Money and Asset Prices in Boom and Bust

SUMMARY

• While most economists today accept that inflation is a monetary phenomenon, there is still much dispute about the mechanism of transmission from monetary policy to inflation and about the significance of different measures of the quantity of money.

• These areas of dispute are extremely important in policy-making. If appropriate measures of the money supply are not monitored and controlled, serious episodes of ‘boom and bust’ will arise.

• In the US and to some extent the UK the quantity of broad money has been neglected in setting monetary policy in the last few years. Interest rates have been regarded not just as the main or even the only instrument of monetary policy, but as defining the stance of monetary policy.

• Fluctuations in the growth rate of broad money played a causal role in:
  – the UK’s boom–bust cycles of the 1970s and 1980s (i.e. the Heath–Barber boom and subsequent bust of the early 1970s, and the Lawson boom and ensuing recession between 1985 and 1992);
  – the US’s Great Depression in the early 1930s; and
  – the Japanese bubble in the 1980s and the macroeconomic malaise of the 1990s.
• In the upswing phase of the Heath–Barber boom and the Lawson boom, the broad money holdings of non-bank financial institutions rose explosively. This led directly to an asset price boom as institutions tried to adjust their money balances to the desired proportion of their total portfolios.

• The US’s Great Depression was accompanied by a collapse in broad money and the Japanese asset price malaise of the 1990s by stagnation in broad money.

• Because of the link between assets and goods markets, asset price booms play a major part in the development of general inflation that inevitably follows a period of lax broad money growth.

• Causality runs from money to asset prices and inflation, not the other way round. In an analysis of the mechanisms at work it becomes clear that broad money, but not narrow money, can cause financial institutions and companies to change their behaviour. In fact, the narrow money holdings of companies and financial institutions are insignificant.

• Theories that relate asset price booms to the volume of credit, or to bank lending, rather than to the quantity of money are misconceived.

• The key variable for understanding and controlling periods of boom and bust is the growth of broad money. The behaviour of the quantity of broad money will remain fundamental to understanding the behaviour of asset prices and the general price level in market economies in the future.