Not By Money Alone

Much of the recent debate on whether the Federal Reserve should decrease the target federal funds rate further and by how much is based, knowingly or unknowingly, on the belief such a move will improve bank balance sheets. With the federal funds rate at 3.00% and two-year Treasuries trading at half that, 1.516%, at the time of this writing, a case can be made the Federal Reserve has yet to turn accommodative.

This is not a new argument. Permit me to quote myself from a September 2005 Columnist Conversation post entitled, "Federal Reserve Not Killing Economy." The concern then was the Federal Reserve had kept its metronomic pace of rate increases in the immediate aftermaths of Hurricanes Katrina and Rita:

> *A whole host of industries, include anything housing-related, grew fat during the past three years, and now it will be payback time.*
>
> *I think it is important to remember the Federal Reserve's primary responsibility is to the banking system and its primary macroeconomic duty is to maintain some semblance of price stability. If it lets inflationary expectations get out of hand, it risks both missions.*
>
> *Many of us were concerned about the global imbalances that built up during the low-rate era, such as the U.S. capital surplus and the weaker dollar. Real estate was alleged to be in a bubble, and commodity prices in general were moving higher, etc. Should the Federal Reserve act to perpetuate these imbalances?*
>
> *Finally, if the Federal Reserve monetizes the fiscal shame going on in Washington (a redundancy?), it will risk serious future inflation. The last time that happened, Paul Volcker had to push the federal funds rate to 20% or so. Maybe we can avoid a repeat by accepting a slowdown today.*

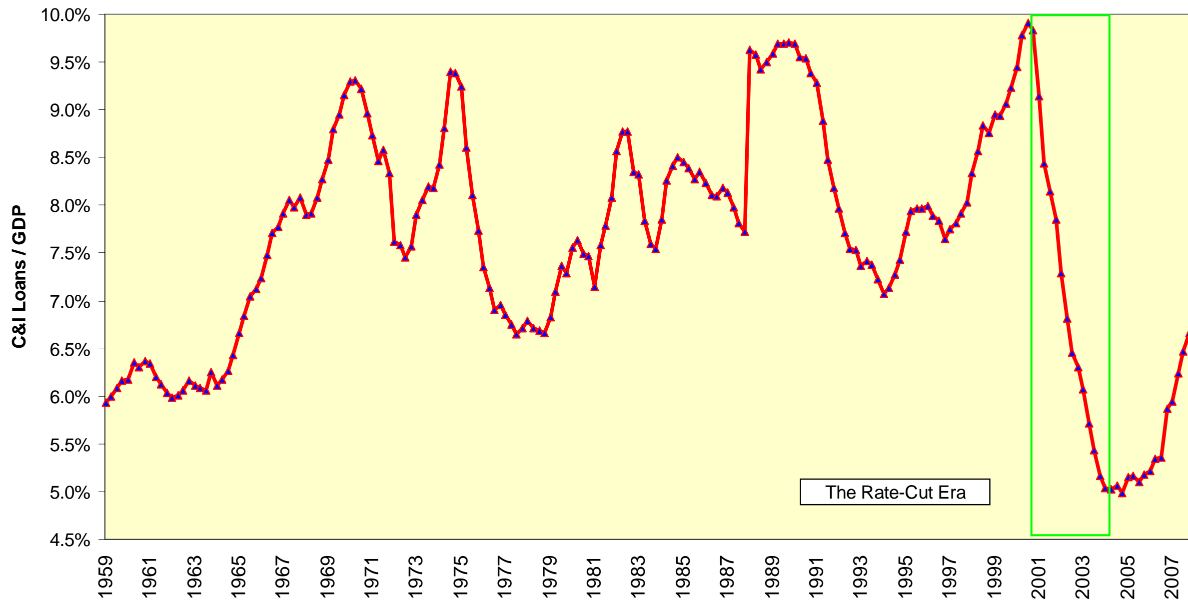
As the chatter continued back and forth in September 2005 whether the money supply was growing too slowly, I decided to address the issue in a column a few days later and updated below.

Here is the conclusion right up front. The demolition of the "shadow banking system" of hedge funds, asset-backed commercial paper, auction rate preferred securities, notional financing in the swap market, structured vehicles and all of the other things that have given us those 10 and 11-digit writeoffs in the last six months are placing good old commercial banks back to the role they once occupied as lenders. As their role increases, the measured money supply will increase by the mechanism of fractional reserve lending. If member banks have to keep a 10% reserve against their assets, each additional dollar of free reserves can expand the money supply by a multiplier of 1/(1-.9), or 10, each time it is re-lent.

The bizarre result will be we had loose money without a surge in the money supply leading to an obvious increase in inflation and then and only then an increase in the money supply. When Milton Friedman famously and correctly said, "Inflation is always and everywhere a monetary phenomenon," he did not specify whether actual monetary debauchery and measured monetary debauchery had to occur simultaneously.

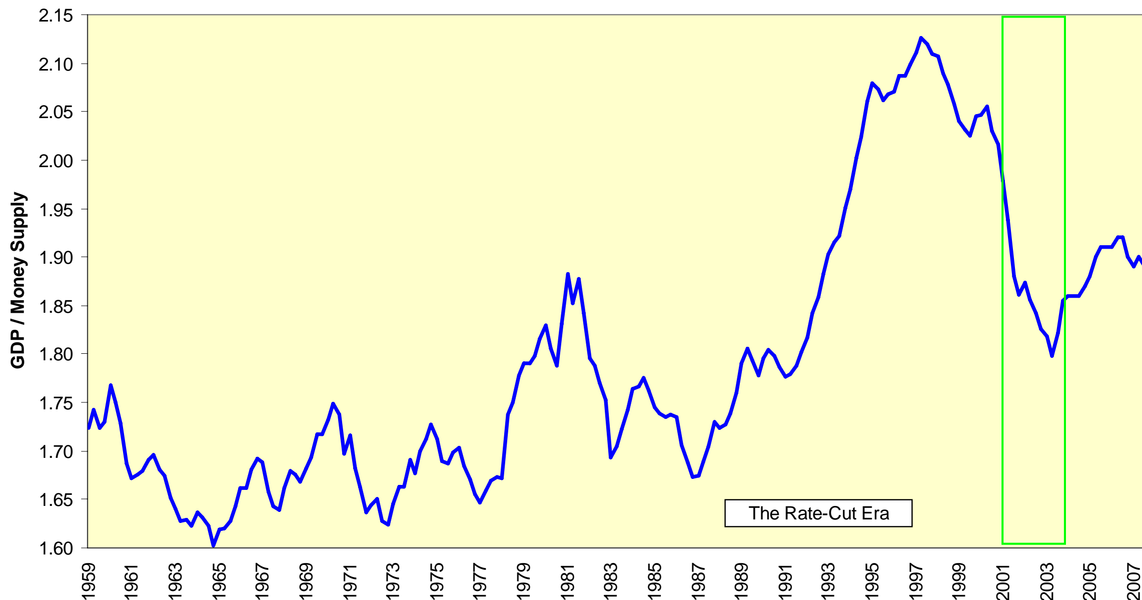
Welcome Back, Banker

In one of those quiet phenomena that go unnoticed until you look, commercial and industrial loans as a percentage of GDP, which fell precipitously during the Greenspan experiment in reckless central bank buffoonery, began rebounding at the end of 2004. The last datum is for the fourth quarter of 2007, but it shows how bank lending actually rebounded during the first round of Bernanke rate cuts. It will be quite interesting to see whether this trend continues in the first quarter of 2008; if it does, we should expect higher money supply growth for each dollar of free reserves in the banking system.



Unsafe At Any Speed

Monetary velocity is the ratio of GDP to money supply. The velocity of M2, which includes currency, demand deposits, savings accounts, certificates of deposit and money market mutual funds, declined sharply during the last rate-cut extravaganza. The last datum here is for the third quarter of 2007. Given the flight to instruments included in M2 and the slowdown in the economy, we should expect velocity to decline significantly for the fourth quarter of 2007 and first quarter of 2008.

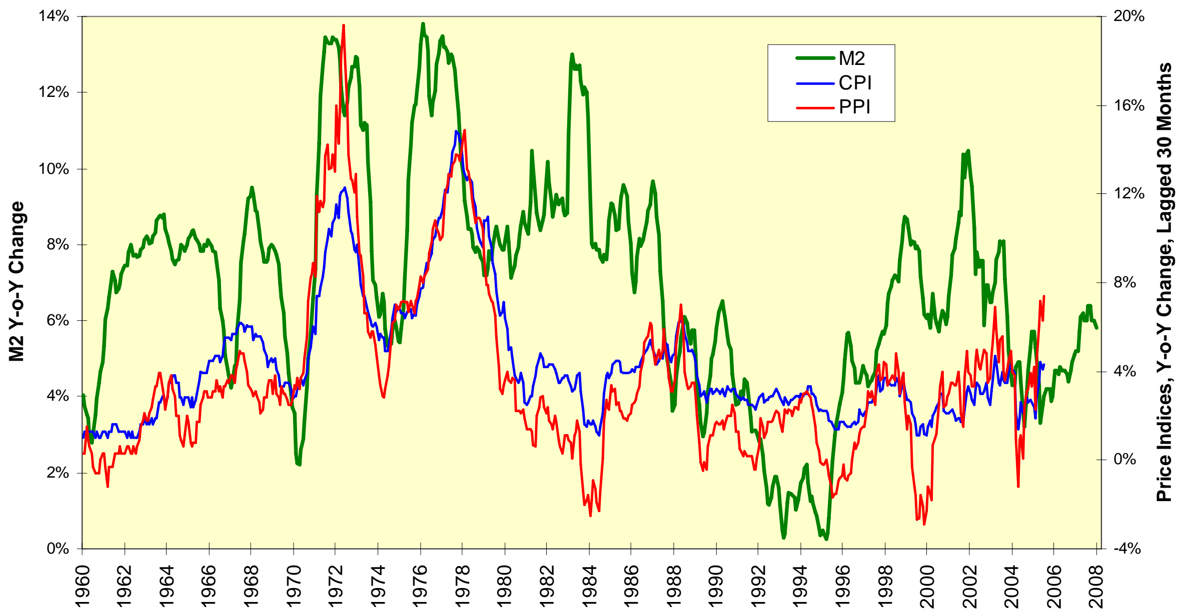


Money And Inflation

Monetary policy acts with long and variable lags, which is the polite way of saying we do not know what is going to happen nor when. Eighteen months is a good lead term, so if we compare the year-over-year growth rates of M2 to those for the consumer and producer price indices, we should use a thirty-month lag.

Can we observe a leading relationship in the chart below? No, and for the reasons offered earlier. The actual liquidity available to fuel our present rise in inflation did not show up in the money supply statistics; it was "off

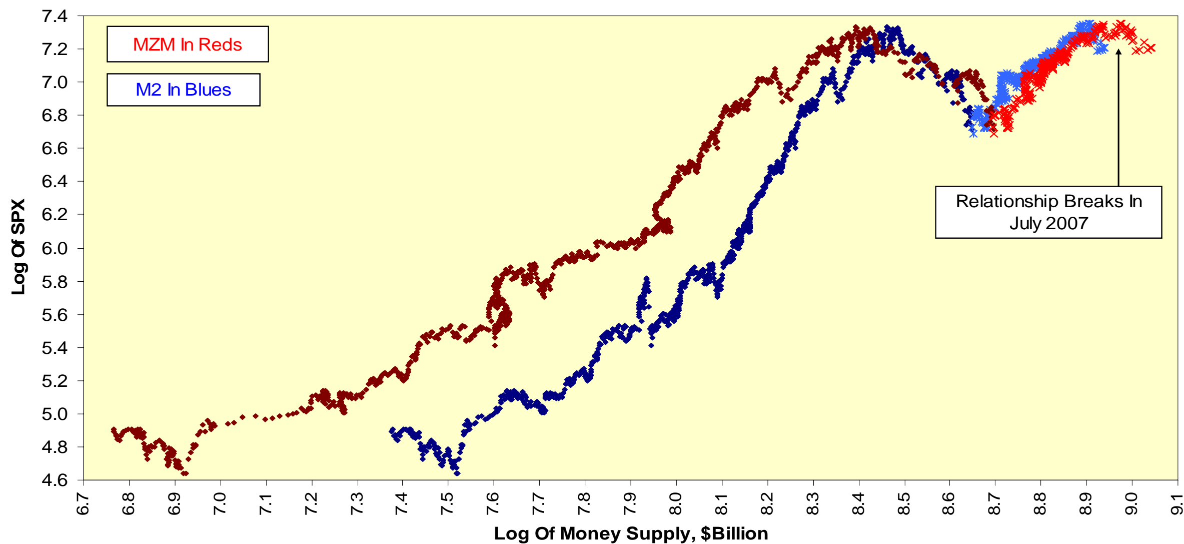
balance sheet" to the banking system. If credit moves back from the shadow banking system to the real banking system, we should see the expected link between money and inflation re-appear and look much as it did in the 1960s and 1970s.



Impact On Stocks

Will a rising money supply boost equities? That was the question before the house in September 2005. The answer, alas, is not necessarily.

Prior to the stock market's peak in 2000, the elasticity between M2 and the S&P 500 was a strong one. The same held for MZM, the St. Louis Federal Reserve's measure of zero-maturity money. Once stock prices turned lower between March 2000 and October 2002, the money supply measures continued to expand. After the bear market ended in October 2002 (lighter blue and red markers), the elasticity to the money supply returned, only to disappear again in the observations made after the onset of the credit crunch in July 2007.



The reason for this change once the credit crunch began in earnest is simple. Investors sold risky assets and piled into assets included in the monetary tallies. The money supply expanded and asset prices, as we all have noticed, contracted.

What will happen once the credit crunch ends, as it inevitably will? We will have a lot of excess money looking for a return within an inflationary environment. This suggests that when the whistle blows all-clear, Treasuries will be sold with a vengeance and a 2003-like flight-to-risk will occur even if the Federal Reserve starts to raise short-term rates.