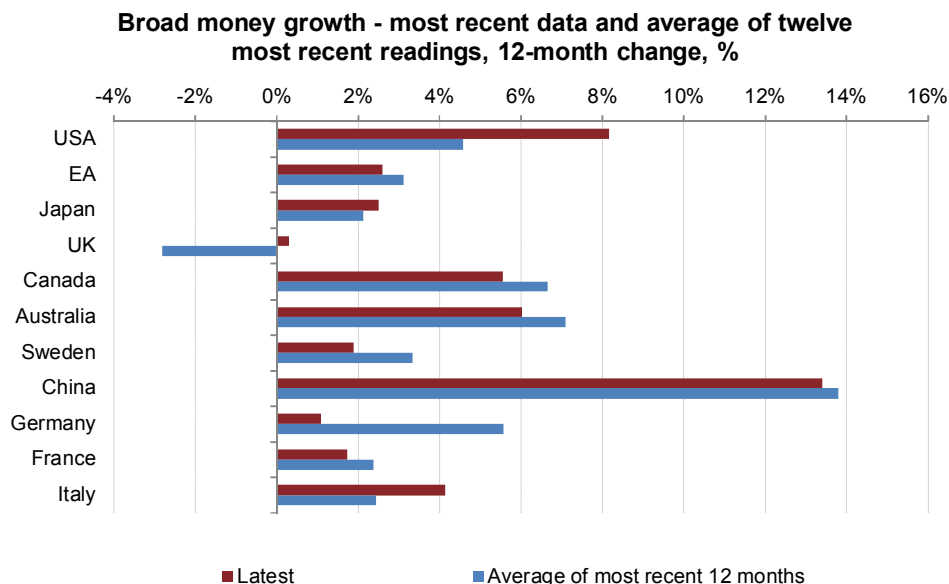


Broad money supports US growth, no inflation risk story

- **Broad money remains a key indicator of activity and inflation**
- **US, Japanese, Italian broad money growth accelerate**
- **Euro area, smaller DMs, China, slowing or flat**

Broad money is a key indicator of activity and inflation in the medium-term in any advanced economy. In the near-term, it is an indicator of asset prices. It is not the sole determinant of either, and its effects are subject to long and variable lags. Nevertheless, for anyone who looks at slightly longer data series, the connection is clear. To take but one example, over the five years to Q1 2013, US nominal GDP has grown by just over 12% and cumulative inflation has been 9%. US broad money – my own recreation of the M3 measure that the Fed ceased to publish in March 2006 – has grown by 13% over the same period. (For anyone keen to consider the current Japanese experiment in ‘quantitative’ and ‘qualitative’ easing, the US monetary base has broadly doubled over the same period; the rate of inflation is unchanged.) The relationships may not be quite as good for every country; but they will be there. They are restated her because they are frequently disregarded or dismissed.

Strangely enough, the one factor where most commentators are prepared to ascribe importance to money is with regards to inflation. Much of the debate around quantitative easing in different countries has concentrated on how this ‘printing money’ will ultimately affect consumer prices. However, the main impact of QE has so far been on the monetary base – ie, cash in circulation and banks’ reserves with the monetary authorities. What matters from an activity and inflation perspective is broad money – ie, the broadest definition of liquidity, mainly the bank deposits (and cash) held by the non-bank private sector.



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The desirable growth rate of broad money varies substantially from country to country. The growth rate consistent with medium term trend rate nominal output growth should be the sum of trend rate real growth, the desirable rate of inflation and some adjustment for long-term changes in the velocity of money. In the case of the United States, this would mean that desirable broad money growth is somewhere in the 5-7% range: 2-3% real trend growth, 2% inflation and a long-term 1-2% fall in the velocity of money. For the euro area the number would be somewhat lower, based on 1-2% real trend growth although to some degree off-set by a more rapid fall in velocity; and so on.

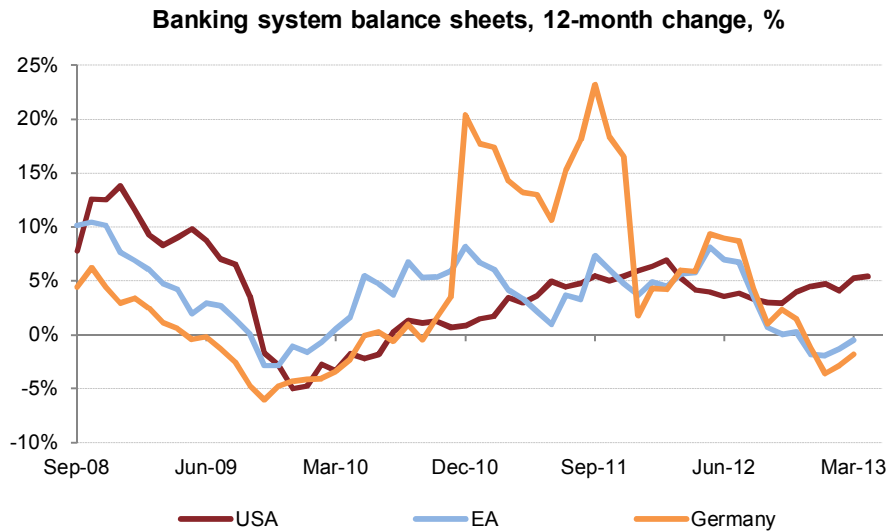
The chart above shows the latest twelve-month change in broad money growth for a number of countries; and the average of the twelve latest 12-month changes. The chart makes two points: First, that broad money growth is accelerating in the USA, Japan, the UK and Italy; while it is slowing in the EA, Canada, Australia, Sweden, China, Germany and France. Second, that broad money growth is at or above the rate in the medium term consistent with trend rate output growth in the USA, Canada, Australia and Italy. In fact, Italy stands out among large EA countries in having seen broad money growth (strictly speaking, the Italian contribution to EA M3 growth) accelerate sharply over the past year. From contracting in 2010 and 2011 and growing weakly in 2012, it has reached what is by historic standards unspectacular but healthy growth in the 4-6% range. The implication is that Italian output growth could potentially surprise on the upside in 2014; although this is tempered by the fact that with a trend growth rate in the 0-½% range, it doesn't take much growth to go above trend. This issue will be revisited in the near future.

The broad money data support the diverging growth view of the world economy in 2013/14. That is to say continued and accelerating recovery in the United States and continued weakness in the euro area. With some of the other countries, the data is perhaps more ambiguous – for instance, although broad money growth is healthy in both Australia and Canada, it is slowing down. In mid-2012, both those countries saw broad money growing at a rate above 8%, while the latest data is in the 5-6% range. A further cause for concern is the very sharp slowdown in both German and French broad money growth. Less than a year ago, German broad money was growing in the 6-9% range, whereas the latest number is barely 1%. The weakness in French broad money growth is less pronounced, but in the summer of 2012 it briefly exceeded 4% before slowing to 1.7% in the year to March.

Moreover, the outlook for future broad money growth seems to spell an increased divergence between the US and the EA. Where the US banking system balance sheet has consistently expanded since June 2010 and is now 19% larger than it was in September 2008 (when Lehman Brothers failed), that of the euro area has recently begun to contract and is only up by 10% over the same period. Significantly, the German banking system balance sheet is also contracting after a surge in 2010-11 (partly brought on by an inflow of deposits from southern Europe). That ties in with other recent data to point to continued German below-trend growth in 2013, dampening previous hopes for a stronger German recovery. These bank balance sheet developments imply that the outlook for credit growth – a key counterpart to broad money growth – is also diverging in favour of the US. This should add to the attraction of US assets, even after the successful run they have had over the past six months or so.

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What about inflation? The only major developed economy that currently has above-target inflation is the UK; while Japan is trying to move from deflation to 2% inflation. The Bank of England is forecasting that UK inflation will remain above target for another two years. But UK inflation is very much induced by the weaker pound; whereas UK monetary data implies that underlying inflationary trends should be lower. M4 growth is barely into positive numbers, having contracted from October 2010 to January 2013, a period that saw the rate of inflation slow from 5.2% in September 2011 to 2.2% in September 2012 before picking up again. That is also the message of the Stein Brothers UK trimmed mean inflation measure,

The Japanese inflation outlook has been treated elsewhere (eg, *What next for central banks?* 12th April 2013). As for the other countries, the one country where monetary data potentially would give rise to inflationary concerns is the United States. But that assumes that current broad money trends remain in place for some time. US broad money growth has only been above 4% since last November, having weakened in mid-2012. The optimistic growth forecast for the US economy rests partly on broad money growth remaining at or around current levels, ideally at least throughout the year. For inflation to become a threat, however, broad money growth would either have to remain at current levels for considerably longer, or accelerate rapidly from current levels in the near term. Unless it does either of those, there is no monetary basis for fearing a return to unacceptably high inflation over the next year or two.

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