

US MONEY SUPPLY PLUNGES AT 1930s PACE AS OBAMA EYES FRESH STIMULUS¹

Ambrose Evans-Pritchard©

The M3 money supply in the United States is contracting at an accelerating rate that now matches the average decline seen from 1929 to 1933, despite near zero interest rates and the biggest fiscal blitz in history. The M3 figures - which include broad range of bank accounts and are tracked by British and European monetarists for warning signals about the direction of the US economy a year or so in advance - began shrinking last summer. The pace has since quickened. The stock of money fell from \$14.2 trillion to \$13.9 trillion in the three months to April, amounting to an annual rate of contraction of 9.6pc. The assets of insitutional money market funds fell at a 37pc rate, the sharpest drop ever.

"It's frightening," said Professor Tim Congdon from International Monetary Research. "The plunge in M3 has no precedent since the Great Depression. The dominant reason for this is that regulators across the world are pressing banks to raise capital asset ratios and to shrink their risk assets. This is why the US is not recovering properly," he said.

The US authorities have an entirely different explanation for the failure of stimulus measures to gain full traction. They are opting instead for yet further doses of Keynesian spending, despite warnings from the IMF that the gross public debt of the US will reach 97pc of GDP next year and 110pc by 2015. Larry Summers, Obama's top economic adviser, has asked Congress to "grit its teeth" and approve a fresh fiscal boost of \$200bn to keep growth on track. "We are nearly 8m jobs short of normal employment. For millions of Americans the economic emergency grinds on," he said.

David Rosenberg, from Gluskin Sheff, said the White House appears to have reversed course just weeks after Mr. Obama vowed to rein in a budget deficit of \$1.5 trillion (9.4pc of GDP) this year and set up a commission to target cuts. "You truly cannot make this stuff up. The US government is freaked out about the prospect of a double-dip," he said. The White House request is a tacit admission that the economy is already losing thrust and may stall later this year as stimulus from the original \$800bn package starts to fade. Recent data have been mixed. Durable goods orders jumped 2.9pc in April but house prices have been falling for several months and mortgage applications have dropped to a 13-year low. The ECRI leading index of US economic activity has been sliding continuously since its peak in October, suffering the steepest one-week drop ever recorded in mid-May.

Mr. Summers acknowledged in a speech this week that the eurozone crisis had shone a spotlight on the dangers of spiraling public debt. He said deficit spending delays the day of reckoning and leaves the US at the mercy of foreign creditors. Ultimately, "failure begets failure" in fiscal policy as the logic of compound interest does its worst. However, Mr. Summers said it would be "pennywise and pound foolish" to skimp just as the kindling wood of recovery starts to catch fire. He said fiscal policy comes into its own at a time when the economy "faces a liquidity trap" and the Fed is constrained by zero interest rates.

¹ www.telegraph.co.uk, May 26, 2010

Mr. Congdon said the Obama policy risks repeating the strategic errors of Japan, which pushed debt to dangerously high levels with one fiscal boost after another during its Lost Decade, instead of resorting to full-blown "Friedmanite" monetary stimulus. *"Fiscal policy does not work. The US has just tried the biggest fiscal experiment in history and it has failed. What matters is the quantity of money and in extremis that can be increased easily by quantitative easing. If the Fed doesn't act, a double-dip recession is a virtual certainty,"* he said.

Mr. Congdon said the dominant voices in US policy-making - Nobel laureates Paul Krugman and Joe Stiglitz, as well as Mr. Summers and Fed chair Ben Bernanke - are all Keynesians of different stripes who "despise traditional monetary theory and have a religious aversion to any mention of the quantity of money". The great opus by Milton Friedman and Anna Schwartz - *The Monetary History of the United States* - has been left to gather dust. Mr. Bernanke no longer pays attention to the M3 data. The bank stopped publishing the data five years ago, deeming it too erratic to be of much use.

This may have been a serious error since double-digit growth of M3 during the US housing bubble gave clear warnings that the boom was out of control. The sudden slowdown in M3 in early to mid-2008 - just as the Fed talked of raising rates - gave a second warning that the economy was about to go into a nosedive. Mr Bernanke built his academic reputation on the study of the credit mechanism. This model offers a radically different theory for how the financial system works. While so-called "creditism" has become the new orthodoxy in US central banking, it has not yet been tested over time and may yet prove to be a misadventure.

Paul Ashworth at Capital Economics said the decline in M3 is worrying and points to a growing risk of deflation. "Core inflation is already the lowest since 1966, so we don't have much margin for error here. Deflation becomes a threat if it goes on long enough to become entrenched," he said. However, Mr. Ashworth warned against a mechanical interpretation of money supply figures. "You could argue that M3 has been going down because people have been taking their money out of accounts to buy stocks, property and other assets," he said. Events may soon tell us whether this is benign or malign. It is certainly remarkable.