



Economic Insights

Ask the Economist

with Milton Ezrati

The Fed and Money Supply — July 16, 2004

by Milton Ezrati

Now that the Federal Reserve Board (the Fed) has turned the corner on interest rate policy, a number of clients are asking about money growth, the velocity of money and the money multiplier, effectively the full range of measures by which economists gauge monetary ease or restraint and its likely impact on the economy. Here are just two examples of these questions:

“Where does the money creation show up in the aggregate numbers?”

“What does the trend in the velocity of money tell you with respect to inflation?”

This discussion looks at recent monetary trends and, though there is always ambiguity, concludes: (1) The Fed already has slowed flows of money and liquidity consistent with its goal to shift monetary policy from stimulus to neutrality but not restraint. (2) Past injections of money and liquidity have yet to be fully reflected in the economy, suggesting that, despite the Fed's ongoing efforts to alter its policy stance, real growth momentum will persist for some time yet. (3) Though past money growth has injected an inflationary risk into the outlook, nothing suggests that the Fed either is behind the curve, as some have suggested, or will fail to forestall future inflation problems.

The Data

The three tables at the end of this discussion lay out the relevant data. Table I shows recent growth of the two monetary measures over which the Fed has the most direct control: total bank reserves and the monetary base. Table II shows the growth of the three main measures of money supply: M1, the most narrowly defined gauge; M2, a broader measure of money; and M3, a still broader measure approaching what many on Wall Street mean when they use the word liquidity. All these statistics are defined specifically on the table. Table III tracks longer-term trends in the money multiplier and money velocity. The former is the ratio of the M2 measure of money and the monetary base and effectively measures how much leverage the monetary base has in actual money creation. Money velocity, the ratio of nominal GDP to the M2 measure of money, tracks the turnover of money in the economy and, by implication, money's impact on gross domestic product (GDP).

From the first two of these tables, it should be apparent that flows of reserves, the monetary base and money slowed late last year and then picked up again this spring. With reserves, the monetary base, and the narrower M1 money measure, the more recent acceleration falls far short of last year's growth. Although this general slowdown in money growth occurred prior to the Fed's latest rate increase, the pattern is entirely consistent with the Fed's desire to move its monetary stance from stimulus toward neutrality. The broader M2 and M3 measures of money show much stronger growth recently. Though the behavior of these broader measures seems to contradict the Fed's stated policy goals, two considerations ought to relieve any anxiety on this front. First, it takes time before Fed actions on reserves and the monetary base can affect the broader monetary aggregates. Second, these broader money measures are as likely to reflect the economy's demands for money as much as they reflect the Fed's decisions on supply, especially over shorter time horizons. With the economy growing well during this past spring quarter and inflation ticking up, it is reasonable that money demand would continue to show growth in these broad measures, despite the general slowdown in the monetary base and other aggregates over which the Fed has more direct control.

The Tale of Velocity and the Multiplier

Although the money multiplier and velocity are crude guides to the effect of money growth on the economy, they have something to offer. The money multiplier, for instance, is roughly in line with where it has hovered since the mid 1990s, suggesting that the broader aggregates, in this case M2, are roughly in line with the behavior of the monetary base. There is no implied need for M2 or presumably M3 to catch up with the base. Neither is there an implication that the broader aggregates are in any way stretched relative to the base. From this perspective then, the Fed has every reason to expect the broader aggregates and, in this context, the economy as well, to follow its control of the monetary base. It has no reason, therefore, to deviate from the gradualist plan that it has made public or, to use the Fed's word, "measured" approach to monetary restraint and rate hikes.

More distant comparisons on the money multiplier might, however, cause a concern. Back in the 1970s and 1980s this ratio reached much higher levels than it shows today. Should these older relationships return, there would seem to be a chance that M2 and the other broad monetary aggregates would run up and away from the monetary base, forcing the Fed to exercise more restraint than is presently anticipated. While such behavior is possible, it is not very likely. In the 1970s and 1980s, when these high money multipliers appeared, both inflation rates and interest rates were high. Because the kind of deposits counted in the narrow aggregates paid no interest and those counted in the broader aggregates did, there was a powerful incentive to move away from the narrow money measures toward the broader aggregates. Though short-term interest rates are on the rise and inflation has picked up, at least for the moment, both are very far from the levels seen in the 1970s and 1980s when the money multiplier was high.

The velocity of money is higher today than in the more distant, high-inflation period of the 1970s and 1980s but lower than in the late 1990s, 2000 and 2001. At first blush, the comparison to the earlier period might seem strange. High inflation would seem to prompt a rapid turnover in money. But two additional considerations explain this seeming contradiction. First, short rates in the late 1970s and 1980s were high relative even to the high inflation of the time, removing much of the incentive to keep money balances low, at least those in M2. Second, the ongoing growth of credit cards and other money management devices has made the economy ever more efficient in its use of the money balances of all types, regardless of the immediate inflation or interest rate influences.

The second comparison between the lower velocity levels today than in the late 1990s suggests that the economy has room to outgrow M2 and presumably the other monetary measures for a while to come. Typically, velocity rises in good economic times because investors and business people see opportunities beyond cash holdings. In tough times, when people retreat into cash, money levels rise relatively and velocity falls. As this economy's momentum continues, levels of consumer and business confidence will improve and people increasingly will tend to seek opportunities beyond cash holdings, raising velocity and allowing a given level of M2 or any other monetary aggregate to support a higher level of GDP. Although the economy and M2 tend to move together, the ability for the velocity to rise will enable the economy to outgrow M2 for a while. Thus, even as M2 growth slows, as is likely, into line with M1 and the monetary base at 4-6 percent annual rates, there is room for the nominal GDP to continue expanding at 7-8 percent for a good while. Even with annual inflation rates of 2 ½ -3 ½ percent, that implies ample real growth in excess of 4 percent and certainly in excess of 3 percent, enough to secure healthy profits growth for the foreseeable future.

TABLE I

**GROWTH IN BANK RESERVES AND
THE MONETARY BASE**
(Seasonally adjusted percent change over indicated time period)

	<u>Total Reserves</u> ⁽¹⁾	<u>Monetary Base</u> ⁽²⁾
2003 May:	0.46%	0.50%
June:	3.59	0.38
July:	2.27	0.37
Aug:	5.23	0.69
September:	-2.84	0.27
October:	-2.02	0.53
November:	-0.83	0.43
December:	-0.48	0.28
2004 Jan.	0.76	0.22
Feb:	-0.55	0.21
March:	3.95	0.22
April:	2.19	0.42
May:	-0.52	0.49
4 Weeks ended:		
May 12:	0.92%	0.30%
May 26:	-3.16	0.46
June 9:	3.17	0.88
June 23:	1.68	0.47

Source: Federal Reserve Board

The historical chart above is for illustrative purposes only.

(1) Total reserves held by banks nationally

(2) Total reserves plus currency in circulation

TABLE II**GROWTH IN MONETARY AGGREGATES**

	<u>M1</u> ⁽¹⁾	<u>M2</u> ⁽²⁾	<u>M3</u> ⁽³⁾
Monthly Percent Change, Seasonally Adjusted:			
2003			
May:	0.92%	0.86%	0.10%
June:	1.04	0.68	0.74
July:	0.19	0.66	0.61
Aug:	0.63	0.67	0.57
Sept.:	-0.01	-0.37	-0.36
Oct:	0.14	-0.26	-0.24
Nov:	0	-0.04	0.58
Dec:	0.76	-0.06	0.34
2004			
Jan:	-0.49	0.12	-0.03
Feb:	1.51	0.83	0.63
March:	1.47	0.77	1.10
April:	-0.26	0.75	0.75
May:	-0.19	1.09	0.71

Annualized seasonally adjusted percent change for the last:

3 Months:	4.1%	10.5%	11.4%
6 Months:	5.6	7.1	8.2
12 Months:	4.9	4.9	5.5

Source: Federal Reserve Board

The historical chart above is for illustrative purposes only.

(1) Money held in checking accounts plus currency in circulation

(2) M1 plus savings accounts and small CDs

(3) M2 plus large CDs

TABLE III**TRENDS IN THE MONEY MULTIPLIER
AND MONEY VELOCITY**

	<u>Multiplier</u> ⁽¹⁾	<u>Velocity</u> ⁽²⁾
1975:	10.61	1.70
1980:	11.26	1.81
1985:	12.37	1.74
1990:	11.49	1.80
1995:	8.31	2.07
1996:	8.47	2.09
1997:	8.45	2.12
1998:	8.49	2.08
1999:	8.33	2.05
2000:	8.31	2.04
2001:	8.56	1.93
2002 Q1:	8.52	1.88
Q2:	8.44	1.88
Q3:	8.42	1.87
Q4:	8.49	1.84
2003 Q1:	8.49	1.83
Q2:	8.54	1.81
Q3:	8.57	1.83
Q4:	8.44	1.86
2004 Q1:	8.44	1.88

Source: Federal Reserve Board

The historical chart above is for illustrative purposes only.

(1) Ratio: M2/Monetary Base

(2) Ratio: Nominal GDP/M2

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