GETTING THE MEASURE of the MONEY SUPPLY

Fixating on the monetary base: Does it stack up? **TIM CONGDON**

The sharp downturn in economic activity in the USA in late 2008 caused the Federal Reserve to react with expansionary monetary measures, including a drastic cut in the Fed funds rate to more or less zero and large-scale purchases of commercial paper (and later of mortgage-backed paper and government bonds).

By spring of 2009 it was clear that the Fed's actions would lead to an unprecedented expansion of its own balance sheet, including its cash liabilities to the banking system. Such liabilities constitute much of 'the monetary base', as understood in monetary economics textbooks.

Some economists believe that changes in the monetary base represent the best measure of monetary policy. These economists tend to call themselves 'monetarists', not least because Milton Friedman of Chicago University believed in the macroeconomic potency of large movements in the monetary base.

The sharp increase in the monetary base in early 2009 prompted several prominent American economists of monetarist (or 'American monetarist') leanings to warn of rising inflation. (For the distinction between 'American monetarism' and 'British monetarism', see essay 13 in my 2011 book *Money in a Free Society*.)

These economists included Alan Greenspan, the much esteemed former chairman of the Federal Reserve, Martin Feldstein, chairman of the Council of Economic Advisers in the early 1980s under President Reagan and Allan Meltzer, the historian of the Federal Reserve. They were worried that the monetary base had soared from just above $800bn in July 2008, before the intensification of the crisis and the radical Fed easing, to over $1,800bn in April 2009.

It is now roughly four years since the American monetary-base monetarists delivered their warnings about rising inflation. Were they right or wrong? The short answer is that they were wrong, but it has to be conceded that for a time their view was plausible.

The Fed's easing was followed in late 2009, and more particularly in 2010, by a powerful change in the USA's macroeconomic environment, with inventory rebuilding replacing the heavy inventory rundowns of 2008 and early 2009. Monetary growth in the developing countries, especially China, also accelerated in 2009, and it was booms in these countries – rather than the leading industrial nations – that took the world out of (the worst phase) of the Great Recession.

As a result, commodity prices rose very quickly in late 2009 and 2010. Declines in the USA's producer price index (PPI) in 2009 were succeeded by big increases in 2010 (see figure). Given the abundance of spare capacity that seemed to be implied by the scale of the output decline in the year to mid-2009, the suddenness and size of these increases were surprising.

Concern about US inflation misguided

However, Greenspan, Feldstein, Meltzer and others were wrong. It is now four years since their warnings but, in recent quarters, the PPI has gone sideways or fallen.

In the year to April 2013 the PPI was in fact down very slightly and current commodity price weakness makes possible a more definite fall at some point in the next few months. The April value of the PPI of 203.6 (1982 = 100) is in fact lower than in July 2008 (205.5).

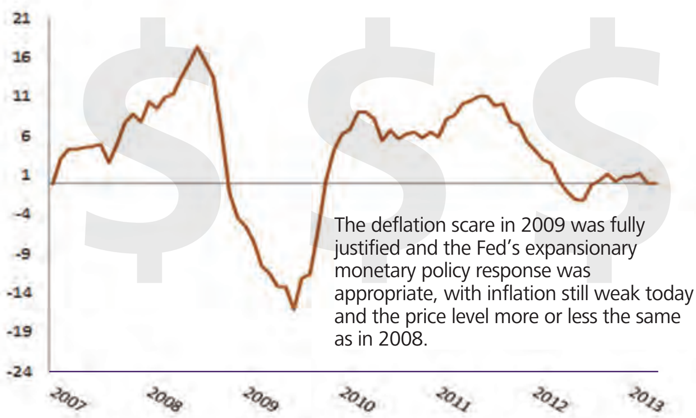
In other words, on this measure the price level has not changed at all in the five years of the Great Recession and its sequel, and the apparent inflation surge in 2010 and 2011 merely recovered the big drop in late 2008 and early 2009.

Nor is the absence of serious inflation to be found only in the PPI numbers. In April the USA's consumer price index fell by 0.4 per cent, so that in the last year it has risen by only 1.1 per cent.

As noted above, in the nine months to spring 2009, the USA's monetary base more than doubled, and it was this development which triggered the Greenspan-Feldstein-Meltzer inflation alarmism. Since spring 2009 the monetary base has expanded much more. In fact, the latest figure

Inflation/deflation in the USA during the Great Recession

Chart shows % annual change in producer price index



for the monetary base is now over $3,100bn. It has nearly quadrupled since mid-2008.

In short, the USA's monetary base has gone up about four times in the last five years, while the PPI has not changed and even consumer price inflation is very moderate. Indeed, many economists would regard a 1-per-cent-a-year increase in consumer prices as 'price stability'.

The "monetary base" is not the same as the "quantity of money"

Two unfortunate habits in American monetarism – for which Friedman must carry some of the blame – are to view monetary policy as best defined by the change in the monetary base, and even to regard the monetary base and the quantity of money as synonymous.

The monetary base and the quantity of money are in fact very different both in their composition and in how they bear on macroeconomic outcomes. The base includes banks' cash reserves, which are not part of the quantity of money according to the usual accepted definitional conventions; the quantity of money is dominated by bank deposits, which are not part of the monetary base. Money and the base are not the same thing at all

Furthermore, the experience of the Great Recession ought to have persuaded everyone that the base and the quantity of money are not always and necessarily correlated. (Incidentally, they were not correlated in the Great Depression, a fact recognised by Friedman and Schwartz in their celebrated 1963 *A Monetary History of the USA* and which ought to have restrained their enthusiasm for the base.)

The best aggregate for understanding the Great Recession has in fact been broadly-defined M3 (which is predominantly bank deposits), but the Federal Reserve actually stopped publishing this measure of money in early 2006!

THE BEST AGGREGATE FOR UNDERSTANDING THE GREAT RECESSION HAS IN FACT BEEN BROADLY-DEFINED M3 BUT THE FEDERAL RESERVE STOPPED PUBLISHING THIS MEASURE OF MONEY IN EARLY 2006!

The absence of broad money data may explain the tendency of American monetary economists to refer to the base when they feel obliged to mention a monetary aggregate at all.

The track record of M1 and M2 in the Great Recession has actually been almost as dreadful as that of the base. The American monetarists' reliance on the base and the narrow money aggregates has done a lot of harm, because it has caused policy-makers to ignore the vital messages coming out of a broadly-defined money aggregate.

Indeed, given that the Fed stopped publishing M3 in 2006, the notion that the base and the quantity of money are the same thing has prevented valuable statistical information being prepared. Moreover, the disintegration of much of 'the shadow banking system' was undoubtedly an important causal factor in the deterioration in macro conditions in late 2007 and early 2008, which occurred before the downturn in M3.

That disintegration would have been identified if the Fed had continued to prepare a series for "L", i.e., a measure of liquidity, in the sense of an aggregate consisting of both money and the near-money liabilities of shadow banks.

Money matters – but not the monetary base

Above all, the analytical failure of American monetary-base monetarism in the Great Recession does not undermine the validity of 'monetarism' understood more generally.

The last few years have seen, across the advanced world, the lowest rates of increase since the 1930s in both nominal national income and the quantity of money, broadly-defined.

Money has mattered in the latest big cyclical upheaval, as it had mattered in previous such upheavals and will continue to matter in the future.

But a key message must be identified and emphasised. If they want their forecasts to work and also to be taken seriously in the public debate, monetary economists must focus on the quantity of money as such, not on the monetary base by itself.

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