

ESSAYS IN INTERNATIONAL FINANCE

No. 148, November 1982

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MONETARY APPROACHES TO THE  
BALANCE OF PAYMENTS AND  
EXCHANGE RATES

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AND  
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*Library of Congress Cataloging in Publication Data*

Rabin, Alan A.

Monetary approaches to the balance of payments and exchange rates.

(Essays in international finance, ISSN 0071-142X; no. 148)

Bibliography: p.

1. Balance of payments. 2. Foreign exchange.

I. Yeager, Leland B. II. Title. III. Series.

HG136.P7 no.148 332'.042s [332.4'5] 82-15587

[HG3882]

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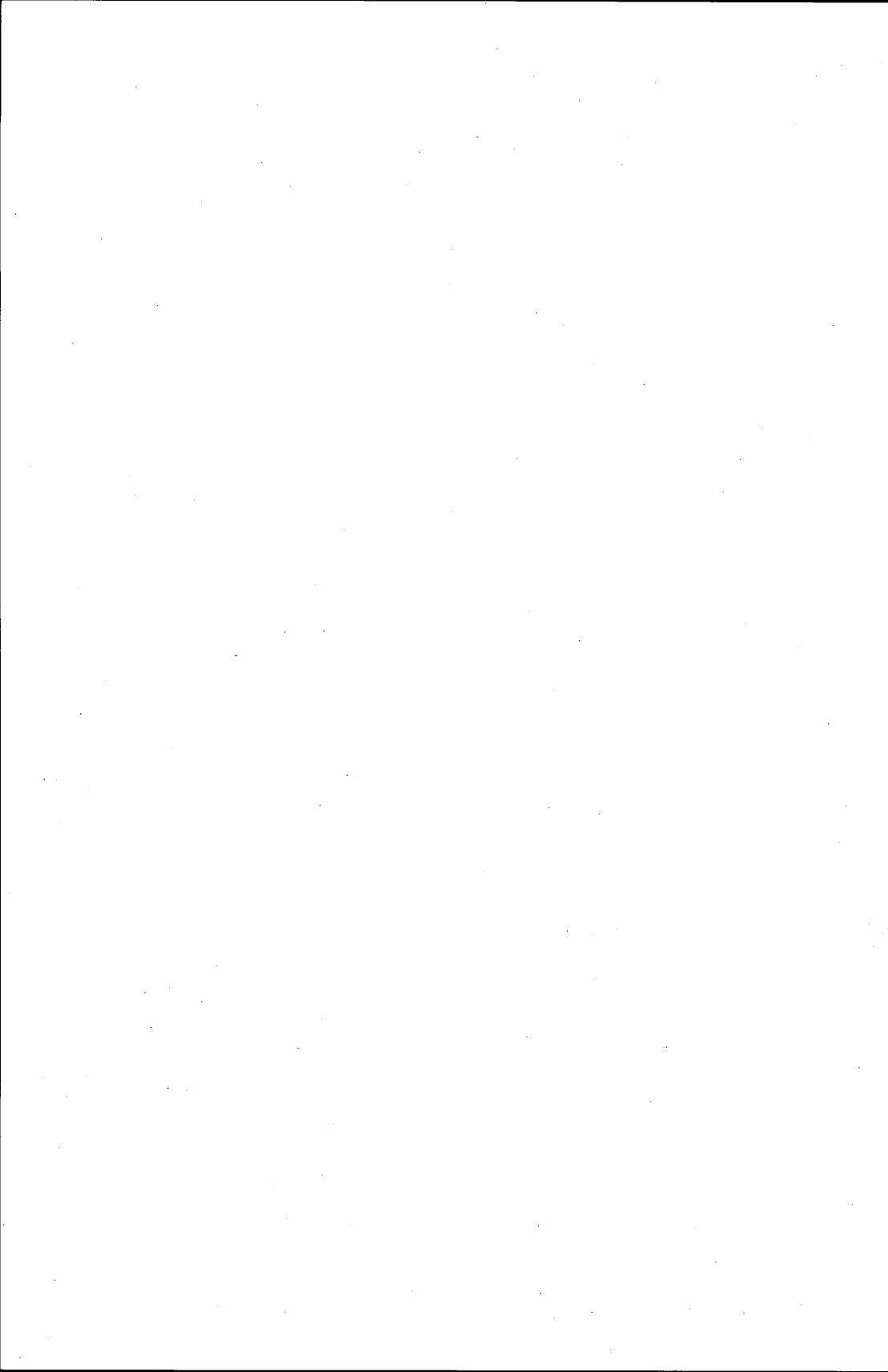
Printed in the United States of America by Princeton University Press at Princeton, New Jersey.

International Standard Serial Number: 0071-142X

Library of Congress Catalog Card Number: 82-15587

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# Monetary Approaches to the Balance of Payments and Exchange Rates

For decades, the role of money suffered relative neglect in general macroeconomics and especially in the areas of balances of payments and exchange rates. Now, at last, the role of supplies of and demands for money has again become the focus of scholarly attention.<sup>1</sup> This development is surely welcome, and we shall illustrate the usefulness of the monetary approach for understanding current conditions and recent economic history. Nevertheless, economists can best exploit the potentialities of the monetary approach if they observe certain distinctions that are too easily neglected and avoid certain errors that have become commonplace in the literature.

## 1 The Monetary Approach to the Balance of Payments

The monetary approach to the balance of payments (MABP) presupposes fixed exchange rates. A version associated with Harry G. Johnson and his followers became fashionable in the early and middle 1970s. We will call it the "strong" version. It *identifies* a country's balance-of-payments surplus under fixed exchange rates with a process of satisfying a demand for domestic money to hold in excess of actual holdings, and it *identifies* a payments deficit with a process of working off a supply of domestic money in excess of desired holdings. Certainly, some such association between monetary and payments disequilibria is common and perhaps even typical. But many authors equate them strictly, and this is fallacious. Whether those authors would stick to their statements under cross-examination is another question. One purpose of this essay is to conduct such a cross-examination.

We begin with statements of the strong version. According to Johnson (1976, pp. 282-283),

The central point of the monetary approach to balance-of-payments policy theory is that balance-of-payments deficits or surpluses reflect stock disequilibrium between demand and supply in the market for money.

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A version of this paper (Rabin and Yeager, 1979) was originally published in *Economic Perspectives*. We thank Maurice B. Ballabon, the editor, and Harwood Academic Publishers for giving us permission to revise and reprint it.

<sup>1</sup> On the point that the monetary approach to exchange rates has been resurrected rather than newly discovered, see, e.g., Humphrey (1978).

Johnson and Frenkel (1976, pp. 21-22) elaborate:

Accordingly, surpluses in the trade account and the capital account respectively represent excess flow supplies of goods and of securities, and a surplus in the money account reflects an excess domestic flow demand for money. . . . Since the money account is determined by the excess flow demand for money, it is clear why the balance of payments is regarded as a monetary phenomenon and this approach is referred to as "the monetary approach."

Again, Johnson (1977, p. 7) says:

A balance-of-payments deficit or surplus represents a transient stock-adjustment process evoked by an initial inequality between actual and desired money stocks.

Other economists interpret the MABP in a similar way. See, for example, Aghevli and Khan (1977), Connolly and Taylor (1976), Humphrey (1976), Mussa (1976), and Whitman (1975).

The theory summarized in these passages contrasts with a weak version of the MABP, which merely seeks illumination by paying explicit attention to actual and desired quantities of money and to any discrepancy between them. The distinction we are making between strong and weak approaches resembles the distinction between a theory and a framework that Leibenstein (1976) draws, in a more general context, in Chapter 2 of his *Beyond Economic Man*. The strong approach is a theory; it makes assertions, conceivably falsifiable, about correspondences or interdependencies or cause-and-effect relationships in the real world. The weak approach is a framework; it merely focuses attention on particular aspects of reality in the hope of developing warranted assertions. Approaches to understanding reality that superficially seem quite different, such as the several approaches to balance-of-payments analysis, may be compatible and indeed complementary. Each may furnish distinctive views of reality.

The weak monetary approach is compatible with the elasticities and absorption approaches to balance-of-payments analysis.<sup>2</sup> This looser approach still pays attention to actual and desired quantities of money. It suggests insights into such matters as why a balance-of-payments surplus or deficit cannot persist indefinitely, even under fixed exchange rates, and how a country can import inflation by way of monetary flows through balance-of-payments surpluses. In short, the weak version of the MABP raises certain questions about balances of payments under fixed exchange rates; it focuses

<sup>2</sup> For a reconciliation of the three approaches, see Mundell (1968) and Yeager (1976). Yeager left rather blurred the distinction between monetary theory and monetary framework, or strong and weak versions. He dealt charitably with this blurred version, presenting what he thought it should say rather than what so much of the literature actually does say. We now recognize that this charity goes too far and that the error exposed here is widespread and needs to be met head-on.



attention on certain aspects of reality. Instead of being a theory, however, it is a framework for analysis.

### *Counterexamples to the Strong Version*

One way to refute the identification of a payments surplus with an excess demand for money and a deficit with an excess supply is to present counterexamples. The familiar dilemma cases provide two.

First is the case of a country suffering both a depression at home and a balance-of-payments deficit. The initiating disturbance might be a drop in the foreign demand for the affected country's goods that drains money out of circulation through the payments deficit. Monetary theory suggests that a depression is associated with a deficient money supply, yet the strong version of the MABP identifies the deficit with an excess supply of money. The contradiction is obvious.

The second case involves both inflation at home and a balance-of-payments surplus. The initiating disturbance might be inflation abroad. (Imported inflation is considered below in a historical context.) Inflation is usually caused by an excess supply of money, yet the strong version of the MABP identifies the surplus with the process of satisfying an excess demand for money. In these two dilemma cases, monetary theory applied to the domestic scene conflicts with the strong version of the MABP. More counterexamples could easily be given.

### *The Basic Errors of the Strong Version*

Here is a list of the basic errors of the strong version. A fuller discussion of each point follows.

1. The strong version omits the market for nontraded goods and services in its analysis of the balance of payments. Yet excess supply or demand in that market can coexist with an excess demand for or supply of money, and this possibility breaks the supposed link between imbalance in the "money market" and in the balance of payments.
2. It is an error to assume that money actually *acquired* must also be *demanded*. Money balances can rise and fall unintentionally. Because the medium of exchange is routinely used and accepted in all markets, changes in money balances do not necessarily correspond to changes in the demand for money "to hold." There is no "money market."
3. The strong version fails to distinguish clearly between an excess demand for or supply of the home money on the foreign-exchange market and an excess demand for or supply of cash balances to hold.
4. The strong version also fails to distinguish between the demand for assets denominated in a particular currency and the demand for holdings of that currency as a medium of exchange. (This is not to deny that a

change in the demand for assets in a particular currency might influence the desired level of transactions in that currency and hence the demand for holdings of it.)

5. Holdings of cash in excess of desired holdings are the proximate cause of the increased spending that bids up nominal prices.<sup>3</sup> The strong version disregards this mechanism in analyzing the international transmission of inflation. (This point is discussed in a separate section below.)

The first error appears to derive from sliding into two notions with Walras's Law in mind: (1) An excess demand for money must be matched by an excess supply of something else, namely goods and services and securities in the aggregate, and this excess supply is expressed in a balance-of-payments surplus. (2) Conversely, a balance-of-payments surplus, supposedly reflecting an excess supply of goods and services and securities in the aggregate, must be matched by an excess demand for something else, namely money. The strong version overlooks the distinction between goods, services, and securities that are internationally traded and those that are purely domestic and not traded, including factors of production. (Nontraded goods must not, of course, be perfect substitutes for traded goods in production or consumption.) An excess demand for or supply of money holdings need not be matched by an opposite imbalance in the markets for internationally traded goods, services, and securities. It can be matched by an opposite imbalance in the markets for nontradables. In the depression-and-deficit dilemma case, for example, an excess demand for money is matched not by excess sales abroad of traded goods but by an excess supply of (or deficient demand for) domestic goods and factors of production. (An Appendix to this essay presents a model showing that a payments surplus can be accompanied by an excess supply of money—and a deficit by an excess demand for money—when nontraded goods appear in the analysis.)

The second error is the assumption that whenever a country's residents are building up or running down their money holdings they are doing so because they consider their existing holdings too small or too large. This error comes from sliding into a causal interpretation of a tautology. It is tautologically true, given careful definitions, that a change in the net foreign assets of a country's monetary system is equal to the change in the residents' holdings of money minus the change in the system's net domestic assets.<sup>4</sup> It does not necessarily follow, however, that a country's balance-of-

<sup>3</sup> See Wicksell (1936, pp. 40-41) for the effect of an excess supply of money on the prices of goods and services.

<sup>4</sup> Consider the identity  $\Delta NFA = \Delta MS - \Delta DA$ , where  $\Delta NFA$  is the change in net foreign assets of the monetary system,  $\Delta MS$  is the change in the money supply, and  $\Delta DA$  is the change in domestic assets of the monetary system. If one comes to think of  $\Delta MS$  as a desired change (to rectify a disequilibrium between money demand and money supply), one is slipping into a causal interpretation. The identity above is neither a behavioral equation nor an equilibrium condition.

payments surplus *is caused by* growth in the demand for money that exceeds growth in the actual money stock generated by the monetary system's domestic operations.

It is necessary to distinguish sharply between different concepts of "demand for money," particularly between supply of and demand for the home currency on the foreign-exchange market and supply of and demand for domestic money holdings. It is highly misleading to speak of the market for domestic money holdings. There is no specific market on which the money stock and the demand for money confront each other and are brought into equilibrium. Nor is there any specific price that adjusts to achieve this equilibrium. The medium of exchange, traded as it is on all markets, is distinct from other goods in not having a market and price of its own. It flows routinely *through* cash balances. People accept it and pay it out even when not intending, except passively and temporarily, to build up or run down their holdings. Money balances are pools into and out of which receipts and payments are made and so serve as buffers against short-term fluctuations in the timing and sizes of receipts and payments. Since the fluctuations are unintended, the rise or fall in money balances can be unintended too.

When Americans fled from bank deposits into currency in 1932-33, they were acting not to reduce their money holdings but rather to shift into what they considered the safer form of money. Yet the unintended consequence was that total money holdings fell as bank reserves contracted. The situation could be similar in a country running a balance-of-payments deficit at a fixed exchange rate. The money supply is shrinking, which means that the country's residents are necessarily running down their money holdings. It could sometimes be true and may even typically be true that the deficit and money-supply shrinkage are occurring because people are intentionally reducing what they consider to be excessive money balances. But it is not always true, as strong monetarism claims, because the money-stock shrinkage can be quite *undesired*.

An instructive analogy can be made between exchange-rate pegging and interest-rate or bond-price pegging in a closed economy (or one with a floating exchange rate). The central bank has committed itself to whatever open-market operations are necessary to hold interest rates at a target level. Now tastes change: people want to acquire more bonds by reducing current consumption (thus freeing resources for real investment), but they do not particularly want to change their money holdings. To keep interest rates from falling below the target level, the central bank sells bonds, with the result that money is removed from circulation. Or suppose an opposite change in tastes occurs that, again, does not directly affect desired money holdings. To keep interest rates from rising, the central bank buys bonds, incidentally creating money.

When transactors deal with the central bank, they do so because they find the bond price attractive, not necessarily because they want to change their money holdings. (They may want to change the proportions of bonds and other nonmoney assets in their portfolios.) Money is used to make or receive payments for bonds because it is the medium of exchange that routinely flows *through* their cash balances. More generally, people are not deliberately trying to reduce or increase their money holdings whenever they buy or sell something. They make the purchases and sales they find attractive at the prices confronting them. If they happen to be dealing with the central bank, the resulting changes in the total money supply and thus in their money holdings can be quite unintended.

Now suppose that the central bank revalues the home currency, cutting in half the pegged home-currency price of foreign exchange. In consequence of all the related price changes, purchases of goods and services and securities abroad become more attractive than sales abroad, the country runs a balance-of-payments deficit, and the home money supply shrinks, with painful deflationary consequences. In brief, by making foreign exchange a bargain and selling it lavishly out of its reserves, the central bank takes out of circulation the domestic money received in payment. Yet this monetary contraction in no way represents an intentional rundown of private money holdings.

Suppose instead that the central bank pegs the prices of foreign currencies too high. With the home currency undervalued, the balance of payments goes into surplus, and the money supply expands as the central bank absorbs the excess private offers of foreign currency. In this case, the surplus is *not* due to an excess *demand* for money. On the contrary, once the money has been acquired, it is in excess *supply*. [For further explanation of how money may be acquired without being fully demanded and even while being in excess supply, see Yeager (1968). Although the discussion there refers to a closed economy, it can readily be extended to an open economy.]

In summary, the strong version of the MABP misinterprets changes in the money supply as representing deliberate and desired adjustments in the money holdings of individual holders. This misinterpretation can be traced to failure to take account of the functioning of money as the medium of exchange. People will always accept money even when they do not want to go on holding it. Yet new money does not automatically go out of circulation just because people do not want to hold it; rather, it touches off an expansionary or inflationary process that tends to make it desired after all. Conversely, shrinkage of a country's money supply does not necessarily represent the deliberate and desired rundown of individual holdings. It could be the unintended consequence of the routine use of money as the

means of payment when domestic holders find purchases of foreign goods and services and securities more attractive than sales abroad.

We are not denying the existence of a well-defined demand for money to hold. Rather, we are concerned to clear up some misconceptions about the way that the demand for money operates. Additional money can be thrust onto a country without being demanded, because of money's role as a medium of exchange, the lack of a market for money, the buffer-stock role of individual money holdings, and the process whereby the nominal supply of money can create its own demand. This process is compatible with, or even presupposes, a fairly definite demand-for-money function. (Again, see Yeager, 1968.)

The third error, failure to distinguish clearly between an excess demand for or supply of the home money on the foreign-exchange market and an excess demand for or supply of cash balances, is illustrated in the following statement by Cleveland and Brittain (1976, pp. 20-21):

There is a measure of truth in singling out hedging or speculation against the dollar as a source of world inflation. Such speculative flows did enlarge the monetary base and the money supply in European countries, as well as in Japan. In fact, inflows of dollars, partly speculative in character, were responsible for much of the increase in other industrial countries' monetary bases in the years 1970-73. . . . But, it is a different question whether the inflows caused the money supply and price inflation in these countries to be greater than they otherwise would have been. Monetary theory suggests that this was probably not the case. Inflation occurs when there is an excess of money supply over the demand for money. The inflows of funds occurred in response to a new, speculative demand for marks. Thus, it was the increase in demand for marks that gave rise to the increase in the supply of marks; therefore, the inflows could not have created or contributed to creating an excess of mark money supply over demand. How, then, could they have raised German prices above the level they otherwise would have reached?

Cleveland and Brittain imply that because Europeans and others were acquiring European currencies, they must have had an excess demand for holdings of them. This does not follow. For example, German firms that had borrowed dollars abroad wanted to exchange those dollars for marks on the foreign-exchange market. Only on that market were marks in excess demand. Once the Bundesbank had created marks to satisfy the excess demand for them there at the fixed exchange rate, domestic cash balances were in excess *supply* at the old price level. The fact that Germans preferred to acquire marks rather than dollars merely reflects the role of marks as the medium of exchange in Germany. It does not mean that Germans were demanding marks as permanent additions to their cash balances. The expansion of the money supply brought about by the balance-of-payments

surplus stimulated spending on goods and services and reinforced inflationary tendencies in Germany.

The fourth error of the strong MABP, which also appears in the statement by Cleveland and Brittain, is the failure to realize that there was a speculative demand for assets denominated in marks rather than for the German medium of exchange in particular. When U.S. and German residents were switching out of assets denominated in dollars into assets denominated in marks, the demand for the domestic medium of exchange was not necessarily changing in either country, or not by an amount anywhere near as large.

### *The Usefulness of the Weak Version*

As already mentioned, the weak version of the MABP should be regarded not as a theory but rather as a framework for analysis that can be reconciled with two other major frameworks, the elasticities and the absorption approaches. These three frameworks for analysis are not causal theories but ways of organizing discussion. Each raises certain questions and focuses attention on certain aspects of reality. Each has its tautological aspects in reference to ex post, realized changes (see footnote 4 above for the tautological core of the weak version of the MABP). Like the strong version, the weak version pays explicit attention to money supply and money demand in balance-of-payments disequilibrium and adjustment. For example, it helps us to understand why a balance-of-payments surplus or deficit cannot go on indefinitely in the absence of changes in the domestic assets of the monetary system. Thus, by using the weak version we arrive in many cases at an analysis similar to that of the strong version. But the weak version does not make the error of always associating a surplus in the balance of payments with an excess demand for money and a deficit with an excess supply of money. Moreover, it is totally compatible with the dilemma cases. Mundell (1968, pp. 150-151) summarizes the usefulness of the weak version as an approach:

It is not meaningful to question the validity of the three approaches. The terms can be defined so that they are correct and assert identical propositions, even if capital movements are included. . . . The identity of the three approaches, when they are properly interpreted, does not mean that each approach is not in itself useful. [Each approach] provides additional checks on the logic of balance-of-payments policies.

In summary, we are not offering a rival theory by supporting the weak version. Rather, we are warning against exaggerations that can make the MABP erroneous.

### *The International Transmission of Inflation under Fixed Exchange Rates and the MABP*

While the strong monetarist theory tends to breed confusion about the international transmission of inflation, the weak version of the MABP can be helpful. It is possible, for instance, for inflation to be *generated* by a disequilibrium exchange rate. A country can import inflation even if inflation is not being exported by another country. Suppose the authorities keep the home currency artificially cheap on the foreign-exchange market and meet the excess demand for it *on that market* by creating more. They create an excess *supply* of money holdings, and spending and prices respond. Furthermore, the translation of world-market prices into domestic currency at the artificially high prices of foreign currencies makes a direct, mechanical contribution to the rise of the home price level.

This direct price linkage also operates when prices at home are linked at a fixed exchange rate with prices undergoing inflation abroad. According to strong monetarism, this direct price linkage is the overwhelmingly dominant mechanism whereby inflation is transmitted. According to the weak version, there are other explanations as well. We can imagine or recall cases in which a country suffers inflation due less to direct price transmission than to the monetary expansion imposed by an overall balance-of-payments surplus corresponding to an interest-rate-motivated or a speculative inflow of capital. [Switzerland is an example of a country whose imported inflation arose from surpluses on capital account (see Allen, 1977).] This monetary aspect of the inflation process goes far toward explaining events of the early 1970s, when other countries were generally running more extreme money and price inflations than the United States, from which they were said to be importing inflation.

More specifically, in 1971 the balance-of-payments deficit of the United States amounted to an unprecedented \$30 billion (official-settlements basis). Massive speculative capital outflows from the United States contributed to this deficit. In light of the huge surpluses experienced by other countries, it is not surprising that those countries suffered rapid monetary expansion in 1971. Nor is it surprising that they suffered from rapidly accelerating inflation two years later. Some such lag of prices behind money is quite typical and is illustrated in the accompanying table. The table also illustrates the international pervasiveness and bunching in time of money spurts followed by price spurts. It provides evidence for the international transmission of inflation, a phenomenon that the strong MABP handles very unsatisfactorily.

Three points should be emphasized regarding the acceleration of world inflation during 1973-74. First, the preceding massive U.S. balance-of-pay-

PERCENTAGE CHANGES IN MONEY SUPPLIES AND CONSUMER PRICES  
IN 13 COUNTRIES, 1968-75

Country	1968	1969	1970	1971	1972	1973	1974	1975
Austria:								
Money supply	6.8	7.7	6.5	15.4	21.8	8.7	5.0	17.2
Consumer prices	2.9	3.0	4.4	4.7	6.3	7.5	9.5	8.5
Belgium:								
Money supply	7.4	2.6	8.3	11.1	14.0	8.8	8.8	14.2
Consumer prices	2.8	3.7	4.0	4.3	5.5	7.0	12.7	12.7
Canada:								
Money supply	-2.1	-3.5	5.2	13.0	11.7	9.0	0.3	18.0
Consumer prices	4.0	4.5	3.4	2.8	4.8	7.6	10.9	10.7
Denmark:								
Money supply	13.9	12.8	1.3	7.8	13.6	11.7	4.7	30.3
Consumer prices	8.0	3.6	6.5	5.8	6.6	9.3	15.2	9.6
France:								
Money supply	8.0	-1.1	11.1	11.8	14.9	9.8	15.2	12.7
Consumer prices	4.6	6.1	5.9	5.5	5.9	7.3	14.0	11.8
Germany:								
Money supply	8.3	6.0	9.6	12.8	13.9	0.8	12.2	14.0
Consumer prices	1.5	1.9	3.4	5.3	5.5	6.9	7.0	6.0
Italy:								
Money supply	11.9	15.9	27.4	19.0	24.1	17.6	9.4	13.5
Consumer prices	1.3	2.7	4.9	4.8	5.7	10.8	19.1	17.0
Japan:								
Money supply	13.4	20.6	16.8	29.7	24.7	16.8	11.5	11.1
Consumer prices	5.5	5.7	7.2	6.3	4.8	11.8	22.7	12.1
Netherlands:								
Money supply	11.4	8.1	11.8	15.0	17.6	0.1	12.2	20.0
Consumer prices	3.8	7.3	3.6	7.5	7.8	8.0	9.7	10.2
Norway:								
Money supply	15.2	8.1	12.6	11.5	16.3	15.5	11.9	16.8
Consumer prices	3.5	3.1	10.6	6.3	7.1	7.5	9.4	11.7
Sweden:								
Money supply	-1.3	-4.0	9.2	9.2	7.6	10.2	25.1	8.6
Consumer prices	2.2	2.2	7.5	7.0	6.5	7.0	9.0	9.8
Switzerland:								
Money supply	12.4	11.7	11.0	17.7	5.4	-0.2	-1.1	4.4
Consumer prices	2.3	2.6	3.6	6.6	6.7	8.7	9.8	6.7
United Kingdom:								
Money supply	4.1	0.3	9.3	15.1	14.2	5.1	10.8	18.7
Consumer prices	4.7	5.4	6.4	9.4	7.1	9.1	16.0	24.3

NOTE: Important changes are italicized.

SOURCE: Calculated from *International Financial Statistics*, various issues.