A "monetarist" case for UK optimism

Simon Ward

09 May 2013

Rather than “flatlining”, the British economy has been regaining momentum since late 2011. This trend is obscured in official GDP statistics by various special factors – North Sea production weakness, an extra bank holiday and the Olympics. Adjusting for their effects, the quarterly change in output has risen from -0.1% in the fourth quarter of 2011 to 0.0%, 0.1%, 0.2%, 0.2% and 0.3% in the first quarter of 2013 – a clear upward trend.

Recent numbers, moreover, probably understate economic improvement because official first estimates of growth tend to be revised up during recovery periods. Quarterly GDP changes since the start of 2009 have already been revised by an average of +0.15%. So the current estimate of a 0.3% increase in underlying output in the first quarter of 2013 may reflect “true” expansion of about 0.5%.

The recent growth revival is no surprise to economists of a “monetarist” persuasion. The Friedmanite rule is that the real or inflation-adjusted money supply leads demand and activity by about six months. Economic weakness in 2011 was foreshadowed by a contraction from mid-2010 in real broad money, as measured by non-financial M4, comprising physical cash and sterling deposits held by households and non-financial firms. The six-month change in real money, however, turned positive in late 2011 and rose further in early 2012, signalling a stronger economy from the second half.

Why has real money growth revived? Part of the story is a slowdown in inflation after a 2011 spike driven by a combination of higher VAT, strong global commodity prices and the lagged impact ofexchange rate weakness.

Nominal money trends, however, have also improved, despite continued weakness in bank lending. This may partly reflect the Bank of England’s QE programme but, interestingly, the recovery began before gilt purchases were restarted in October 2011. QE may have had a much smaller impact than the Bank claims: its operations may have substituted for gilt purchases by banks, which were under strong pressure to raise their liquidity ratios – such buying has similar monetary effects. QE has boosted banks’ reserves, allowing them to meet liquidity targets without expanding their gilt holdings.

A less-discussed reason for faster money growth is the effort by banks to restructure their liabilities to reduce reliance on non-deposit and overseas funding. The repayment of such funding can lead to an expansion of domestic deposits included in the money supply. An example would be an overseas investor using funds returned by a UK bank to buy a UK corporate bond at issue – a fall in banks’ overseas liabilities would then be matched by a rise in corporate deposits. The ongoing shift in bank funding sources may partly explain why money growth has remained solid despite the suspension of QE in November 2012.

Real non-financial M4 rose at an annualised rate of 2.1% in the six months to March. The composition of growth is encouraging, with strength focused on cash and instant-access deposits – these components, which constitute narrow money M1, are more likely to be related to future spending. Real non-financial M1 increased by 5.4% annualised in the latest six months.

Sectorally, corporate money holdings are expanding faster than those of households. Corporate liquidity has a closer relationship with the economic cycle – similar increases historically have presaged stronger investment and hiring, with a resulting rise in wage incomes lifting consumer spending.

Some commentators claim that companies are holding more money because of a lack of profitable investment opportunities and as a precaution against cash flow problems, given the difficulty of accessing bank credit. It is certainly plausible that the desired ratio of bank deposits to borrowing has risen as a result of the recession and more restrictive credit conditions. The actual ratio, however, has climbed by more than two-fifths in the four years since the economy bottomed, reaching a new high in data extending back to 1998 – this is unlikely to be fully explained by rising precautionary liquidity demand.

There is, moreover, no sign of any breakdown in the relationship between corporate money growth and the economy. The “soft patch” in 2011 was preceded by a contraction of real corporate liquidity. Recent economic improvement has occurred on schedule following a liquidity revival in 2012. Six-month growth in real corporate M4 holdings was 5.7% annualised in March and reached 7.9% in January – the highest since 2007.

Monetarist optimism on economic prospects contrasts with “creditist” pessimism, based on the idea that a pick-up in bank lending is a precondition of stronger growth. This notion, however, is at odds with historical evidence that, while money leads the economic cycle, credit is a coincident or lagging indicator. In the US, the Conference Board includes bank business loans and consumer credit in its lagging economic index.

This lagging relationship suggests that bank lending will revive as growth continues to strengthen during 2013. There are already hopeful signs, such as a rise in unused sterling credit facilities in the six months to March – the first such increase since 2007. A credit pick-up, in turn, would provide additional support for monetary expansion.

The monetary foundations for a sustainable economic recovery are in place. The Bank of England should avoid further policy experimentation and focus on achieving its inflation target while allowing banks to operate in a stable regulatory environment.