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Domestic Credit by Richard Freeman

Runaway growth of money supply

Paul Volcker's monetarist approach to the economy keeps producing more of what it pretends to want less.

Since taking office in August 1979, Federal Reserve Board Chairman Paul Vocker has pursued a monetarist policy on money supply and credit. It is ironic but predictable that money supply growth is now once again out of control.

According to the figures of the St. Louis Federal Reserve Bank, for the week ending Sept. 3, the two-month growth average of M1-A is 13.6 percent and that of M1-B is 16.5 percent, well above the growth targets set by the Federal Reserve Board for these aggregates. No one on Wall Street is willing to make any firm prediction as to when money supply growth will abate.

In the short-term, there has been an immediate jump in money supply figures over the last two months. In July, there was a large $5 billion social security increase which was mailed out in checks to recipients and soon entered the banking system. Also in July, there was a large $8.4 billion mortgage loan commitment by the savings and loans associations, an attempt to stimulate housing growth. It is the resulting housing growth and the lowering of mortgage rates that has accounted for a large share of the economic recovery of July-August, which will prove to be short-lived.

But according to Bob Giordano of Goldman Sachs, the July social security and housing figures, among others, should have had a chance to wash out of the banking system already. Why then is money supply still exploding?

By attempting to make money growth and not industrial output primary, and by restricting money supply growth in the 3 to 5 percent range in order to theoretically keep GNP growth at 3 percent, the monetarists are already undercutting real growth targets. As two-thirds of GNP is office building, gambling casino and other value less production, this leaves at best a 1 percent real production growth.

In practice, the monetarists impose even lower levels of economic growth. In the U.S., industrial production is down 8 percent since the spring.

Thus, attempting to limit money supply invariably lowers production, lowers productivity, and makes the control of inflation impossible. The U.S. inflation rate is still over 10 percent.

This can be seen in the M1-A money supply bulge. For example, as a result of the sharp cut in production and the tight reins on credit Volcker emplaced in March, corporations were forced to borrow from banks on a short-term basis. When interest rates fell in the early summer, corporations sought to restructure their debt from short-term bank borrowing to long-term bonds. In July, the total corporate bond calendar was a staggering $5 billion, most of the funds going not to capital formation—which has been falling—but to inventory financing and some short-term bank debt retirement. In August, corporate bond issues continued strong at $2.9 billion. In September, the corporate bond calendar was also strong until interest rates started rising sharply.

This large volume of corporate funding got transferred into checking accounts and show up as money supply growth. Thus, corporate refunding and inventory financing operations taken as measures against Volcker's tight money policies in the spring have contributed to money supply growth recently! To stop this, Volcker is threatening to once again raise rates.

The corporate fundings, of course, were mostly pass through of funds, but of the kind which aided money supply activity. The increase in the federal budget deficit to pay for increased anti-recession payments such as unemployment insurance has also led to money supply growth.

Volcker's policy will inevitably lead to zigs and zags in money supply growth, with each change in money supply followed by tight contractions of credit. Another shift in money supply is underway. "Because Volcker has been accommodative to financing to keep the economy up, money supply will grow 13 percent in the third quarter," says Robert Synch of Bear, Stearns investment bank. He added, "we see Volcker having to follow this growth up with credit tightening that will push the federal funds rate up to 12 percent by late this year, and the prime up to 15 percent."

This will kick off the same monetarist stop/go cycle. The economy will respond with further production collapse.

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