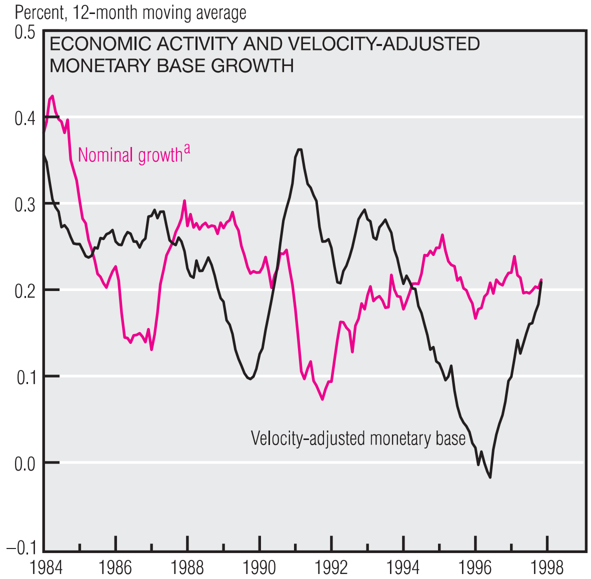
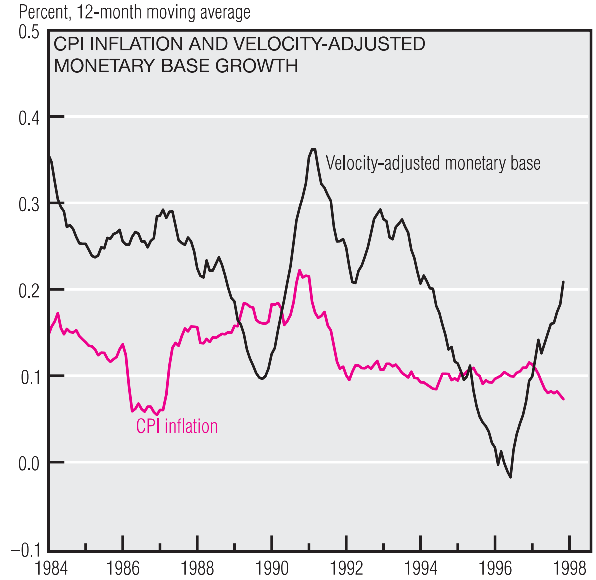
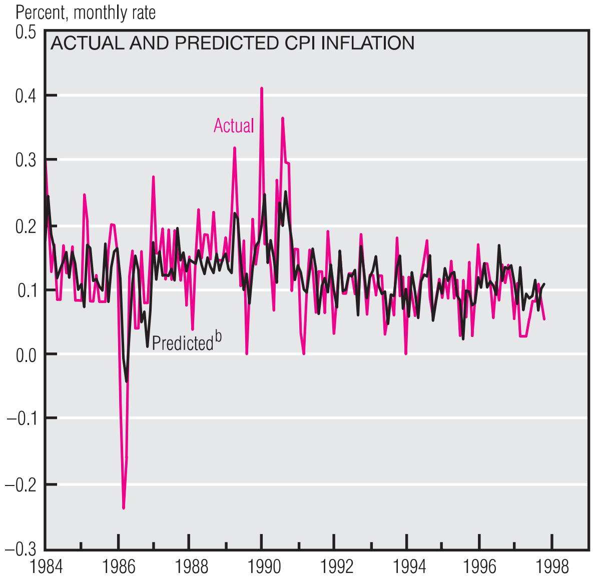
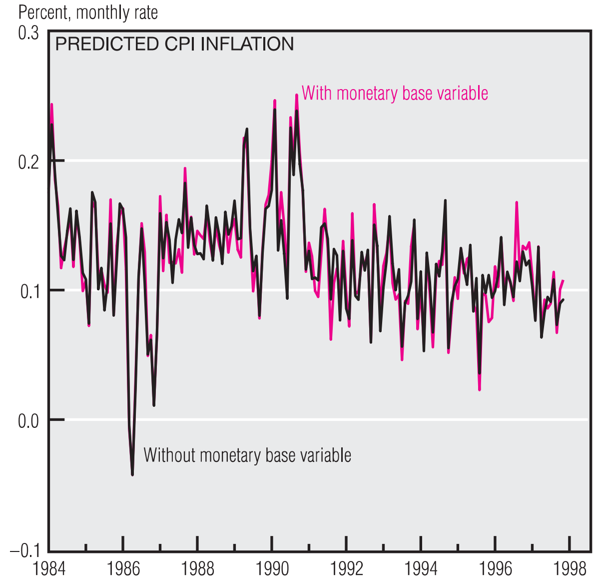
Inflation and Money Growth









a. Nominal growth is defined as the change in the log of the Commerce Department/Conference Board index of coincident indicators plus the change in the log of the Consumer Price Index (CPI).
b. Forecast model includes lagged values of monetary growth.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; and the Federal Reserve Bank of Cleveland.

It is an article of faith among monetary economists that in the long run, inflation is everywhere and always a monetary phenomenon. The specific premise of this statement is that nominal spending in an economy is directly related to the nominal money stock and people's willingness to hold it, a feature of money demand that is often termed *velocity*.

Unfortunately, monetary policy cannot wait for the long run, because it is conducted at frequencies that require predicting the relationship between money growth, nominal income growth, and inflation on a nearly month-to-month basis. Even more vexing, the relationship between growth in the monetary base —the aggregate most directly controllable by the central bank—and nominal income growth or inflation is far from tight. This holds true even when base growth is adjusted for growth in velocity.

Indeed, changes in the rate at which the monetary base expands or contracts have virtually no predictive value with respect to monthly movements in inflation. Inflation-forecast models that include the history of inflation and nominal income growth are not improved by including information on money growth rates.