The whigs versus the schoolboys

The Whig interpretation of history is captured by the phrase “onward and upward.” The course of recent financial and economic events in the United States and Europe throws that notion into doubt. With each passing day, something new – and negative – pops up. This pattern fits the schoolboys’ interpretation: “it’s just one damn thing after another.”

Just take a look at the money supply growth data for the U.S. The broadest measure of money published by the Board of Governors of the Federal Reserve System in Washington, D.C. is M2. This measure is widely used by analysts. It has been rapidly accelerating. At present, M2 is growing at an annual rate of 10%, lending credence to the onward and upward phrase (see the accompanying chart).

But, the M2 money supply figure has shortcomings. It represents a simple sum of the components that make up that metric. In short, each component carries the same weight. A much superior measure of the money supply is the so-called Divisia metric. With this measure, each component of the money supply is assigned a weight,
depending on its usefulness as a medium of exchange. So, currency, traveler’s checks, and demand deposits receive a relatively “high” weight; whereas, institutional money market funds receive a relatively “low” weight.

In addition to weighing the components of the money supply to produce a Divisia metric, it is important to include the broadest range of components possible. The broader the measure of the money supply, the better. Prof. Bill Barnett has done just that with a broad money measure: Divisia M4.* Unlike M2, the broader Divisia M4 has been falling rapidly and is now flat.

This contraction of the money supply spells trouble, leaving us with a schoolboys’ interpretation. The U.S. economy is most likely headed for a recession by the middle of 2012.

We can be rather confident about this gloomy conclusion because of the following combination: no money supply (Divisia M4) growth and a very “weak” economy. One reliable measure that tells us what is happening today in the U.S. economy is the Federal Reserve Bank of Chicago’s National Activity Index. The index is a weighted average of eighty-five monthly indicators. A value of zero signals that the economy is growing in line with long-term trends. Positive and negative readings signal above and below trend growth rates, respectively. As the accompanying chart shows, the U.S. economy is struggling – unable to even reach its long-run trend rate of growth.

When we turn to Europe, the schoolboys are riding high. Events in Greece aren’t a surprise. Ever since 1832, when that Balkan nation [Greece] was recognized as a modern state, it has been a serial deadbeat.

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As a task force of Eurocrats arrived from
Brussels to dispense “expert” advice, a Greek newspaper printed the following headline: “The Prison Guards Have Arrived.” If space would have permitted, the headline could have included the following additional words: “They Have Come Often, But The Prisoners Always Escaped.”

To appreciate just how desperate things are in Greece, we only have to look at the accompanying chart of broad money supply (M3) growth rates for the Eurozone. In September 2011, the M3 metric was contracting at an annual rate of 13.6% in Greece. (Note: the M3 data for the Eurozone are a simple sum of the M3 components, not a Divisia metric, because the Eurozone does not report Divisia data.) Given that the broad money measure (M3) in Greece has been contracting for 20 months, Greece’s new prime minister, Lucas Papademos, will have trouble finding the “light switch.”

In Italy, where the markets finally did what the political system was unable to do – dump Silvio Berlusconi – the new prime minister, Mario Monti, will also find it difficult to stabilize and then turn the economy around. The annual growth rate of broad money (M3) in Italy has been declining and now is registering “no growth.”

Prime Minister Monti will be fighting a huge headwind. Italian banks are scrambling to raise more capital, as well as their capital asset ratios. With banks’ share prices trading below book value, this means that banks will be forced to reduce their risk assets (loans). Indeed, UniCredit, Italy’s largest bank, has announced that it will shed 11% of its risk-weighted assets, the bulk coming from its corporate and investment banking operations.

While the Italian bank recapitalizations might be just what the bank regulators ordered, they will deliver a blow to the already non-existent growth of Italian broad money (M3), pushing that metric into negative territory and perhaps delivering a crippling punch to the economy.

The bank recapitalization exercises and balance sheet contractions visiting Europe and most other parts of the globe promise to have wide-ranging negative economic consequences. It really is one damn thing after another.

*Note: For those who want to delve into the intricacies of Divisia indexes, the best place to start is Prof. Barnett’s new book – Getting It Wrong: How Faulty Monetary Statistics Undermine the Fed, the Financial System, and the Economy. It will be released by MIT Press in December. Also, Prof. Barnett’s new Divisia money supply measures will be on the Center for Financial Stability’s website (http://www.centerforfinancialstability.org/) by early December 2011.

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