Remember The Money Supply?

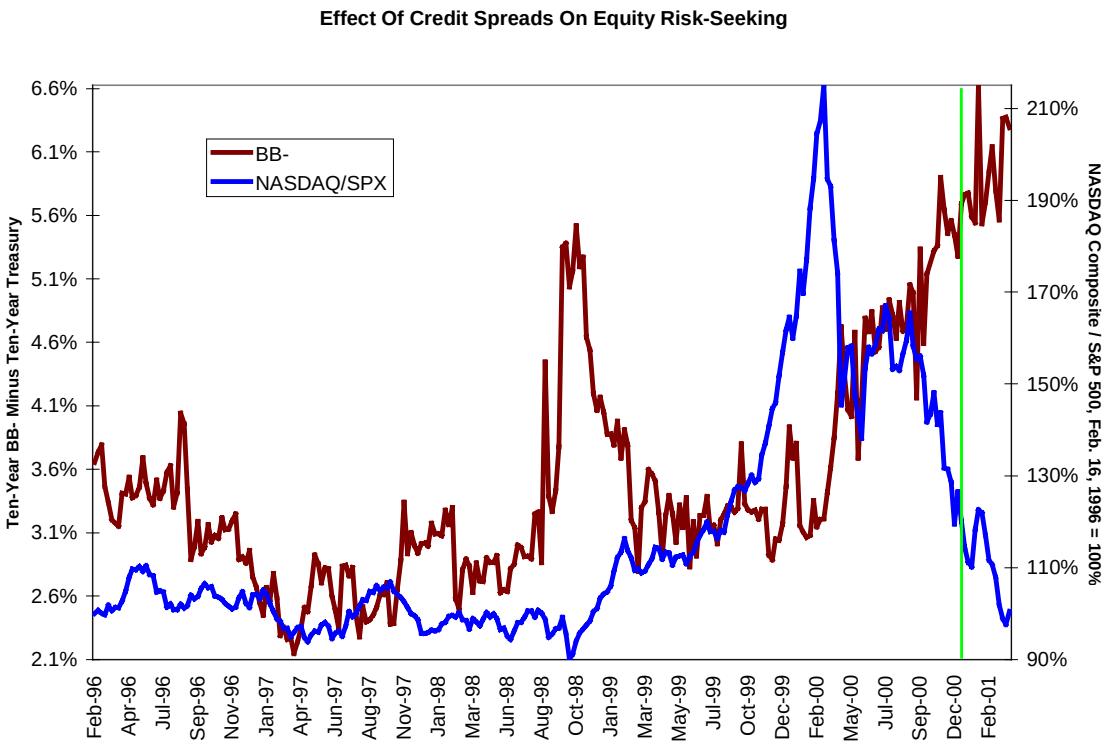
If the word "monetarism" were inserted into the lead sentence of this column, you wouldn't read further. It's one of those ideas in economics that, like hemlines on skirts, rises and falls in fashion. It's time for monetarism to sashay down the runway one more time: Our beloved Federal Reserve risks an implosion in the money supply if it does not become more aggressive in monetary ease. The consequences of such a failure would be severe.

It's impossible to speak of monetarism without mentioning Milton Friedman and his *Monetary History Of The United States*. The Nobel Laureate demonstrated that the Federal Reserve allowed the money supply to contract by one-third during the early 1930s despite repeated rate cuts. The Bank of Japan repeated this mistake in the 1990s. How can the money supply contract when interest rates are plummeting toward zero? The answer is twofold. First, deflationary forces gripped both economies; in such an environment a nominal interest rate of zero can be a very high real interest rate. These high real rates discourage borrowing and monetary creation by bank lending. Second, both economies faced excess capacity following long capital spending booms. Why borrow to expand operations when inventories are piling up and your current plant and equipment is underutilized? If any of this reminds you of the present situation in the high-tech sector, it should.

Broken Speedometers

Andrew Mellon, who served as Secretary of the Treasury under Presidents Harding, Coolidge, and Hoover, summed up the reaction to the 1929 stock market crash and ongoing recession as "liquefy stocks, liquefy bonds, liquefy real estate. Liquefy, liquefy, liquefy." This flight from risk into cash, which can be seen today in the burgeoning assets of money market mutual funds – from $1.704 trillion to $2.078 trillion within the past year – and in a relentless outflow from riskier stocks and bonds into the safety of Treasury securities.

The three 50 basis point cuts in the federal funds rate so far in 2001 have been remarkably ineffective in restoring any sort of risk-seeking behavior. The spread between low-grade BB- corporate bonds and ten-year Treasuries is wider now than it was at the time of the first rate cut, noted on the chart below, and the relative performance of the NASDAQ composite to the S&P 500 has continued to deteriorate.



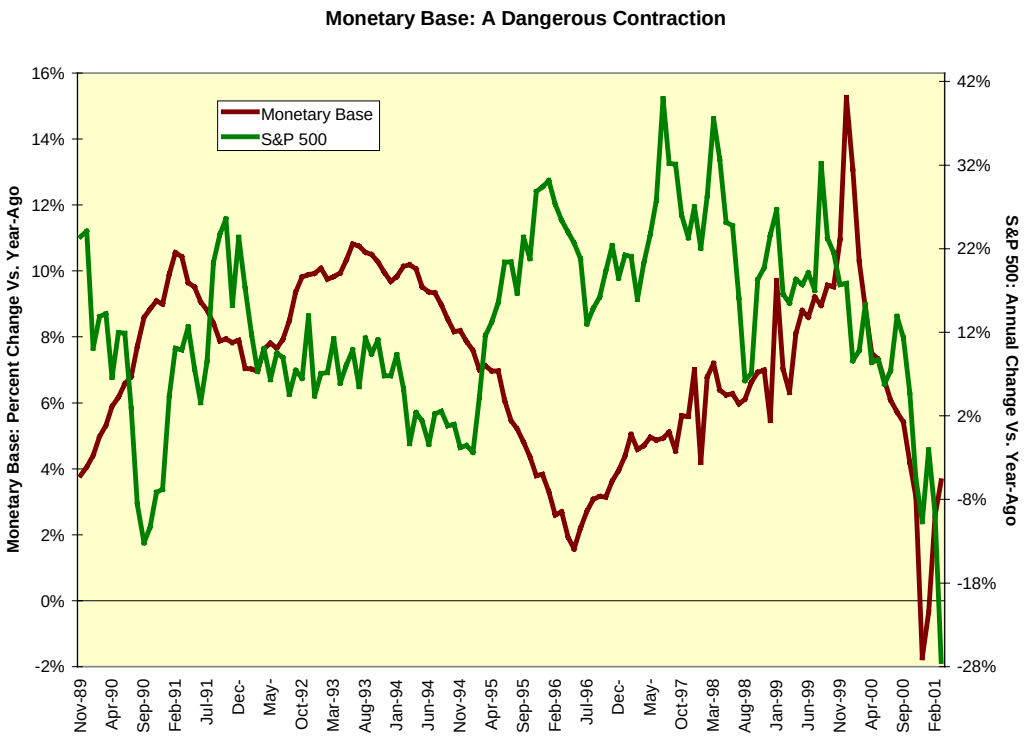
The Fed continues to fear inflation, but this argument is increasingly lame. For one, the price indices as constructed fail to take key features of consumer behavior into account. The consumer price index, for example, assumes no technological improvements in its underlying market basket, and does not allow for either substitution or price elasticity of demand. As a result, the CPI can be pushed higher quickly by jumps in certain of its components even while most of us do not feel the inflationary impact.

Worse, our economic data system is still geared toward the manufacturing economy of the 1950s and 1960s. We can count automobiles with great precision, but we are less adept at measuring intellectual property, the cornerstone of the 1990s boom. The shock to the economy of the loss of a generation of young entrepreneurs may not be as great as the loss of a generation in wartime, but the concept is parallel. How can we measure the loss to the economy from what will be years of risk-averse behavior? It's often said economic forecasting is like driving in the rearview mirror; we are now doing this with a broken speedometer to boot.

If inflationary pressures were in fact a problem, they would show up in both the commodity and currency markets. After all, if each dollar is worth less, then it stands to reason both commodities and foreign currencies should be worth more. This has hardly been the case over the past year. The trade-weighted dollar index has gained 11.4%, while the Bridge/CRB commodity index has fallen 0.5% from year-ago levels. The commodity plunge would look far weaker without the explosive increase in natural gas prices.

It All Comes Down To Money

The monetary base is the total amount of money in circulation plus reserve deposits at central banks. While it's not a perfect measure of total liquidity – no such measure exists in an open global economy with free capital flows – it is indicative of the resources available to support both real and financial asset prices. Its growth rate slowed markedly from mid-1993 to mid-1996; the Asian crisis began a year later. A flood of liquidity prompted by the Asian and then Russian crises of 1998 led to the global financial inflation of the late 1990s. The culmination of this process was the Fed's flood of money in anticipation of Y2K problems, proof positive that belief in the occult did not die in the ancient times.



Once Y2K was out of the way, the Fed slammed on the brakes and produced a rather precipitous drop in the monetary base growth rate; it actually contracted between in December 2000 - January 2001. This contraction exacerbated the effects of high energy prices, the NASDAQ shock, and our fiscal surplus. Small wonder the economy is contracting and the stock market just completed its worst quarter in more than a generation.

Unless the Fed forgets its inexplicable fixation on a non-existent inflation and its self-delusion that the economy, as measured by outdated statistics, is doing just fine, we're going to be in serious macroeconomic trouble. There's still time to avoid a catastrophe, but a massive injection of liquidity – and not just a token rate cut here and there – is necessary. And once that's done, we as a society are going to have to think about whether delegating so much power to central banks is a good idea.