Does Money Matter?

Money, so they say
Is the root of all evil today.
-- Pink Floyd

Indeed, one would have to have spent entirely too much time on the dark side of the moon to question whether the money supply, in some way, shape, manner or form influences the economy. The question of how those influences occur and to what extent can ignite the closest thing to a barroom brawl amongst practitioners of the dismal science.

I will leave the theological debates to others. The issue of whether we are stumbling into a stealth tightening either through the actions of our good friends at the Federal Reserve or through our own slack credit demand is one that has garnered an unusual amount of attention of late. Let's try to piece some answers together and then take a look back over the past quarter-century or so to see whether changes in the money supply have affected those things we hold near and dear, principally our own personal money supply.

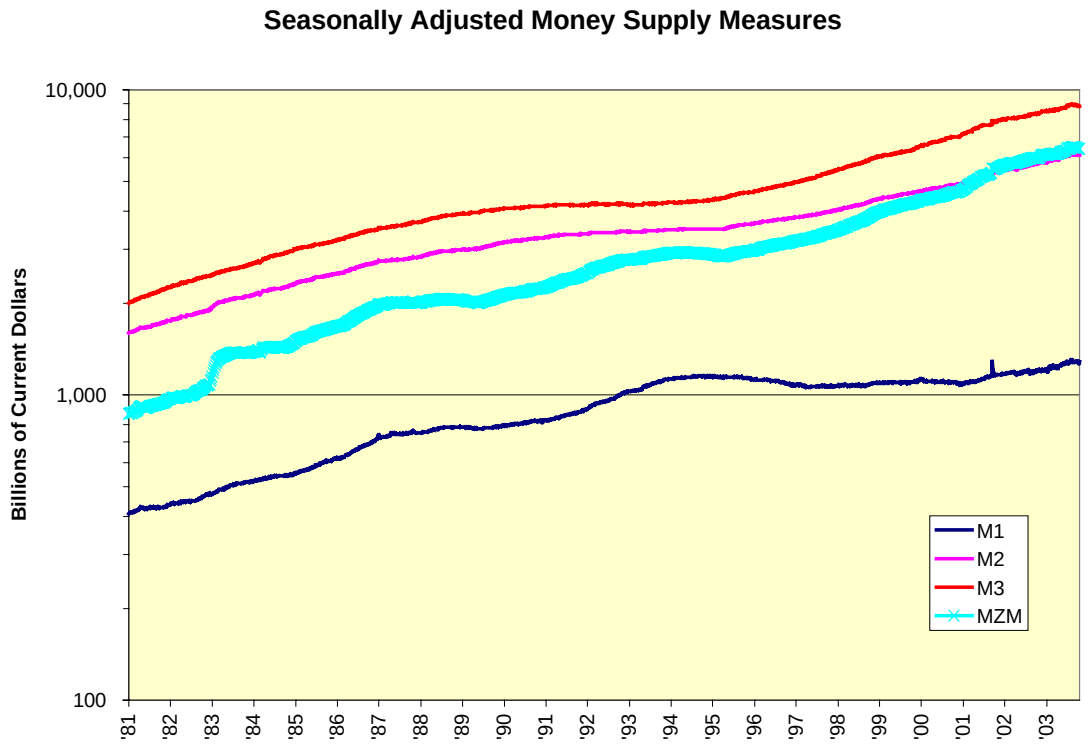
Measuring Money
Money is devilishly difficult to define as it is inextricably bound to credit. Most of us remember from our long-ago economics classes that banks can create money within a fractional reserve system. If the reserve requirement, or the amount banks cannot lend, is 10%, an initial $1 billion deposit can be relent ad infinitum to a maximum equilibrium quantity of $1 billion / 10%, or $10 billion. Eurodollar and other offshore banking deposits do not have a reserve requirement.

All of this was well and good during the era when banks and banks alone handled banking functions. This has not been the case since the growth of markets such as commercial paper, wherein large corporate borrowers borrow directly in capital markets or since asset securitization took debts off of banks' books. The 1980 Depository Institution Deregulation Act recognized these changes and others like them. Finally, many consumers have lines of credit through asset management accounts and home equity lines of credit.

The old breakdown of the money supply had:

M1: currency and demand deposits such as checking accounts;
M2: M1 plus savings accounts, time deposits such as CDs, and retail money market mutual funds;
M3: M2 plus institutional money market funds, eurodollars, repurchase agreements and large time deposits

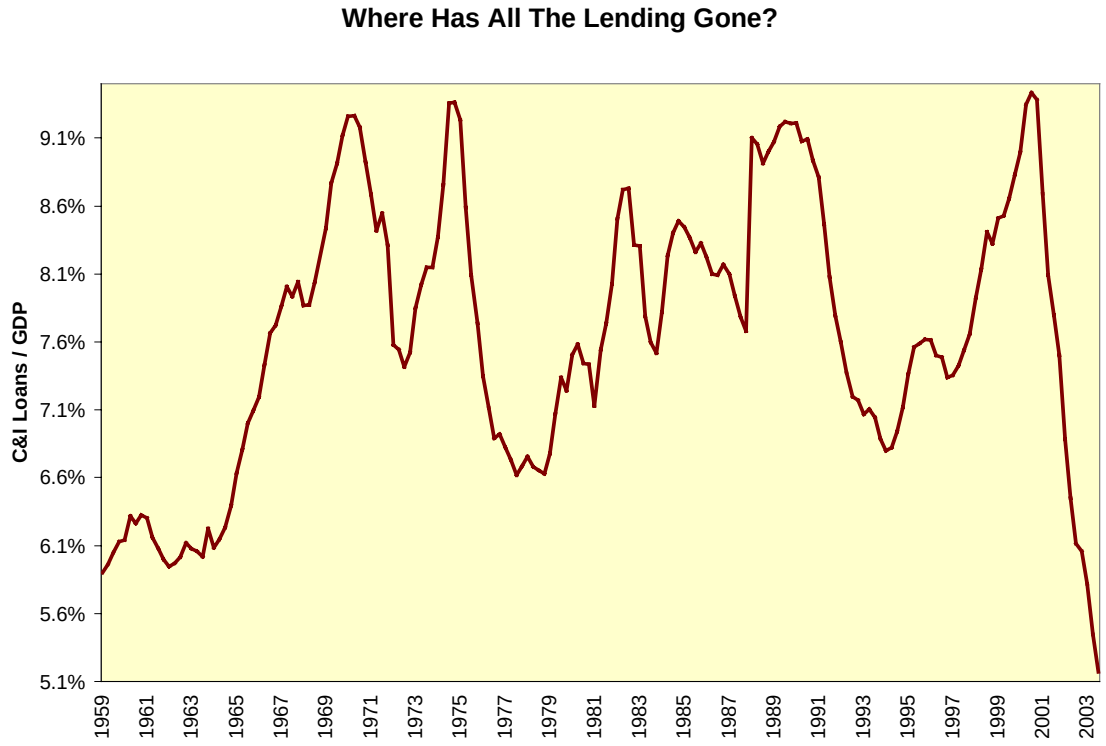
The St. Louis Federal Reserve created a new measure of money, or zero-maturity (MZM), to handle all of the distortions produced by deregulation and financial innovations. While the traditional M's are additive up to M3, MZM moves differently; it does not include small time deposits, for example, which do not have a zero-maturity.



The Fed And Monetary Creation

The Federal Reserve can stimulate the expansion or effect the contraction of the money supply by its open market operations. If it buys Treasury securities, it increases free bank reserves and these reserves can be lent through the banking system. Conversely, the sale of Treasury securities contracts the supply of free reserves available for lending.

These activities only affect the final money supply indirectly. The Fed can be quite active in supplying reserves and driving the federal funds rate, the rate at which banks lend to each other, down to a target, but it can neither force banks to lend nor can it force businesses to borrow. Recent concern about a slow or declining growth in the money supply has to focus here: The level of commercial and industrial lending as a percentage of the GDP is the lowest since the data became available in 1959.

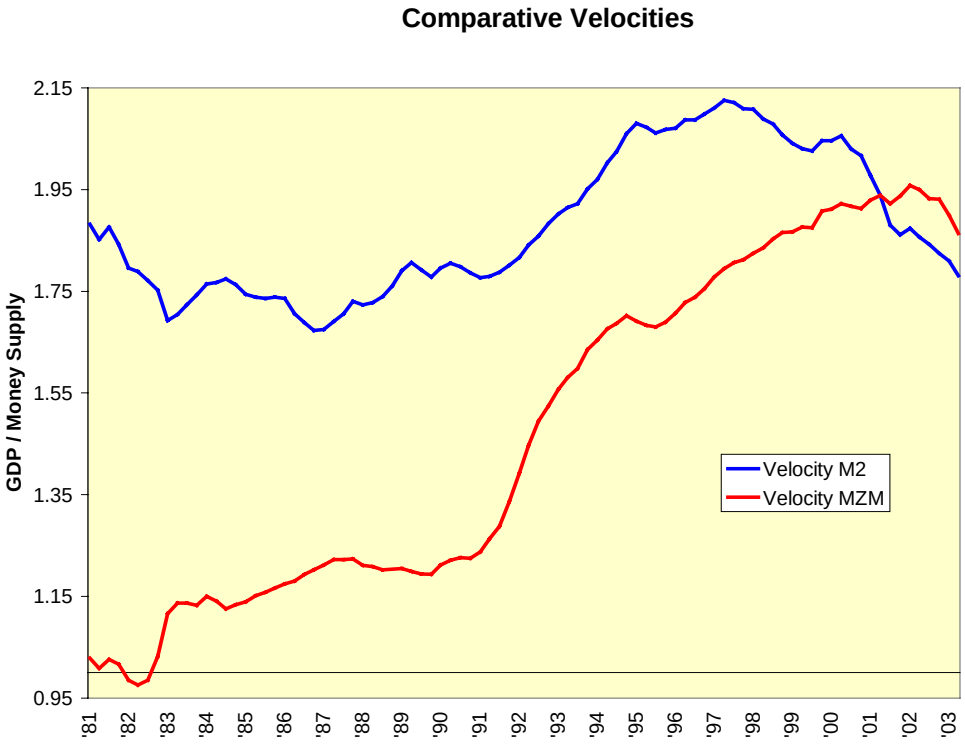


The low level of loan demand can be attributed to a number of causes, such as the aftermath of the equity bubble and the slack capacity in many industries - why borrow when you do not need to expand? - tighter controls on inventories, a structural shift in the U.S. economy to outsourcing production overseas and the growth of non-bank lending. Moreover, commercial and industrial loans are considered a lagging indicator of economic activity, and since the economy has started to reaccelerate only recently, we should expect loan demand to follow.

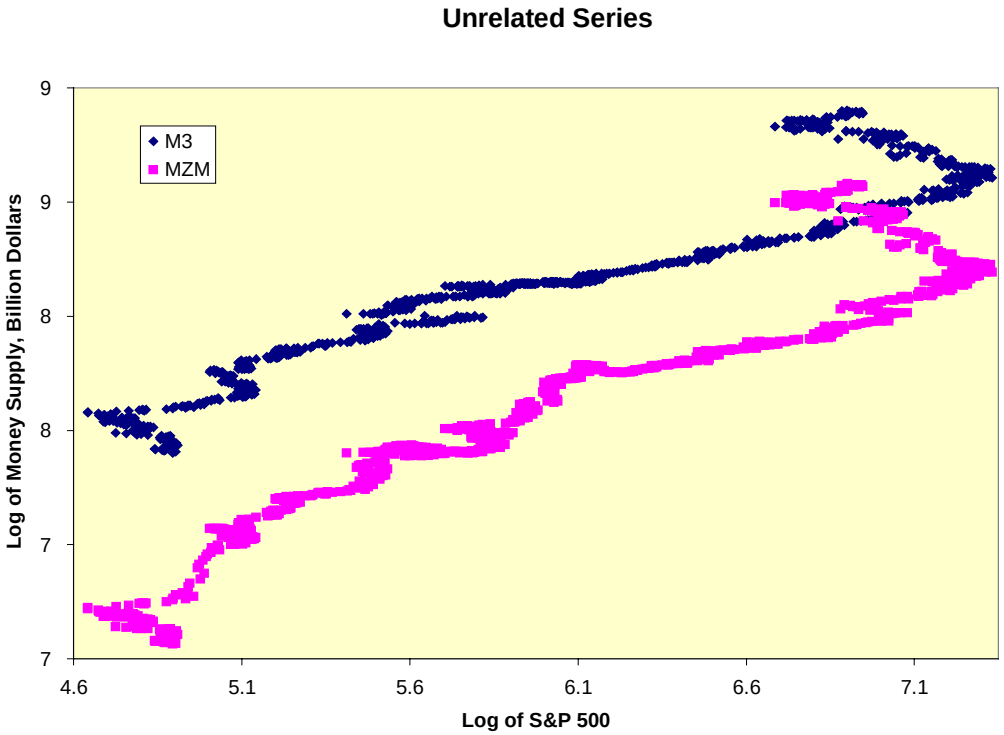
Relationship To GDP And Stocks

The velocity, or ratio of GDP to money supply, of the traditional monetary aggregates and MZM differs as well. In a July 1996 research letter, the Federal Reserve Bank of Cleveland attributed the different velocities to the outflow of small time deposits into mutual funds. It linked the outflow to the opportunity cost of keeping funds in T-bill instruments and measured a four percentage point drop in demand for MZM for every percentage point increase in this opportunity cost.

The velocity of both M2 and MZM has been declining in the face of the Fed's aggressive rate cutting campaign; the last datum is from the second quarter of 2003. This confirms the inefficacy of monetary policy to stimulate demand. Monetary policy may have prevented deflation, a real danger in the face of contracting credit demands.



It is axiomatic that excess liquidity finds its way first into financial assets; it is far easier to purchase a claim on a productive asset than to create the productive asset. Over the 1981-2000 period, the money supply as defined both by MZM and M3 had a very solid and near-linear percentage relationship with the growth of the S&P 500 index. Once the bubble broke, however, stocks fell even as the money supply continued to grow.



The question is raised whether stocks, which eroded in the face of an expanding money supply during the bear market, will now crumble in the face of slower or negative monetary growth. Only if total credit continues to contract in the face of both low interest rates and a resumption of global demand; total credit includes the global supply of liquidity available for conversion into dollars.

Given slack capacity and improving productivity, it is quite possible for loan demand to remain soft, both in the United States and globally. Viewed in this light, central banks may need to remain vigilant against further monetary contraction until global growth is confirmed.

This means the Fed's decision to keep the funds rate at 1% for a "considerable period," while notably ineffective in achieving other goals, is laudable in forestalling what could be further monetary contraction and thus is to be commended.