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FIRST Trust ADVISORS L.P.

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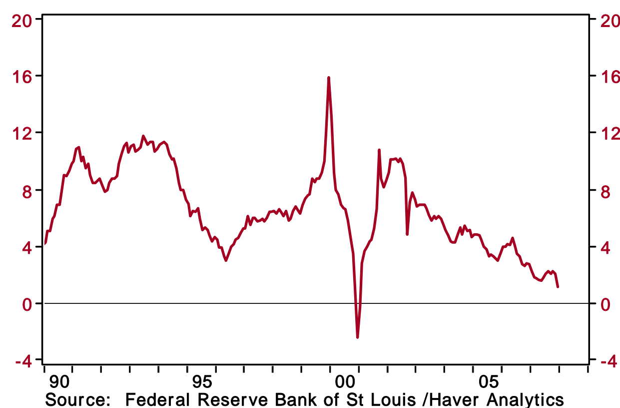
Slow Money Supply Growth Doesn't Mean Low Inflation

With gold trading near $900 an ounce, oil prices in the $90s, and the foreign exchange value of the dollar very weak, it's hard to imagine that the Federal Reserve is running a restrictive monetary policy.

Nonetheless, there are many who fear tight money is a threat to the economy. Some of them view weak money supply growth as clear proof that the Fed is too tight and that more (and aggressive) interest rate cuts are needed.

These analysts focus on slow growth of the Monetary Base and M1 measures of the money supply. Base money includes currency in circulation and bank reserves, and is often called "high-powered money" because it is multiplied by bank lending.



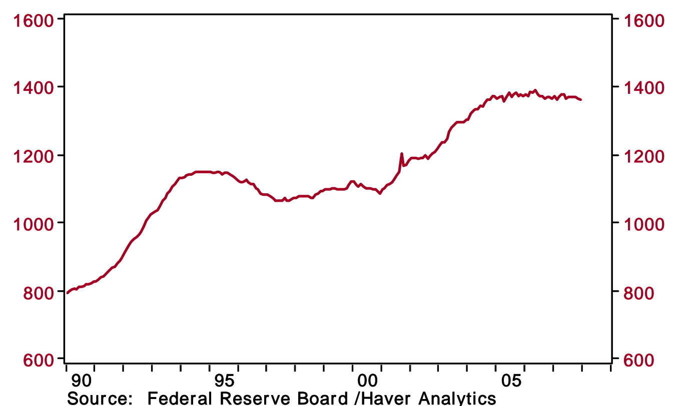
The M1 measure of the money supply includes currency in circulation, travelers' checks, and demand deposits. Base growth has slowed sharply, while the M1 money supply has been flat for four years.

The fear of this slow money growth emanates from Milton Friedman's research. He found that economic cycles are caused by fluctuations in the money supply and that inflation is always and everywhere a monetary phenomenon.

As a result, slow money growth would signal economic trouble. Slow money growth would also signal prospects for lower inflation. Both of these forecasts would give the Fed more room to cut rates.

However, changes in bank regulation over the past few decades, as well as more dynamism in the global financial system have made it virtually impossible to judge the stance of monetary policy by using any measure of the money supply. In fact, money supply data have become nearly useless as a forecasting tool.

We do not believe monetary policy is tight, nor do we believe further interest rate cuts are in the best interest of the financial markets. Money supply measures have been hopelessly compromised by changes in the economy.



As an example, banks utilize "sweep accounts" to move checkable deposits to savings-type deposits. This is significant because banks are required to hold reserves against checkable deposits, but not for savings deposits. Many banks have used these accounts to reduce their required reserves to an amount that can be covered by vault cash plus their Fed deposits needed to cover transactions that take place in the normal course of business.

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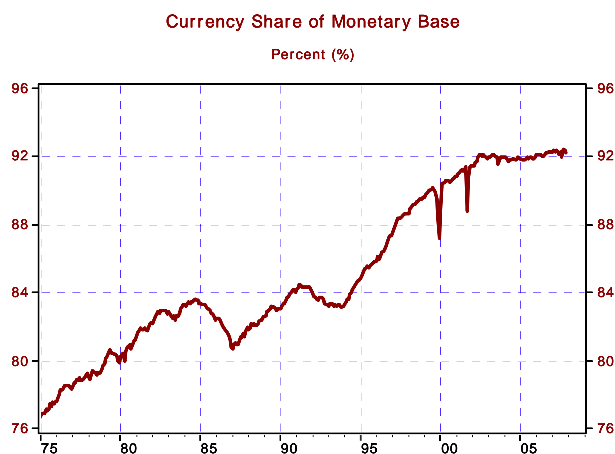
As a result, from a technical perspective many banks hold zero reserves. The Fed has encouraged this process, as have many other central banks around the world. What it means is that bank reserves are becoming much less important for the conduct of monetary policy. In 1994, currency was just 84% of the Base; today it is 92% (see chart). In other words, currency has become the primary mover of growth in the Monetary Base.



Source: Federal Reserve

And this brings up a second factor. Electronic payments systems – such as PayPal and the use of credit cards for online bill payments or purchases – means consumers need less currency. As technology continues to advance, and more consumers become comfortable with electronic payments, the need for currency will continue to decline.

Third, for many years a majority of US currency has circulated abroad. As a result, the domestic portion of M1 does not always grow at the same rate as total M1. For example, foreign investors and consumers may expect the dollar to depreciate and switch their cash holdings to the Euro. In this case, even if the Fed is injecting more dollars into the domestic banking system, the overall growth rate in M1 could slow.

Another interesting development is that following 9/11 the US Treasury Department slammed the gate shut on terrorist money laundering and counterfeiting. In addition, the newest anti-counterfeiting $20 bill was released in October 2003. These developments force evil-doers to use different currencies to ply their tradecraft, and it may be another reason behind the slowdown in M1 money supply growth in the past four years.

The good news is that money supply measures are not necessary for judging the stance of Federal Reserve policy. All of the information needed to judge Fed policy can be found in commodity prices, the exchange value of the dollar, and the gap between interest rates and nominal measures of economic growth. These indicators signal Fed policy is loose today, not tight.

The bottom line is that both the Monetary Base and M1 have become very unreliable tools for monetary authorities, investors and forecasters. Just look back at the mid-1990s. The Monetary Base slowed significantly between 1993 and 1996, while M1 fell between 1994 and 1998, yet both nominal and real GDP expanded strongly.

We remain confident in our models, which use interest rates to measure the Fed. These models suggest that the Fed was accommodative before it started easing in September and is even more accommodative today. This means that a tight money induced slowdown in the economy, or any decline in inflationary pressures, remains highly unlikely.

Brian S. Wesbury, ***Chief Economist***
Robert Stein, ***Senior Economist***

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