



Daily Note: 14 January 2008

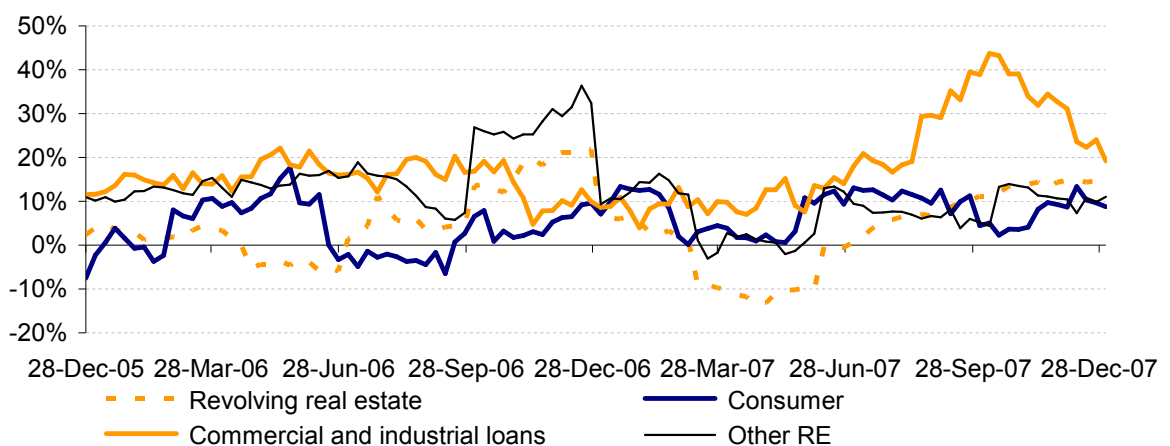
US broad money signals inflation up, growth down

WE SUGGEST: US inflation to accelerate – Fed rate cuts will fuel process

SUMMARY: US broad money growth is sending out two signals. Rapid nominal broad money growth implies that inflation will remain elevated. But slowing real broad money growth shows output growth weakening in 2008 and most likely 2009. Lower interest rates will fuel inflation further. Meanwhile, a fall in the monetary base is probably temporary.

At the end of last week, the Fed published full monthly data for credit from commercial banks. This is also the data that we use to compile our own 'M3-like' measure of US broad money. Recent broad money and credit developments are certainly interesting. Nominal broad money growth accelerated in October and November. This was very much influenced by companies switching from raising money directly from capital markets to bank borrowing in the wake of credit market turmoil. However, the growth of this borrowing – commercial and industrial loans – peaked in September (thirteen-week, ie, three-month annualised rate) and is now rapidly slowing again. This may partly be due to lower market (and policy) interest rates, but also because of lower corporate spending – a clear signal of imminent weaker output growth. Weaker growth is also the message from banks' consumer credit, which has slowed from 13.3% in the thirteen weeks to 12th December, to less than 9% by the end of the month.

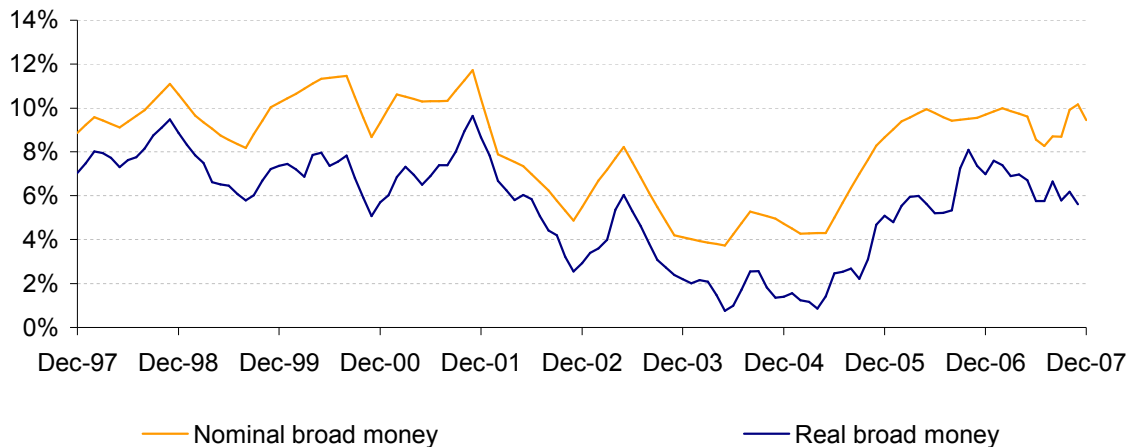
US credit by borrower and purpose,
thirteen-week annualised change, %



Even with the somewhat weaker credit growth, broad money growth remains rapid. Nominal broad money growth slowed to 9.5% in the year to December, but this is still marginally above the 9.4% twelve-month average for the year. Of more importance, however, is the slowdown in real broad money growth. This peaked more than a year ago, at 8.1% in the year to October 2006. Since then it has slowed to 5.6% in November 2007. This is still in excess of the requirement for trend output growth; the

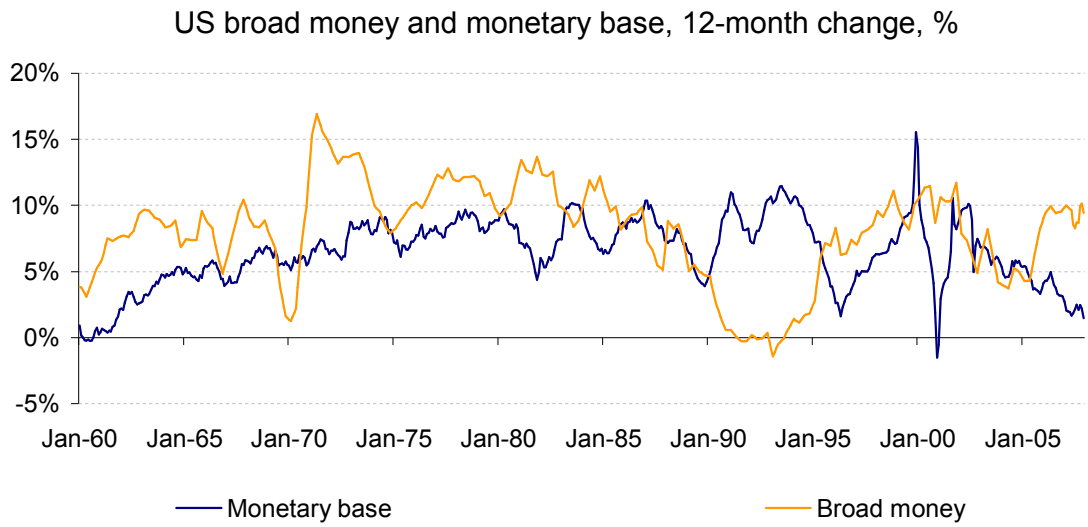
average of real broad money growth since 1960 in the US is 3.7%, compared with real GDP growth of 3.4%. On this basis, broad money growth is still indicative of healthy output growth. However, over the past fifteen years, average real broad money growth has been appreciably higher than real GDP growth – 4.2% vs. 3.1%. On this basis, current real broad money growth trends imply output growth at best at trend – and then only assuming that broad money growth does not slow any further for a significant period of time. Moreover, even this assumes a shift of liquidity away from financial markets.

US broad money, 12-month change, %



But if credit growth now is slowing, it mean weaker broad money growth as well, since these are two sides of the same coin. However, as noted above, nominal broad money growth remains rapid at 9.5%. Moreover, where real broad money growth has slowed since 2006, nominal broad money growth has not. The implication is that inflationary pressures continue to build up. Hence a dual message of lower output growth and higher inflation. (It should be noted that – at the moment – it seems that output growth is leading broad money, rather than the other way around. This is an unusual, but not unprecedented situation. If it is indeed the case, then weaker output growth will feed into further weaker broad money growth, which could start short-lived but nevertheless vicious circle.)

One of our clients last week drew our attention to a contraction in the US monetary base and asked about its significance. (Monetary base consists of notes and coins in circulation – about one-tenth of the total base – and banks’ deposits with the central bank.) While the Fed (and the BoJ) tend to attach importance to the monetary base, we are less convinced of its usefulness as an indicator of output growth and/or inflation. While relevant, it tends to be influenced by other factors (as currently seems to be the case) and while it does have some indicative properties, broad money tends to be an earlier and more reliable indicator of output growth. A case in point is the Japanese experience over the past ten years or so, where large increases in monetary base and minimal growth of broad money have resulted in minimal output growth. In the current US situation, the weakness of monetary base growth seems to be due to banks drawing down their deposits with the Federal Reserve and preferring to hold the cash themselves in the autumn. Based on the intra-month developments, it seems that the drawdown in the monetary base slowed or even reversed once the Fed and other central banks began their joint liquidity injections in mid-December 2007. If this is the case, the next two fortnightly reports of monetary base (this coming Friday and 1st February) should confirm the change in trend.



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