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E-BRIEF

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MONETARY POLICY

Money Still Talks – Is Anyone Listening?

by
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- Skeptics of Quantitative Easing (QE) will be inclined to attribute the recent surge of US money growth and signs of recovery in its wake to coincidence.
- Advocates, however, will suggest that QE's first round in 2009 prevented a collapse of the money supply like the one that turned the initial downturn of 1929/30 into the Great Depression, and that its second round is now promoting recovery.
- Closer to home, they will also hope that the Bank of Canada will notice that money still talks as clearly as ever, and will pay attention when it sets interest rates.

Twenty years ago, a C.D. Howe Institute publication (Laidler and Robson 1991) warned readers that "Money Talks" and urged them to listen. This advice is not widely followed nowadays, despite occasional reminders from this Institute.[1] Discussions of monetary policy tend to follow the rhythm of the Bank of Canada's interest rate decisions, and money growth can neither reveal much information nor be fine-tuned over six-week intervals. However, over longer horizons it can. Canada's current recovery is fragile, but a recent step-up in broad money growth is supporting it. The Bank should take note and keep money growing at around 5 to 6 percent for a while. Such a policy, which, be it explicitly noted, does not necessarily require interest rates to be held constant, carries little risk of higher inflation.

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1 See Bergevin and Laidler (2010) and Siklos (2010).

Recent Evidence from Canada and Elsewhere

Broad money growth increased here last autumn, after beginning to rise in the US earlier in the year. Meanwhile, it has remained flat or even negative in Europe and the UK (see Figure 1).[2] These divergences have foreshadowed the Canadian economy's recent hesitant turnaround, the US's incipient recovery, and abysmal performances in the euro zone and the UK. Both the European Central Bank – which until recently did not try quantitative easing (QE)– and the Bank of England – which started well but with inadequate follow-through – should have followed the Fed's vigorous and longer sustained example.

How Money Growth Works

Money growth still influences demand in the same old ways. Always and everywhere, the public maintains stocks of money, mainly in the form of bank deposits, or in assets readily convertible into them, to serve as buffers between their payments and receipts, to ensure that unexpected shocks to either side do not force sudden and costly revisions on plans for the other. In tranquil times, such stocks tend to be small, but in turbulent times when prospects look bleak, their desired size grows significantly. Financial institutions – henceforth "banks" for the sake of brevity – which provide these stocks, in turn hold stocks of the assets – often called high-powered money – that are used to settle imbalances among themselves. These typically consist of deposits with the central bank, and currency – mainly used to stock bank tills and automated tellers. As with the public's demand for money, banks' appetite for high-powered money varies dramatically between tranquil and turbulent times.

The transmission of monetary policy's effects always involves the terms on which banks can obtain or maintain immediate access to high-powered money in general, and its deposit component in particular, and/or the amount of it actually available to the banking system as a whole.

During the recent and tranquil era of "great moderation" that characterized Western economies, many central banks, including the Bank of Canada, conducted policy simply by controlling the overnight interest rate at which banks borrow and lend high-powered money among themselves. Reducing this rate tended to increase inflation because it increased banks' willingness to lend to the public, which they then signaled by cutting their own lending rates. As the public responded by borrowing more from the banks, the volume of the banks' monetary liabilities, notably of the deposits serving the general public, also expanded more rapidly.

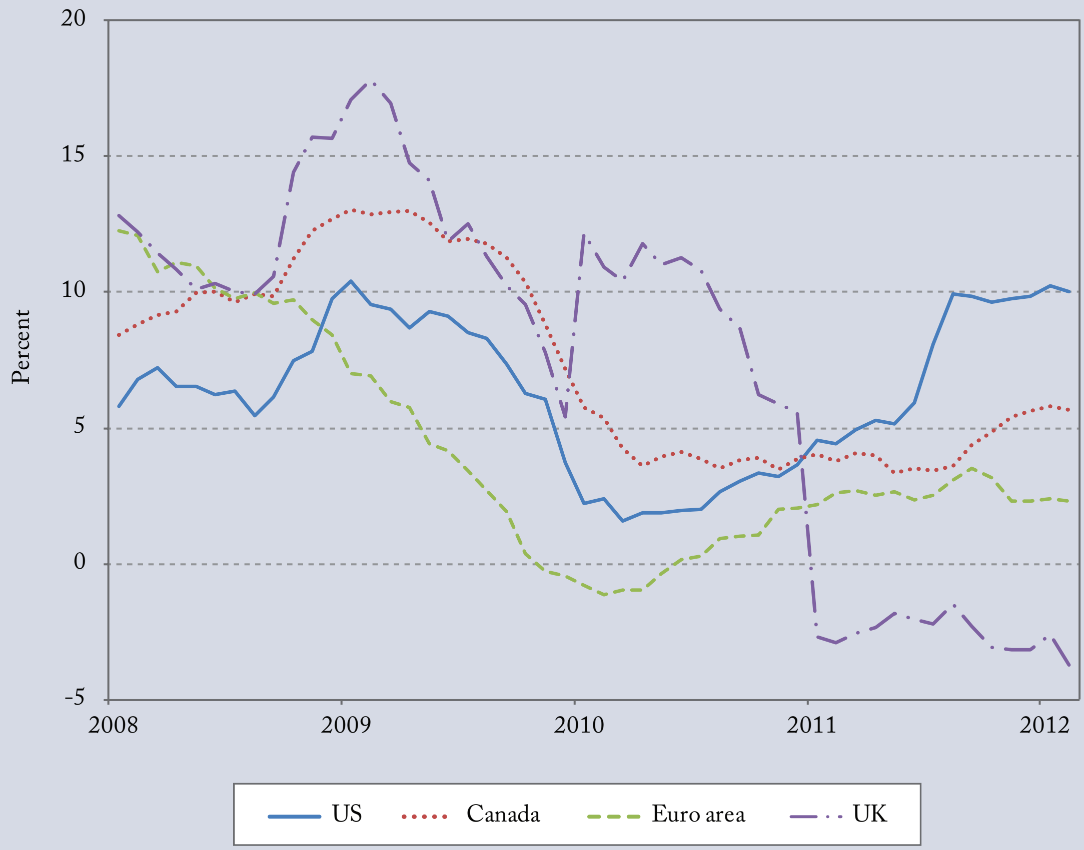
In turn, (and other things equal, as they tended to remain during the moderation) rising lending would encourage spending and so, crucially, would the rising volume of money that it engendered, as the intensity with which it burned holes in metaphorical pockets increased. The pace of the economy would then speed up, and upward pressure would be exerted on inflation.

This story is adequate for tranquil times, but a financial crisis creates mistrust among banks, a decrease in their willingness to lend to one another, and a concomitant increase in their own demands for buffer stocks of high-powered money or assured ready access to them.[3]

2 A fuller analysis would also pay attention to the behavior of narrower aggregates, which contain information of their own. For discussions in the Canadian context, see once more Bergevin and Laidler (2010) and Siklos (2010).

3 These phenomena, and the obstacles they create for monetary policy in times of crisis, have been much studied over the years, indeed centuries. Gale and Yorulmazer (2011) provide a recent formal treatment, while Mehrling (2011) though less formal in style, is no less penetrating, explicitly linking the complex ways in which they arise in today's financial system to their treatment in earlier literature.

Figure 1: Growth Rates of Broad Money in Canada, the US, Europe and the UK (year-over-year growth of non-seasonally adjusted data at monthly intervals)



Sources: Statistics Canada, the US Federal Reserve, the European Central Bank and the Bank of England. Broad Money refers to M2 for the US, M2+ for Canada, M4 for the Bank of England and M3 for the Eurozone.

A scramble for central bank liabilities thus marks the beginning of any crisis, and banks' loans to one another and to the public shrink, as does money growth. Individual members of the public also attempt to maintain their cash holdings by selling assets and cutting spending, but this can only work for a fortunate and quick-off-the-mark few, not the whole economy. So, left untreated, a financial crisis quickly becomes one of output and employment, and what begin as liquidity problems – cash shortages – for businesses and banks turn into insolvency problems.

How QE Fits In

When the whole economy wants more cash, only the central bank can bring relief. And its typical first response is to cut the overnight rate as far as it will go – which in Canada recently turned out to be 0.25 per cent in practice – and then to lend all that the banks wish to borrow. This response, however, leaves the overall volume of borrowing to be determined as the sum of what each bank requires for its own purposes, and this amount may not be enough in the aggregate to halt a contraction in money growth, let alone reverse it to whatever extent might be needed to restore the economy to an even keel.

The conventional response nevertheless proved adequate in Canada in 2008/09 – with some help from new and temporary lending facilities – but not everywhere. Where it wasn't, central banks had the further option of entering financial markets as buyers of securities – this is all QE is – to force into the banking system a volume of high-powered money sufficient to over-satisfy banks' tendency to hoard liquidity. This would be expected to induce an expansion of the system's lending, and hence to put however much upward pressure on the rate of money growth that turned out to be sufficient to overcome the public's own hoarding tendencies and stimulate a recovery of spending.[4]

In the recent crisis, QE's introduction was controversial, even in the US, because it was not clear how or whether it would work. Competing economic theories offered contradictory predictions, and available empirical evidence was ambiguous: QE had been tried in the US for a few months in 1932 to little lasting effect, and again in Japan at the turn of the millennium. Some argued that these were both cases of sound policy being given up too soon, but not everyone agreed.

Conclusions

Right now, QE skeptics will still be inclined to attribute the recent surge of US money growth and signs of recovery in its wake to coincidence, pending further research. Its advocates, however, will suggest that QE's first round in 2009 prevented a collapse of the money supply like the one that turned the initial downturn of 1929/30 into the Great Depression, and that its second round is now promoting recovery.[5]

Advocates will also be encouraged that the ECB is finally undertaking a form of QE, through long-term lending to the banking system, and hope that it follows through to whatever extent is needed to induce a significant upsurge in money growth. Closer to home, they will also hope that the Bank of Canada will notice that money still talks as clearly as ever, and will ensure that the recent step-up in its growth rate to the 5 percent range – hardly a harbinger of rising inflation – is sustained for a while.

4 The classic interpretation of Fed policy in 1932 as a successful experiment abandoned too soon is still Milton Friedman and Anna Schwartz (1963, pp. 322 et. seq.), while Laidler (2004) expressed optimism about the Japanese experiment at a time when it was still not clear that it had been given up. Paul Krugman (e.g., 2010) has been a systematic dissenter from such views during the recent crisis.

5 The British economist Timothy Congdon deserves special mention here, not least for being very quick off the mark (September 2011) in drawing attention to the recent recovery of US money growth and its likely consequences for 2012.

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