Biggest danger is bank bashing

Solid money growth shows US can withstand Fed tightening

Steve Hanke, Advisory Board

For over a year, newspapers were filled with speculation about when and by how much the Federal Reserve would raise the federal funds interest rate. Well, the Fed finally raised the rate in December. Now, everyone is wringing their hands over what the tightening cycle will look like.

This obsession with the course of the fed funds rate is curious to say the least. Indeed, since the early 1980s, there have been five episodes in which the Fed raised rates. And, in each of these cases, economic growth remained steady or accelerated.

So, why all the hand-wringing? This is probably a Keynesian hangover. Yes, the Keynesians focus on interest rates. The mainstream macro model that is widely used today is referred to as a 'New Keynesian' model. The thrust of monetary policy in this model is entirely captured by changes in current and expected interest rates. Money is nowhere to be found.

This is amazing, particularly since Keynes dedicates quite a few pages in *A Tract on Monetary Reform* (1923) to money and its role in national income determination. Then, in his two-volume 1930 work, *A Treatise on Money* – a work of which the dean of monetarism, Milton Friedman, wrote approvingly – Keynes devotes a great deal of space to banks and their important role in creating money.

In particular, Keynes separates money into two classes: state money and bank money. State money is the high-powered money that is produced by central banks. Bank money is produced by commercial banks through deposit creation.

Keynes spends many pages in *The Treatise* dealing with bank money. This isn't surprising because, as Keynes makes clear, bank money was much larger than state money in 1930. Well, not much has changed since then. Today, for example, bank money accounts for almost 82% of total M4 money supply in the UK.

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We should keep our eyes on money broadly measured (state, plus bank money), and money properly measured (Divisia, not simple sum measures). A monetary approach to national income determination is what counts over the medium term. The link between growth in money supply and nominal GDP is unambiguous and overwhelming. There are centuries of clear evidence for this – even though plenty of deniers of basic principles remain in evidence.

Let's look at the world's largest economy, the US. Chart 1 shows the growth rate for nominal final sales to domestic purchasers, which is a good proxy for nominal aggregate demand, and the growth rate for broad money (M4 as reported by the Center for Financial Stability in New York).

Since the 2008 financial crisis, the money-nominal aggregate demand linkage has been rather tight. We can also observe that the US remains in a growth recession. The economy is growing, but at less than its post-1987 average rate.

After three rounds of quantitative easing, how could this anaemic growth picture prevail? Well, when it comes to broad money, bank money is what counts. And the policies that have affected the growth in US bank money (read: Basel III and the Dodd-Frank legislation) have been massively contractionary and procyclical.

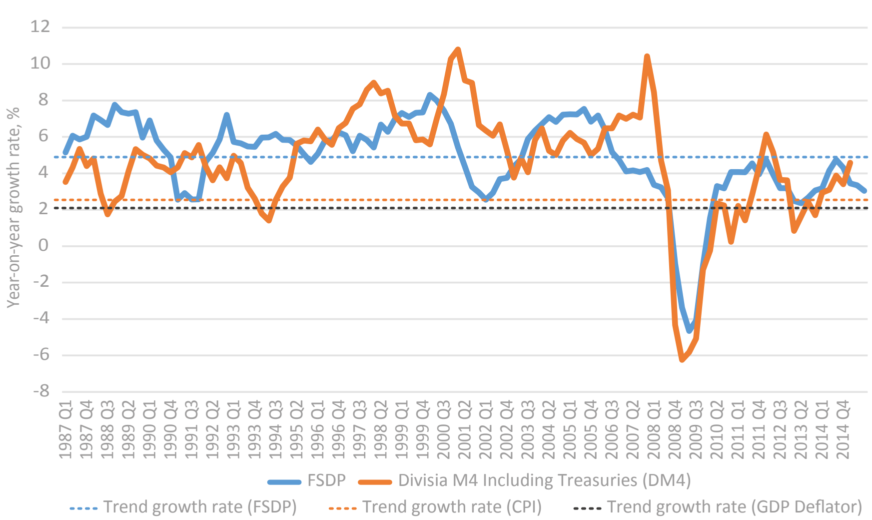
To mitigate this tightness, the Fed has engaged in quantitative easing. But the squeeze on bank money has thrown cold water on much of the QE. In consequence, broad money has grown slowly since 2008, and so has nominal aggregate demand.

However, since early 2013 the growth rate of broad money has accelerated. It is now growing at a 4.6% annual rate – the highest reading since May 2013. If this continues, nominal aggregate demand should reach its annual trend rate of 4.8% in the near future.

So the US economy looks in a healthy enough state to withstand a modest further increase in interest rates. The biggest risk to the US economy is not Fed interest rate tightening, but another round of bank bashing through misplaced regulations. ■

Chart 1: Growth rate for nominal final sales to domestic purchasers

US final sales to domestic purchasers and Divisia M4



Source: Federal Reserve Economic Database

Notes: FSDP = GDP + Import - Export - ΔInventory; FSDP data measured quarterly; Divisia M4 data lagged 3 quarters.

Steve Hanke is a Professor of Applied Economics and Co-director of the Institute for Applied Economics, Global Health, and the Study of Business Enterprise at The Johns Hopkins University in Baltimore. He is also a member of the OMFIF Advisory Board.