Growth in real money supply is what is important for taming inflation, and for the Fed

ECONOMY & POLICY

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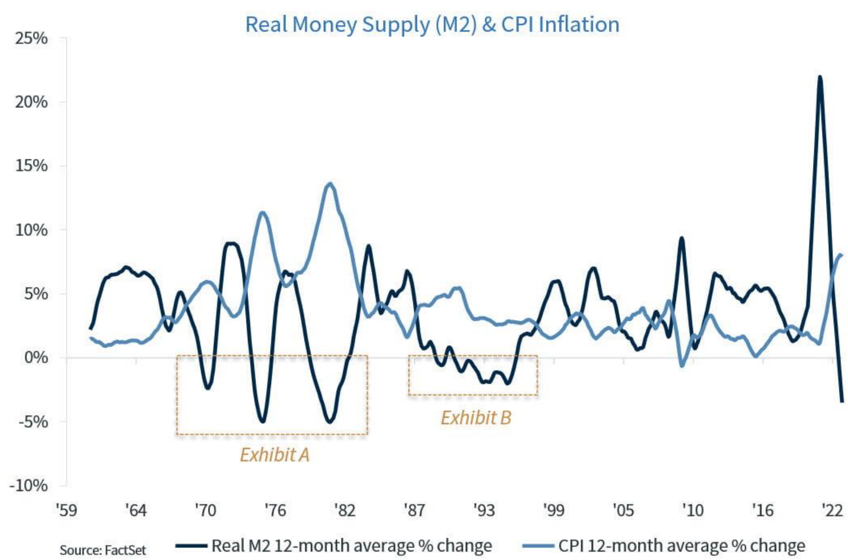
Chief Economist Eugenio J. Alemán discusses current economic conditions.

Two weeks ago, we wrote (see our March 10, 2023, *Weekly Economics*) that a reduction in money supply should not be considered out of the ordinary and showed that while growth in the nominal supply of money recorded its first negative reading since 1960 on a year earlier basis, real money supply growth has been negative during long periods of time during the last 63 years. In fact, as is the case with variables in an economy, what is important is not its nominal value but its real value.



This is also true for the supply of money. What we should be looking at is the growth rate in the real money supply, not the nominal money supply. But we also said in that weekly publication that the expansion in the money supply, both real as well as nominal, wasn't a 'normal' monetary cycle. In fact, it was no monetary cycle at all because a monetary cycle would mean strong growth of lending. But this is not what happened. What happened was a very large transfer from the U.S. government to Americans, individuals as well as firms, of direct payments in terms of checks, extra unemployment insurance, as well as PPP loans that ended up being gifts to firms.

Normally, the U.S. Federal Reserve (Fed) reduces money supply by increasing interest rates and this reduces the growth rate of loans. However, this time around, since banks did not lend that much coming into this latest tightening cycle, there is very little that the Fed could tighten today. The only exception is, as we mentioned in that weekly publication, credit card lending.

The good news is that the recent banking issues, with the fall and takeover by federal regulators of two banks, will help the Fed tighten the only sector of credit that was growing too fast for its taste, credit card lending. This will help in slowing consumer demand further and help the Fed buy time until all the excess funds (excess savings accumulated during the COVID-19 pandemic) are flushed out of the system.

According to our estimate, real money supply growth will need to come down by 8% to 9% on a year earlier basis and, perhaps, remain in negative territory for several years for the Fed to achieve its 2% inflation target, just as what happened after Paul Volker took the reins at the Fed, followed by Alan Greenspan, and conquered inflation (see graph above). That is, they don't want the large swings in the growth rate of real money supply characteristic of the late 1960s, 1970s, and early 1980s (exhibit A). They will want to achieve something akin to what happened during the late 1980s and early 1990s (exhibit B). For now, they are in the early stages of real money supply coming down, as growth in real M2 was down by 3.5% in January of 2023 compared to January of 2022.

Our estimation of real M2 growth, as well as what we have been writing for some time (see our *Weekly Economics* for January 13, 2023) also supports our view, and the Fed's view, that interest rates will be higher for longer, despite what markets are expecting today. The only possibility for the Fed to start lowering interest rates faster, as the markets are speculating today, would be that inflation starts to come down faster, something that has not been the case so far. Thus, until that happens, markets will be wrong to second guess the Fed's commitment to remaining higher for longer.

Federal Reserve comes out hitting, changing our view of the terminal rate

The largest banks in the U.S. changed their expectations for the federal funds rate to no change for this latest meeting of the Federal Open Market Committee (FOMC). We were also very close to changing our estimate because we knew it was going to be a tossup. However, we kept our estimate of a 25 bps hike, and, for now, it paid off.

But the path forward is even more difficult to predict than this latest decision. In the end, the next decision, as well as every other so far, will be data dependent. The Fed Chairman's extreme hawkishness weeks before the recent issues with the U.S. banking system made us increase our terminal rate for the current monetary tightening cycle to 5.50% compared to our previous terminal rate of 5.25%. However, after the recent banking sector turmoil we think that the Fed will probably stop at 5.25%, which means that we are now expecting, again, just one more increase of 25 basis points during the May meeting of the FOMC.

We agree with the Fed that the recent events in the banking system will be "like increasing the federal funds rate" so they will probably will not need to go to 5.50% as the Fed Chairman had speculated. That is, the recent turmoil in the banking sector will probably be enough to tighten the only sector of lending that is growing too fast, as we argued above: credit card lending.

However, we still believe that even if credit card lending slows down considerably, there is very little more the Fed can do to rein in inflation because we continue to argue that you cannot tighten something that has not loosened up. That is, we still believe that they should stay put and ride this one out, waiting for all the money the federal government injected into the economy to flush out over time.

Consumer Price Index is a measure of inflation compiled by the U.S. Bureau of Labor Statistics. Currencies investing is generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.

Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. A value above 100 signals a boost in the consumers' confidence towards the future economic situation, as a consequence of which they are less prone to save, and more inclined to consume. The opposite applies to values under 100.

Leading Economic Index: The Conference Board Leading Economic Index is an American economic leading indicator intended to forecast future economic activity. It is calculated by The Conference Board, a non- governmental organization, which determines the value of the index from the values of ten key variables

GDP Price Index: A measure of inflation in the prices of goods and services produced in the United States. The gross domestic product price index includes the prices of U.S. goods and services exported to other countries. The prices that Americans pay for imports aren't part of this index.

FHFA House Price Index: The FHFA House Price Index is the nation's only collection of public, freely available house price indexes that measure changes in single-family home values based on data from all 50 states and over 400 American cities that extend back to the mid-1970s.

Expectations Index: The Expectations Index is a component of the Consumer Confidence Index® (CCI), which is published each month by the Conference Board. The CCI reflects consumers' short-term—that is, six- month—outlook for, and sentiment about, the performance of the overall economy as it affects them.

Present Situation Index: The Present Situation Index is an indicator of consumer sentiment about current business and job market conditions. Combined with the Expectations Index, the Present Situation Index makes up the monthly Consumer Confidence Index.

Pending Home Sales Index: The Pending Home Sales Index (PHS), a leading indicator of housing activity, measures housing contract activity, and is based on signed real estate contracts for existing single-family homes, condos, and co-ops. Because a home goes under contract a month or two before it is sold, the Pending Home Sales Index generally leads Existing-Home Sales by a month or two.

DISCLOSURES

Import Price Index: The import price index measure price changes in goods or services purchased from abroad by

U.S. residents (imports) and sold to foreign buyers (exports). The indexes are updated once a month by the Bureau of Labor Statistics (BLS) International Price Program (IPP).

ISM New Orders Index: ISM New Order Index shows the number of new orders from customers of manufacturing firms reported by survey respondents compared to the previous month.ISM Employment Index: The ISM Manufacturing Employment Index is a component of the Manufacturing Purchasing Managers Index and reflects employment changes from industrial companies.

ISM Inventories Index: The ISM manufacturing index is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories.

ISM Production Index: The ISM manufacturing index or PMI measures the change in production levels across the

U.S. economy from month to month.

ISM Services PMI Index: The Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI) (also known as the ISM Services PMI) report on Business, a composite index is calculated as an indicator of the overall economic condition for the non-manufacturing sector.

Source: FactSet, data as of 12/29/2022