

January 28, 2009

Downunder Daily

Does Money Matter?

How much money matters now matter for investors.

Central banks are willing and able to increase money supply. If you believe that money matters, then the recent rise in monetary aggregates is important. Often rising money supply has been a leading indicator of improving economic activity and (importantly for investors) rising asset prices. Joachim Fels, co-head of Morgan Stanley's global economics team, believes that the emerging liquidity cycle should help support asset markets, end the recession, and prevent lasting deflation (see *The Global Monetary Analyst: A New Global Liquidity Cycle*, 14 January.)

I'm more circumspect. I don't doubt the ability of policy-makers to boost money supply. That is clearly happening in several countries (Exhibit 1 shows the lift in US monetary aggregates). I'm circumspect because I'm not sure that money supply matters. I think what matters is credit, and I'm not convinced that policy makers will be able to accelerate credit growth.

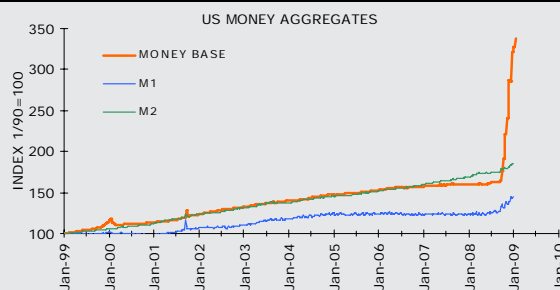
To be fair, credit and money supply usually follow similar cycles. More importantly, money supply growth has historically led credit growth (Exhibit 2). If the pattern repeats now, then faster money supply growth would lead to a credit recovery.

I think that in this cycle the link between money expansion and credit will be severely impaired by the likely reversal in some of the trends associated with the financial super-cycle seen through the past 20-30 years.

Historically, money and credit were linked via the balance sheet of credit intermediaries (banks). The bulk of money supply (M2) is intermediaries' deposits, or their liabilities. Credit is intermediaries' assets. Therefore, an increase in money supply was almost tantamount to an increase in bank liabilities, which the banks sought to deploy via higher lending.

Exhibit 1

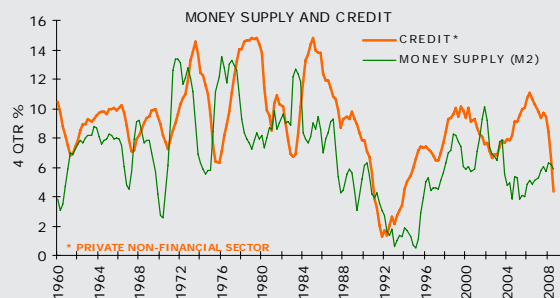
Does Creating More Money ...



Source: Federal Reserve; Morgan Stanley Research

Exhibit 2

... Create More Credit?



Source: Federal Reserve; Morgan Stanley Research

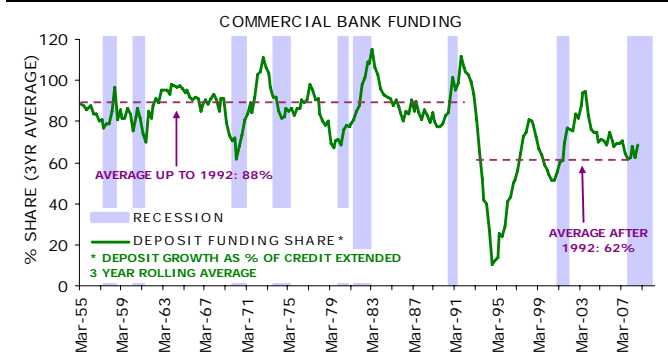
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The share of credit funded by deposits has a cyclical element (which explains the lag between money supply and credit growth). But over the past 15 years, there was a structural shift as deposits became a less important source of bank funding (Exhibit 3). This loosened the link between credit and money (and partly explains why, say, in the early 1990s, credit growth accelerated before money supply growth did).

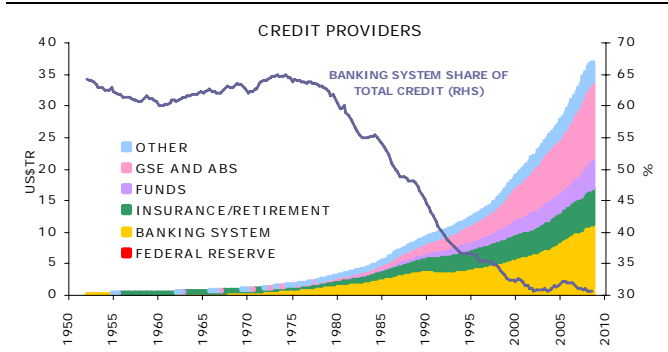
Exhibit 3
Forced Into Wholesale Funding



Source: Federal Reserve; Morgan Stanley Research

The greater reliance on non-deposit funding meant that banks could grow credit faster than deposits (money supply). But if the wholesale funding model retreats, then there is likely to be an extended period when the reverse applies: Bank credit expands less rapidly than deposits do. This change would also be accompanied by a likely reduction in bank leverage.

Exhibit 4
Non-bank Credit Is Crucial



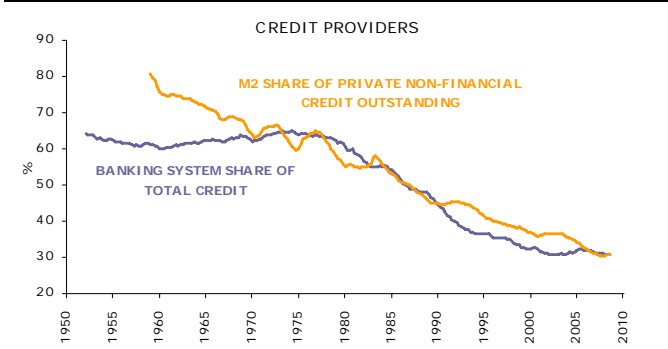
Source: Federal Reserve; Morgan Stanley Research

A second structural factor that may crimp the flow-through of money supply expansion to credit expansion is the change in the non-bank sources of credit. Exhibit 4 shows the sources of credit in the US. The standout feature is the declining relative importance of banks: In the early 1980s, banks accounted for over 65% of the credit outstanding; now their

share is around 30%. This reflects the rise of the so-called shadow banking system.

The problem ahead is that even if bank-sourced credit flows resume, aggregate credit may contract as disintermediated credit flows shrink. These disintermediated flows included the securitization markets, many of which collapsed last year. (One example: The issue of US commercial mortgage-backed securities [MBS] fell to US\$12bn last year from \$230bn in 2007 – a 95% drop.) The risk is that the structural increase in disintermediated credit – one of the defining trends of the financial super-cycle – is now reversing. The shadow banking system was in part founded to avoid regulatory oversight, so it's difficult for regulators and policy-makers to prevent its implosion.

Exhibit 5
'Money' Got Leveraged. Will It Delever?



Source: Federal Reserve; Morgan Stanley Research

The trend to wholesale funding of intermediaries and the rise of disintermediated capital flows and the shadow banking system led to one trend: credit growth consistently outpacing money supply growth through the past 15-20 years. Exhibit 5 shows that M2 accounted for almost 80% of outstanding credit in the early 1960s, and now that share is down to 30%. Over the same period, banks' share of credit provision also declined, not coincidentally, to around 30%. In a sense, 'money' was leveraged throughout the past 25 years. My view is that money will be delevered going forward. That implies that money supply growth will not quickly feed into credit growth.

Monetary policy working with long and variable lags is the flip side of the usual variable lagged link between money supply expansion and credit expansion. Credit expansion is a sign of (stimulatory) monetary policy working. In this cycle, the credit recovery still seems a long way off, which is another way of saying that the monetary policy lag is likely to be unusually long.

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	Count	% of Total	Count	Total IBC	% of Rating Category
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