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Point Of View

Credit Feast And Famine

Steve Hanke, 03.12.10, 10:00 AM EST
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Why isn't the economy booming? The Fed's high-powered money isn't going into bank deposits and loans to businesses and individuals.

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More From Steve H. Hanke

The fourth quarter's growth rate in GDP came in at an annualized 5.9%. That's anemic. At this stage of the recovery we should have seen a number closer to 7.5%. Why the weakness? Following the bursting of the dot.com bubble and the deflation scare of late 2002, the Fed fueled what would become the mother of all credit booms.

In the 2000--08 period bank credit outstanding doubled from $4.7 trillion to $9.4 trillion, but that was hardly the sum total of the intoxicant that soused the world financial system. To avoid minimum capital requirements mandated by the Basel Accord, banks created off-balance-sheet vehicles and coupled them with new methods of securitization to juice total so-called nonbank credit (that includes lending by insurance, mortgage and finance companies but excludes asset-backed securities, commercial paper and repurchase agreements) from $6.3 trillion to $14.9 trillion.

Combine a credit boom with artificially low interest rates from the Fed and you get the misdirection of capital toward longer-term, capital-intensive projects and away from those that were less capital-intensive and had shorter lives. Dramatic changes in relative prices accompanied the boom. While the Fed's favorite inflation target--consumer prices, less those for food and energy--gave the impression that the credit boom was spread evenly over the economy, this was not the case. This flavor of CPI increased at a modest 2.4% annual rate during the 2000--08 period. But housing and commodity prices surged upward. From the first quarter of 2000 until it peaked in the first quarter of 2006 the Case-Shiller Home Price Index rose at an 11% annual rate. The CRB Spot Index climbed at a 10.3% annual rate until it peaked in 2008.

Postcrisis the Fed went on a different kind of credit-creating binge, ballooning its balance sheet from $909 billion in August

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2008 to $2.3 trillion now. This is high-powered money, made amply available by the Fed at virtually no cost to the borrowers. Alas, these funds are not flowing to consumers and businesses but rather to the banks, which are reluctant to lend to households. The households have lately shown more of a penchant for saving than borrowing anyway. In the private sector, borrowers who leveraged up during the credit boom are attempting to repair their balance sheets. The resulting net repayment of loans and weak demand for credit show up on the asset side of financial institutions' balance sheets.

In essence, this is a credit contraction, and it has engendered extremely slow growth in broad measures of the money supply. In consequence, the money multiplier, or the ratio of broad money (M2) to high-powered money (M0), has fallen like a stone. (M2 includes currency plus demand and time deposits; M0 is just currency plus reserves on deposit at the Fed.) In July 2008, before the collapse of **Lehman Brothers** (LEHMQ - news - people), the multiplier was just above nine; it's now four. Sparked by deleveraging, the sharp drop in the money multiplier signifies why the economy is not booming: The economic mechanism that transforms the Fed's high-powered money into deposits and bank loans is stalled.

By contrast, when the panic of 2008 hit, leverage in most Asian countries was modest. China, India and Indonesia have hardly missed a beat. Investors can play the comparative strength of the Indian and Indonesian economies against developed Europe with some currency bets. Purchase the rupee and rupiah and sell the euro. You can do this with most brokers, who will execute the transactions on the interbank foreign exchange market.

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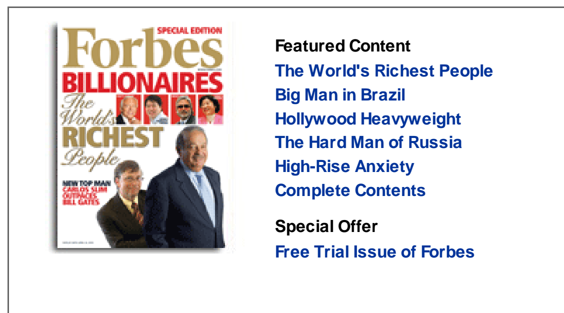

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Last year I made seven recommendations: three exchange-traded funds that hold commodity positions, and the stocks of four companies paying good dividends: **Leggett & Platt** (LEG - news - people), Philip Morris International, **Verizon** (VZ - news - people) and **Kellogg** (K - news - people). Had you acted on all seven tips, you would have made 3.2% after allowance for a 1% transaction cost. Had you put the same money on the same dates into the S&P 500 (with no transaction debit), you would be up 5.8%. I'm carrying all seven positions forward as 2010 recommendations.

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. Visit his homepage at www.forbes.com/hanke.

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