Finance and Economics

Decoding money-supply data

Narrow success, broad concerns

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Unorthodox monetary policies have mixed effects on the money supply

“INFLATION is always and everywhere a monetary phenomenon,” said Milton Friedman. So when central banks started pursuing unorthodox monetary policies, including the purchase by central banks of government debt, to boost their economies, some commentators started muttering about the possibility of a descent into Weimar-style hyperinflation. Others took a different view. They looked at the repeated attempts by the Bank of Japan to pull its economy out of a deflationary mindset and concluded that other central banks might prove equally impotent.

A look at money-supply data in leading economies provides both sides with ammunition. There has been fairly rapid growth in the most narrow measures of money, those closest to cash. Ideally, there would be a “multiplier” effect as growth in narrow money led to increased lending. But broader measures of money are more sluggish. Growth in these measures and growth in credit are what count for economic activity.

In America, for example, M1, which includes banknotes, current accounts and overnight deposits, grew by 17.4% in the 12 months to July, while M2, which also includes savings accounts, rose by just 8.1% over the same period. The difference between the two was even starker over the past three months. In the euro zone the growth rate of M1 rose to 12.2% in the year to July from 9.4% in June. Yet the growth rate of bank lending to non-financial corporations fell to 1.6% in July, and loans to households were flat year-on-year.

None of this sounds like Zimbabwe. For those kind of eye-popping figures, you have to delve into the minutiae of the data. For example, Britain used to publish a number for M0, a very narrow measure of money supply consisting of notes and coins in circulation plus reserves held by commercial banks at the central bank. Between July 2008 and July 2009, M0 more than doubled. But this is not really a sign that the printing presses have been working overtime. Virtually all the jump is due to an increase in bank reserves, following the decision by the Bank of England in March to implement a policy of creating money to purchase assets, or “quantitative easing” (QE). In the three months to July reserves held at the central bank rose at an annualised rate of 1,968%.

When the Bank of England buys gilts from the private sector as part of its QE programme, it pays for them by crediting the reserves account of the seller’s bank. Between April and July reserves jumped by almost £111.3 billion ($175 billion), the counterpart of the asset purchases made through QE. The European Central Bank (ECB) has not formally adopted a policy of QE but the result has been the same. It offered a huge €442 billion ($620 billion) one-year loan to banks in June, but they put much of it on deposit at the ECB.

To some, this game of pass-the-parcel is a sign that QE is doomed to failure. “Even before QE began, the system had far more liquidity than banks needed,” says Mark Capleton, a strategist at Royal Bank of Scotland. The sharp rise in narrow-money growth has not translated into lending to companies and individuals. Figures released on September 1st showed that British consumers had repaid debt in July for the first time since comparable records began to be kept in 1993.

Yet the absence of such an effect is not proof that QE has failed. First, QE may have been successful in addressing other aspects of the credit crunch, for example by boosting confidence and reducing the high rates being paid in the money markets and on corporate-bond issues. Second, there are likely to be lags between the implementation of the policy and growth in broad money. Banks have to be confident enough to lend and companies and individuals must want to borrow. The multiplier could yet emerge.

There may be tentative signs that the pace of broad-money growth is accelerating. The measure the Bank of England likes to emphasise is M4 excluding intermediate OFCs (other financial corporations), since they are really part of the banking system. In July this measure grew by an annualised 7.4%. That is within sight of the 10% growth rate that Richard McGuire of the Royal

Bank of Canada says would translate into healthy 5% growth in nominal GDP.

But the problem is that nobody is entirely sure how, or indeed whether, QE will work. And as the money-supply data show, it is difficult to judge whether they have so far done too little or too much.

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