FP Comment

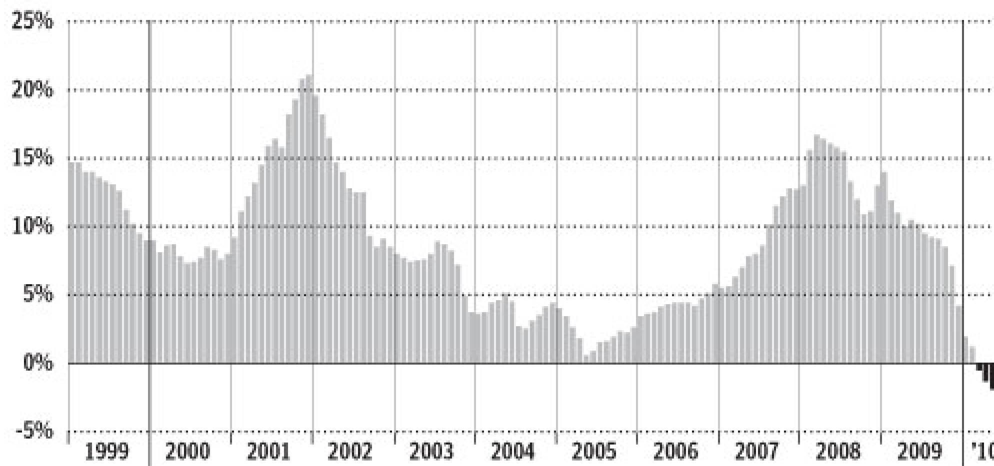
A growth recession

Financial Post Staff July 30, 2010 – 10:30 pm

BROAD MONEY CONTRACTION

U.S. MONEY–ZERO–MATURITY MONEY STOCK

YEAR–OVER–YEAR PERCENT CHANGE, SEASONALLY ADJUSTED



SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS ANDREW BARR / NATIONAL POST

WHERE DID ALL THE CREDIT GO?

U.S. credit indicators 2008-2010

	August 2008	June 2010	% change
U.S. federal reserve high powered money	US$843B	US$1.9T	+125.38%
Banks (M2)	US$7.8T	US$8.6T	+10.26%
Shadow banks	US$16T	US$13T	-18.75%
International positions of banks	US$37.4T	US$32.2T	-13.9%
OTC derivatives	US$684T*	US$615T*	-10.09%

*Nominal

SOURCES: U.S. FEDERAL RESERVE SYSTEM, BANK FOR INTERNATIONAL SETTLEMENTS, AUTHOR'S CALCULATIONS

ANDREW BARR / NATIONAL POST

Research shows that monetary policy dominates fiscal policy

By Steve Hanke

Financial panics are usually followed by sharp economic snap backs. The post-Panic of 2008 has failed to follow this typical "V-shaped" economic-recovery pattern. After almost two years, the U.S. economy remains

mired in an anemic recovery, with a current 2.4% year-over-year rate of growth. This paltry growth rate doesn't even reach the United States' long-term trend rate, and is well below the sizzling growth rate we should be observing (6%-7.5%). The picture is much the same in Europe, where growth is even more anemic.

The fiscalists have reached for their standard elixir: larger government deficits. For them, more fiscal "stimulus" is just what the doctor ordered. Prof. Paul Krugman, for one, has been peddling fiscalism in virtually all of his *New York Times* columns for the past several months. Without yet more stimulus, he believes that a double-dip recession is likely.

While Capitol Hill (and most G20 countries — led by Germany) has pushed back against the U.S. fiscalists, no one knows for certain how the political game will play out in Washington. Before the end game arrives, it's important to determine whether the standard fiscalist (Keynesian) arguments hold water. Nobelist Milton Friedman addressed the issue in a 1999 *Wall Street Journal* column.

Prof. Friedman wrote:

The Keynesian view is that government deficit spending is cyclically stimulative whether it is financed by borrowing or by newly created money. The monetarist view is that spending financed by newly created money is cyclically stimulative whether the spending is by the government or the private sector. Government spending financed by borrowing may or may not be stimulative depending on how much private spending is crowded out by government spending. Either outcome is possible, depending on conditions. It is not easy to distinguish between these views on the basis of empirical evidence, because fiscal stimulus generally is accompanied by monetary stimulus. The relevant evidence is provided by those rare occasions when fiscal and monetary policy go in different directions.

To test whether the Keynesian or monetarist view was supported by the empirical evidence, Prof. Friedman recounted two episodes in which fiscal and monetary policies moved in different directions. The first was the Japanese experience during the early 1990s. In an attempt to restart the Japanese economy, repeated fiscal stimuli were applied. But monetary policy remained "tight," and the economy remained in the doldrums. Prof. Friedman's second example was the U.S. experience during the 1992-97 period. Those years were marked by "tight" fiscal and "loose" monetary policies, and the economy was in an expansionary phase.

Prof. Friedman concluded with the following remark: "Some years back, I tried to collect all the episodes I could find in which monetary policy and fiscal policy went in opposite direction. As in these two episodes, monetary policy uniformly dominated fiscal policies."

Prof. Tim Congdon, chief executive at International Monetary Research Ltd., has recently tested the efficacy of Keynesianism in the United States by comparing changes in the output gaps and general government structural balances. While using different metrics, his findings are consistent with Prof. Friedman's. In the 28-year period Prof. Congdon reviewed, the U.S. economy did not behave in the way that Prof. Krugman and other Keynesians have asserted and proselytized. Indeed, the number of years in which the economy

responded to fiscal policy in an anti-Keynesian fashion was double those in which the economy followed the Keynesian dogma.

If monetary, not fiscal, policy dominates, just what is monetary policy telling us? First, the dramatic collapse in broad measures of money in the United States (see the chart above) explains why the US$862-billion stimulus of February 2009 hasn't worked as advertised. Broad money includes: funds that are readily accessible for spending (currency in circulation), savings and demand deposits, balances in money market mutual funds and institutional money funds. In short, these assets are what people think of as "money," plus all those assets that are very liquid and could easily be converted into "money."

The contraction in the growth rate in broad measures of money also indicate that a growth recession — below trend growth rates — in both the United States and Europe will continue. But why is broad money growth contracting? After all, the Federal Reserve and the European Central Bank have dramatically increased the size of their balance sheets since September 2008. To understand why, we have to acknowledge that broad money includes credit, and credit has been contracting.

Banks and other financial institutions — spooked by new legislation and the prospect of new punitive regulations — aren't anxious to make loans. They want to deleverage and hold more precautionary balances. That's the supply side of the picture.

As for the demand side, potential borrowers are deleveraging, too. They are attempting to bring their debt levels down relative to their income flows. In consequence, both the demand for and supply of credit has shrunk. This can be seen by examining the table of credit indicators for the United States, also seen above.

The indicators depict a modern fractional reserve banking system — one in which a small quantity of reserves (capital) is multiplied into a much larger volume of loans and deposits. The Fed provides reserves to banks and the non-bank public. This so-called high-powered money is multiplied into deposit liabilities held by traditional banks in the United States. The deposits of firms and individuals at these banks represent money, as measured by M2.

Shadow banks represent the next layer. These include investment banks, mortgage finance companies, private equity pools, structured investment vehicles, etc. Banks and other financial institutions outside the U.S. accept U.S. dollar deposits, issue dollar-denominated debt and make dollar-denominated loans and investments. This segment does not hold reserves at the Fed and is more leveraged than its onshore counterparts. The final indicator represents over-the-counter derivatives. Each measure represents more leverage (less capital to assets) and more credit.

By comparing the credit indicators from August, 2008 — just before the panic — with June, 2010, we get a clear picture of money and credit dynamics. While the Fed has pumped up high-powered money by 125% boosting the M2 measure of money by 10.3%, all other layers of the credit triangle have shrunk since August, 2008.

Until broad measures of money show some signs of life, the U.S. and Europe can expect a growth recession — at best.

Financial Post

Steve H. Hanke is a Professor of Applied Economics at The Johns Hopkins University in Baltimore and a senior fellow at the Cato Institute in Washington, D.C.