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Analysis and insight into trends in money and banking, and their impact on the world's leading economies

Occasional e-mail from Tim Congdon of International Monetary Research Ltd. – 17th April, 2015

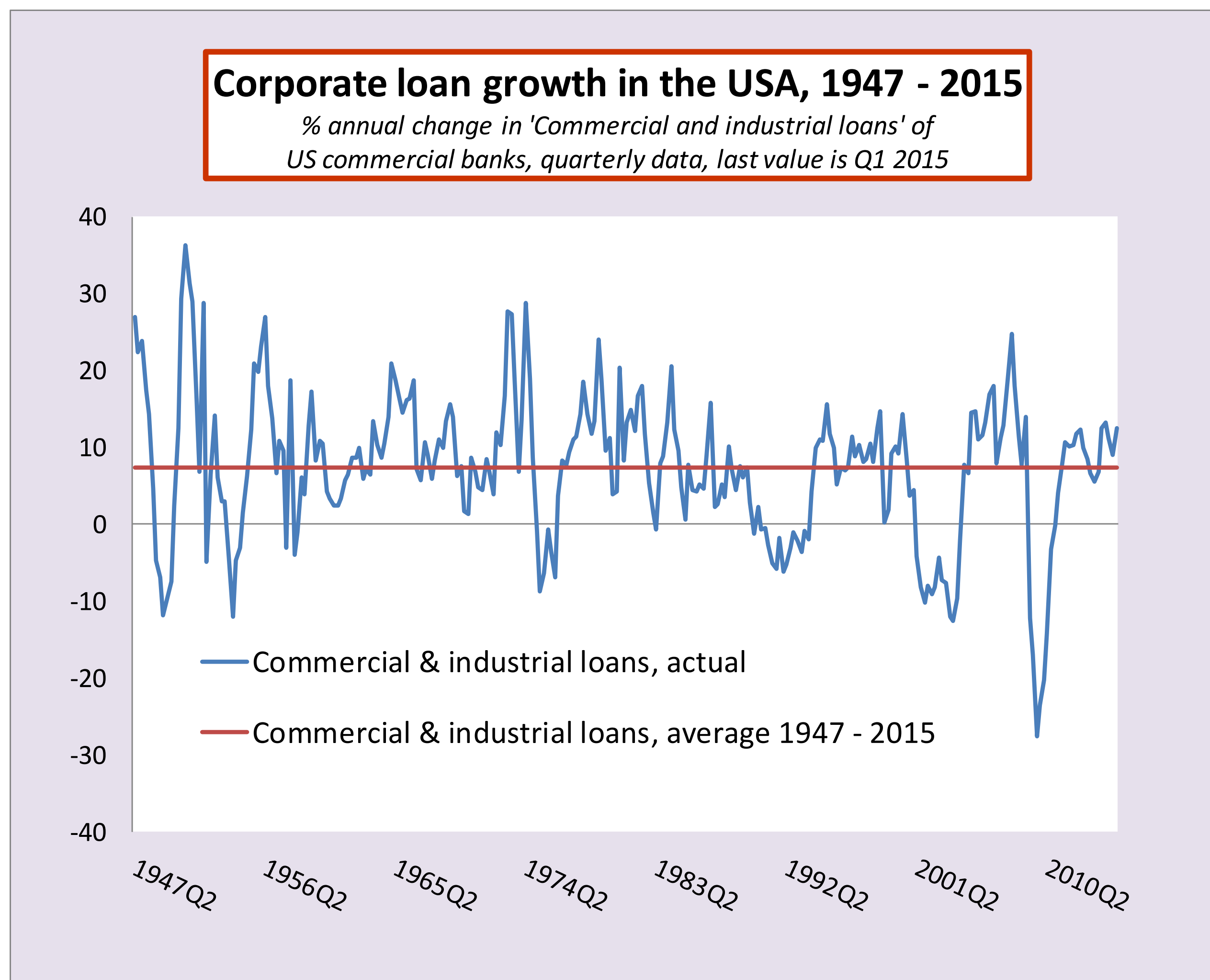
High growth of money in the USA driven by recovery in growth rate of bank credit to historical averages: deflation won't last, and inflation likely to return as a policy problem by 2017 and 2018

The main point of this note is to reiterate that in the occasional notes of 18th February and 18th March, focussing this time on the USA. Although moves towards tighter regulation are still afoot, the American banking system is growing strongly. In particular, the smaller banks – which are gaining market share from the large banks with their unfortunate 'systemic' status – are booming. This note shows that 'industrial and commercial loans', which constitute about 10% of US banks' total assets, are now soaring. Admittedly, real estate loans are less dynamic. Total 'loans and leases to the private sector' – in effect, bank lending to the private sector – are moving forward at not far from double-digit % annual rates

The latest numbers from Shadow Government Statistics, based on official data, show that US M3 growth in the three months to March was 7.4%, an acceleration from earlier months. (In the twelve months to March M3 was up by 5.6%.) Given that the price level is falling because of the big drop in energy prices, the implication is exceptionally high rates of growth of real money. That continues to signal above-trend growth in demand in the USA from the second quarter of 2015. Without a major upward adjustment in interest rates, the USA will see tightening labour and product markets in the next few quarters. As energy prices head back upwards, perhaps in 2017 or 2018 (who knows?), the problem facing US policy-makers will change radically. They will no longer be concerned about deflation; they will instead be worrying about inflation. Dollar bond yields are far, far too low.

Return of bank credit growth in the USA

In my occasional note of 18th February I argued that a dramatic change in the American credit market was under way. The US banking system – which had to shrink its risk assets in 2009 and 2010, and to a lesser extent, in 2011 – 13 – had started to grow quite quickly. The smaller banks were in a particularly fortunate position, because they were not deemed to have 'systemic' significance and therefore did not confront the same regulatory demands for extra capital as the likes of Citibank and J. P. Morgan. I suggested that the growth rate of US bank credit to the private sector had returned, more or less, to the long-run average since the Second World War, a period usually regarded as suffering from persistent, although often mild, inflation. By implication, dollar bond yields – which were being priced as if for permanent price stability or even deflation – were much too low. The main point of today's note is to reiterate the message. In the 18th February note I noted that 'the three-month annualized growth rate of broad money (i.e., M3) has been in the low teens' and conceded 'this may be a blip'. We now have two more months of data and these data suggest that the pattern of high money growth is well-established. The evidence is building that the higher rate of broad money growth is not a blip, but the unsurprising response of the American private sector to extraordinarily low interest rates and a banking system now well beyond convalescence from the shocks of the Great Recession.



Fundamental here is the growth rate of bank credit to the private sector. Some economists (whom I call – following Ben Bernanke – 'creditists') believe that this matter in its own right. That is not my position, which is far more traditional, and sees the equilibrium levels of national income and wealth as functions of the quantity of money. However, these matters are not straightforward, because new bank loans add to banks' assets and lead to identical increase in bank liabilities. The extra liabilities typically include and indeed are dominated by extra bank deposits, which are money. As a result, the growth rates of bank credit to the private sector and broad money are correlated. I therefore do care about bank credit to the private sector, because – in the absence of such policies as 'quantitative easing' – such credit is the key driver of money growth.

Anyhow, the upsurge in US bank credit continues. In the years to December 2014 and March 2015 the category 'Loans and leases in bank credit' – which roughly corresponds to bank credit to the private sector, in UK parlance – was up by 5.7% and 10.8% respectively. These numbers compare with a fall of 5.7% in 2010, and meagre increases of 1.6%, 4.1% and 1.1% in 2011, 2012 and 2013 respectively. 'Industrial and commercial loans' have been remarkably buoyant. They dropped by 9.2% in 2010, but surged by 12.0% last year and were up by 18.4% in the year to March 2015. (All the figures in this paragraph relate to the US commercial banking system as a whole. Increases at smaller banks would have been higher than indicated in the last few sentences.) Real-estate-backed loans are much larger than 'industrial and commercial loans', and are not growing so spectacularly. But the striking feature here is the ability of the US banking system to put on extra assets – including the often risky assets that corporate loans constitute – after a period of retrenchment.

Is bank credit growth accelerating?

If anything, the growth of US bank credit appears to be accelerating. Logically, the growth of broad money remains high. According to data from Shadow Government Statistics (based – it should be emphasized – on official sources of information), the M3 measure of broad money increased from $16,548b. in February to $16,605b. in March, an increase of only 0.3%. But this modest advance followed much more pronounced increases in previous months. So the annualized rate of change in the three months to March was 7.4%. (In the year to March M3 was up by 5.6%.)

Given the persisting downward pressure on commodity prices, the USA's main price indices indicate either very subdued inflation or outright deflation. The producer price index for 'final demand goods' (i.e., finished goods 'at factory gates') was 0.8% lower in March than a year earlier, while price indices for commodities and inputs at earlier stages of processing had even larger declines. It seems inevitable that the deflators used in estimating the national accounts (i.e., the 'gross domestic product deflator' and the like) will be negative for much or all of 2015. So an annual increase in nominal broad money of 5% plus will translate into an increase in real broad money of 6% - 7% plus. The past history of the relationship between real broad money and demand argues – as I said in the 18th February note – that the US economy will achieve above-trend, even much above-trend, growth in the year from mid-2015.

Despite all the complaints about the patchy and indifferent recovery, the USA has accomplished a big drop in unemployment since mid-2009. Above-trend growth will cause product and labour markets to tighten. A rebound in energy prices is widely believed to be certain at some date, even if that date is quite distant. My own view (for what it is worth) is that oil prices will be moving towards $80 - $100 a barrel in late 2016 or early 2017, when non-OPEC production will begin to slip because of the

current round of investment cutbacks. Inflation on the main indices ought then to be in the 2% - 3% area, *and rising*. The probability has to be that the Fed will be too late in tightening monetary policy. Inflation control will return as the central problem for American monetary policy in 2018 and 2019. This view will receive reinforcement if annual broad money growth stays in the 5% - 10% vicinity seen since early 2014.

17th April, 2015