

INTELLECTUAL AMMUNITION

Money Supply Mishmash

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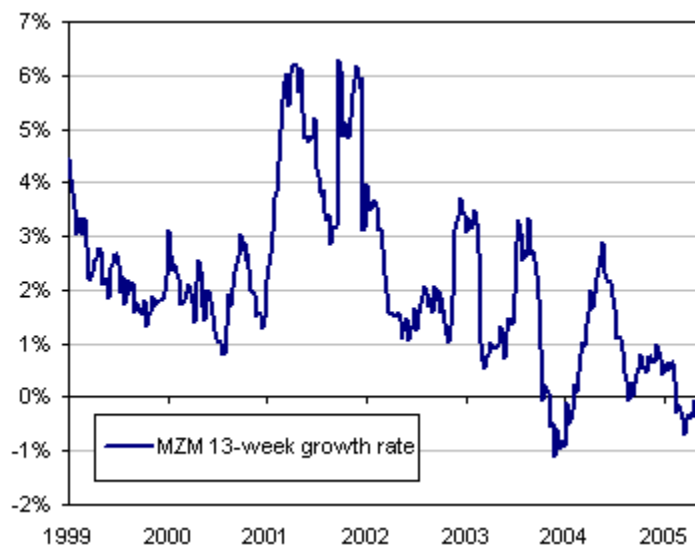
The inflation-denying soft-patch brigade has found a new way to be wrong.

Last week's **jobs report** showing **payroll** gains of 274,000 in April, with an average monthly addition of 211,000 in the first four months of the year, abruptly -- and thankfully -- defused much of the hype that had been building around the notion that the **US economy** has hit a "soft patch," "growth pause," or significant slowdown. As welcome as the job growth was, perhaps most encouraging was the 0.9% rise in **aggregate hours worked**, the biggest monthly jump in this critical measure of labor input since early 1997 in the first stages of the late-90s growth acceleration. On a 12-month basis, hours worked are up 3.1%, best since 1998, and based on the relationship between hours worked and **real GDP** over the past 20 years, consistent with a growth rate of about 4.8%.

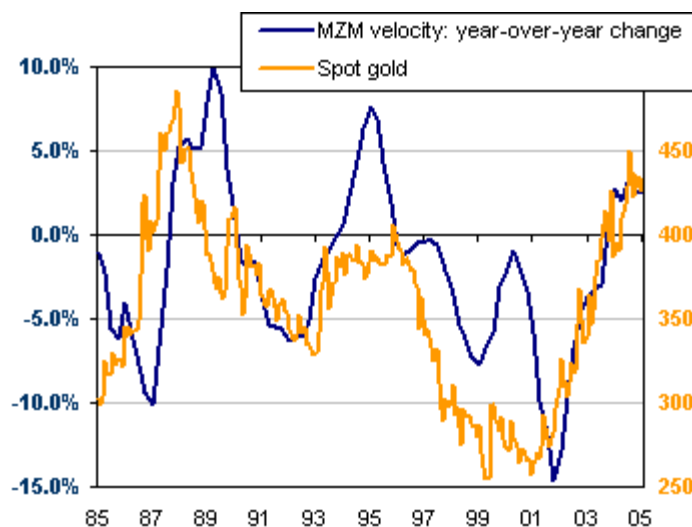
The good news on jobs, however, wasn't good enough for some **Wall Street** hands who still forecast a sharp deceleration in the pace of expansion. In making this call, they have pulled from the dust bin of discarded economic nostrums **money supply** growth data which, they say, shows that **the Fed** has already gotten too tight. **MZM** -- the Fed's broadest measure of immediately available funds -- has been virtually flat this year, after growing at annualized rates of more than 5% through much of 2004. Of particular concern, according to this view, is that monetary growth is slower than **nominal GDP**, arousing fear that there is insufficient money to fund an acceptable level of transactions volume.

What this formulation ignores, however, is monetary **velocity** -- the ratio of nominal GDP to money supply. Any purported reliable relationship between monetary growth and nominal output must also assume stability of velocity, which essentially measures the **demand for money** relative to the goods for which it exchanges. Such an assumption, however, has been highly misplaced over the years. Velocity has proven to be highly variable, swinging according to the **inflationary** or **deflationary** influences being exerted by the Fed on real dollar purchasing power.

During the Fed's deflationary siege of 1999-2001, for example, soaring money growth was at first seen by some as an indication that the Fed was providing ample liquidity -- after all, money was growing faster than nominal GDP! In fact, though, the rapid monetary growth was a reflection of rocketing money demand and



plunging velocity which precipitated a collapse of nominal -- or money -- GDP. The failure of velocity to behave as assumed led to the discrediting of the monetarist model during the early to mid-1980s. Its credibility is unlikely to be revived by this latest analytical diversion.



In the first quarter, MZM declined at an annual rate of slightly more than 1%, after growing an annualized 2.5% in last year's fourth quarter. Rather than accompanying a decline in nominal growth, however, money GDP rose by 6.4% in the quarter, up from 6.2% in the final quarter of 2004. MZM velocity more than doubled on the quarter and is now up 3.6% in the past four quarters, the highest four-quarter growth rate since 1995. In other words, contrary to indicating that the Fed is too tight the reversal in monetary growth reflects the decline in money demand and rise in velocity that customarily accompanies an inflation uptrend. The

chart at left, showing the close correspondence between MZM velocity and the price of gold, offers confirmation that recent money supply behavior has been indicative of the dollar's declining real value.

With **real short-term interest rates**, even after 200 basis points in Fed hikes, still at negative or barely positive levels -- depending on the inflation measure used -- the incentive to hold short-term dollar balances is virtually nonexistent, so the decline in money demand is not difficult to understand. At a **fed funds** rate of 3%, the current real rate is about half its long-term average of 2.5% even using the **PCE core deflator**, which has been the price index of choice for those downplaying inflation risks. By this measure, restoring a real equilibrium level would require another 125 basis points in rate hikes, assuming no further escalation of the readings from this index, which is now showing 12-month change of 1.7% (on a year-over-year basis, the core PCE was rising at a rate just slightly above 1% early last year). As it happens, our long-standing forecast has been that the Fed would remain in the mode of 25 basis point per **FOMC** meeting policy normalization through the end of this year, which would put the funds rate at 4.25%. We have seen no data or arguments persuading us that the need for such action has diminished.

Bottom Line: From our perspective, signs of labor market vigor are probably most significant for their likely effect in keeping the Fed from calling a too early halt to its policy normalization process. Arguments suggesting that a reversal in money supply growth indicates that the Fed is already too tight do not withstand scrutiny. Rather than indicating a shortfall in the availability of money balances, behavior of the monetary aggregates manifests a decline in money demand consistent with incipient inflation. With gold continuing to trade more than 30% above its 10-year moving average, the notion that the Fed has already done enough to normalize policy -- never mind that it's done too much -- is badly misplaced. **Long-term Treasuries** appear to be willfully avoiding absorbing this reality. When they finally do, as they inevitably will, today's yields will quickly come to be seen as a distant memory. **TM**