



INTERNATIONAL MONETARY RESEARCH LIMITED

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

**Monthly e-mail from Tim Congdon of International Monetary Research Ltd. –
10th February, 2016**

Global money round-up at the start of 2016

Not much has changed in the last few weeks to alter the mid-January assessment. **Sure enough, the oil price remains close to its lows, and estimates are being made of the cost that banks face from write-offs from energy loans. But in general banking systems are well-capitalized and do not face heavy loan write-offs because of bad debts. Falling commodity prices imply very low inflation or even deflation in the rest of 2016. Governments and central banks can readily implement expansionary policies (such as QE) if they have to. At the start of the year the only central bank expected to tighten policy was the USA's Federal Reserve. The suggestion was four ¼% hikes in Fed funds rate that would take it towell, over 1%! But the four hikes now look very unlikely.** The prospect remains for steady, if rather slow, growth of banking systems in the major countries, and so for moderate growth of broad money, and also of nominal GDP.

In qualification, both officialdom and the commentariat seem to be confused about the causes of the current "lowflation". Key central bankers and regulators apparently do not understand that the Great Recession of 2008 – 10, like the Great Depression in the USA 1929 – 33, was caused by a collapse in the rate of change of the quantity of money. (They are determined to blame the banks, in one way or another.) They seem further not to appreciate that the effect of tightening bank regulation will be again to depress the rate of growth of the quantity of money, with wider disinflationary/deflationary consequences. The sometimes simultaneous advocacy of 'deleveraging' and 'quantitative easing' reflects the muddles in official thinking and among influential commentators.

Money trends in late 2015 in the main countries/jurisdictions

What are the latest money growth trends in the main countries? And what is the message for global economic activity over the next year or so, and for inflation/deflation over the medium term thereafter? The table below summarizes the key numbers. Beneath the table I make an overall assessment, and later make some comments on recent banking and monetary developments in the USA.

Name of country/ Jurisdiction	Share of world output, in purchasing-power-parity terms, %	Growth rate of broad money, in last three months at annualised rate, %	Growth rate of broad money, in last twelve months, %	Comment:
USA	16.1	2.6	3.9	Annual money growth slipping and QT holding back M3 in recent months.
China	16.9	10.7	13.5	Major easing intended, but political worries cause capital flight.
Eurozone	11.9	5.4	4.7	QE has had positive effect on M3 growth, but banks still under regulatory cosh.
India	7.1	10.1	11.6	Positive retail inflation, but falling producer prices. Monetary policy is steady.
Japan	4.3	2.1	2.5	Broad money growth low and wilting, with QQE to be continued.
UK	2.3	4.0	3.7	Money growth is moderate, with recent small upturn. .

Financial markets have been spooked in the opening weeks of 2016 by talk of an imminent or probable recession. But two points must be emphasised,

- i. no one in central bank or regulatory officialdom, or in top political positions, in the main countries wants a recession in 2016 or even, frankly, a slowdown in growth from the rather meagre levels of the last four/five years, and,
- ii. with inflation at close to zero, and a widespread view that the latest bout of weak commodity prices signals outright deflation, policy-makers have ample scope to pursue expansionary monetary policies.

The concern seems to be that policy-makers are ‘running out of ammo’. This is baloney. The running-out-of-ammo argument rests on the idea that monetary policy is described – adequately and completely – by ‘the rate of interest’, where the phrase ‘the rate of interest’ means the money market rate set by the central bank. In the most extreme form of this kind of statement, no attention is paid at all to the quantity of money.

But it is a simple matter to assemble evidence which shows that the change in nominal national income and expenditure is much better correlated with the change in the quantity of money than with any interest rate concept. Further, the creation of money by the state is child's play. All that is necessary is for,

- i. the government, or an agency of the state such as the central bank or a public sector institution, to borrow from the banking system, and
- ii. to use the loan proceeds to purchase something – anything – from the non-bank private sector.

It should be obvious that, by these means, the state expands the quantity of bank deposits held by non-bank private-sector agents, i.e., the quantity of money, broadly-defined. In other words, policy-makers have the ability to raise nominal national income by any extent they wish, if they adopt sufficiently expansionary monetary policies. The processes at work are so straightforward, and the mechanics of the operations can be so shockingly brazen, that many nations have monetary constitutions that try to deter money creation of this kind. For instance, while Germany still had the deutschemark as its national currency, the government was forbidden from borrowing on overdraft from the Bundesbank. (The Bundesbank was nevertheless free to purchase government securities in the market, perhaps from non-banks, which would have the effect of money creation.)

Misunderstandings about this subject are widespread. Take, for example, Martin Wolf's column in the *Financial Times* of 5th February, under the title 'Prepare for the next recession'. Its seventh and eighth paragraphs were contradictory. The seventh paragraph claimed that 'one instrument' would be 'the deleveraging of economies', with the 'forced conversion of debt into equity'. The eighth suggested that another instrument would be 'a still bigger scale of quantitative easing'.

I had to rub my eyes in astonishment. As I said in the introductory e-mail message, 'The growth of national expenditure, income and output in nominal terms is a function of the growth of the quantity of money, where the quantity of money is broadly-defined to include bank deposits.' The evidence in support of this proposition is clear and overwhelming for all countries over all historical medium and long runs.

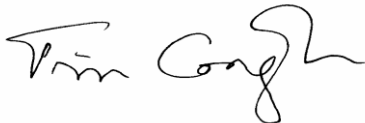
What, then, is wrong with deleveraging? Banks do not own equities, as equity-type risk is always excessive given the high gearing in their balance sheets. Their assets are dominated by very safe securities or loans, where the banks take collateral (i.e., a claim on borrowers' assets) to ensure that borrowers will make every effort to repay. Loans are a form of debt, while most of the securities held by banks are debts of governments or companies in good credit standing. The effect of the 'forced conversion of debt into equity' would be to cause a contraction in banks' assets and hence in their deposit liabilities, i.e., in the quantity of money. *Deleveraging – understood as the removal of debt from an economy – is a deflationary policy. It is the sort of nuttiness that was implicit in Andrew Mellon's recommendation of 'liquidation' as the answer to the 1929 – 33 Great Depression.*

By contrast, QE is expansionary. (That is why the seventh and eighth paragraphs were contradictory.) I have no problem with the suggestion that more QE would avert another recession, although the operations do need to be calibrated properly and organized with the right intermediate target in mind. (They should focus on the quantity of money, broadly defined, not on the monetary base.) But Wolf seems to believe that, because QE operations have been enormous and have caused central bank balance sheets to balloon relative to GDP, they are reaching some kind of natural limit. No, the purpose of such operations is to increase the quantity of money, not the monetary base (i.e., the central bank's liabilities). It is not necessary for the central bank to be involved here at all. Instead of

the central bank borrowing from the commercial banks and using the loan proceeds to buy government securities which are held in a central bank subsidiary, *the government* can borrow from either the central bank or the commercial banking system, and use the loan proceeds to buy government securities which it cancels. (There is no point in the government holding claims on itself.) When the government conducts operations of this sort, the result is to raise the banking system's claims on the government. If the transactions bypass the central bank, as they can easily do, there is no effect on the ratio of the central bank's balance sheet to GDP, and any disquiet about a very high such ratio is irrelevant.

The discussion is not at all theoretical. When the British government financed its expenditure in the Second World War it issued so-called 'Treasury deposit receipts' to the clearing banks and used the resulting deposits to purchase war material of all kinds. In 1945 TDRs were a very high proportion of banks' total assets. *But they did not appear on the Bank of England's balance sheet to anything like the same extent.* The UK commercial banking system has in the past, over extended periods, had claims on the state in excess of 60% of assets. We could easily return to that situation, if necessary.

The state can *never – repeat, never* – 'run out of ammo' in the conduct of expansionary monetary policy.

A handwritten signature in black ink, appearing to read 'Tim Conger'. The signature is fluid and cursive, with a prominent loop at the end of the last name.

10th February, 2016



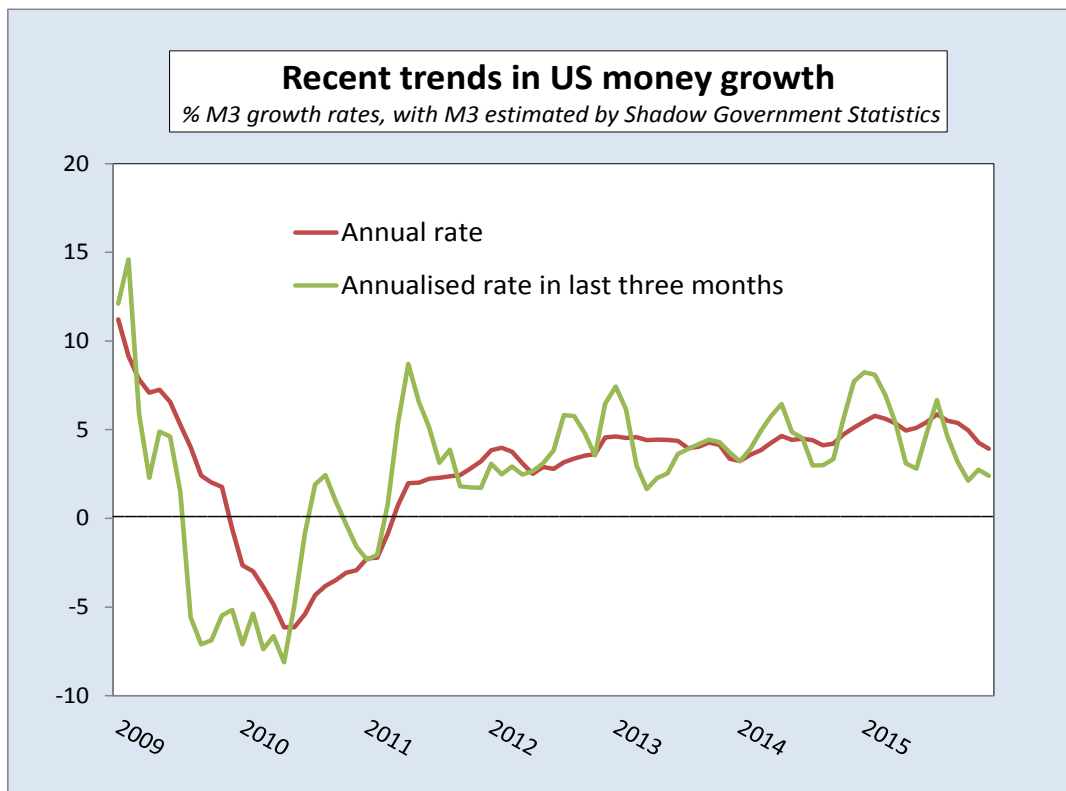
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USA

	% annual/annualised growth rate:	
	M3	Nominal GDP
1960 - 2014	7.6	6.7
Four years to 2014	4.0	3.9
Year to January 2016	3.9	n.a
Three months to January 2016 at annualised rate	2.6	n.a.

Sources: Shadow Government Statistics research service for M3 after 2006 and US Bureau of Economic Analysis for GDP



M3 growth slows as Fed Fund rate rises

Summary: In the final quarter of 2015, US M3 grew at an annualised rate of 2.6%, the lowest three-month-annualised growth rate since May 2013. January was no better. M3 was up, but only by 0.3%. The annualised growth rate in the three months to January was 2.4%. The money growth deceleration – essentially due to the reversal of ‘quantitative easing’ – has now lasted for two or three quarters, and will have a bearing on macro outcomes. (Note that the M3 data used in this note are from the Shadow Government Statistics research company.)

Month-to-month wobbles in money growth should not cause too much alarm. But, when a money growth trend lasts two or three quarters, it starts to matter. US M3 dropped in December after two positive months and a previous drop in September of some \$24b. M3 rose in January, but by a mere 0.3%. The decline in broad money growth has now persisted for long enough that it needs to be noted and discussed. As it happens, the stock market has had a rough start to 2016, while the strong dollar has been holding back manufacturing output. (Companies producing goods and services for the energy sector, particularly oil and gas, are in severe recession.)

Concerns about premature ‘quantitative tightening’ – which were expressed first in our September commentary – have to be repeated. The extent of QE/QT can be measured by banks’ cash assets. (The mechanics of QE are that the Fed credits sums to banks’ cash reserves, the banks credit identical sums to a Fed account and the Fed uses the balance in its account to buy securities. If the securities are bought from non-banks, their bank deposits – and the quantity of money – increase.) Banks’ cash assets fell in late 2015 and the fall has not been countered by asset purchases so far in 2016. Specifically, they were almost \$3,000b. in October 2014 and still averaged \$2,759b. in October 2015, but on 27th January they were \$2,497.3b. Whatever happens in the next few months, if we take the average level of banks’ cash reserves over say, the six months to March or April 2016, it will almost certainly be lower – by a few hundred billion dollars – than in mid-2015. In that sense, the Fed has allowed QT, the opposite of QE, to happen.

For the record, “loans and leases in bank credit” – a category in the US data which roughly corresponds with bank lending to the private sector in the UK – rose in January by slightly more than ½ %. But some banks – particularly the big banks – are obliged to trim expansion plans because of tightening regulation. Any Fed QT will restrain money growth and the US economy in 2016. The strong dollar is already a constraint on manufacturing.

Tim Congdon/John Petley
8th February, 2016

	% annual growth rate:	
	M3	Nominal GDP
1960 – 2014	7.6	6.7
1960 – 1970	7.7	7.7
1971 – 1980	11.4	10.7
1981 – 1990	7.7	7.7
1991 - 2000	5.6	5.6
2001 - 2010	7.1	3.9
Four years to 2014	4.0	3.9



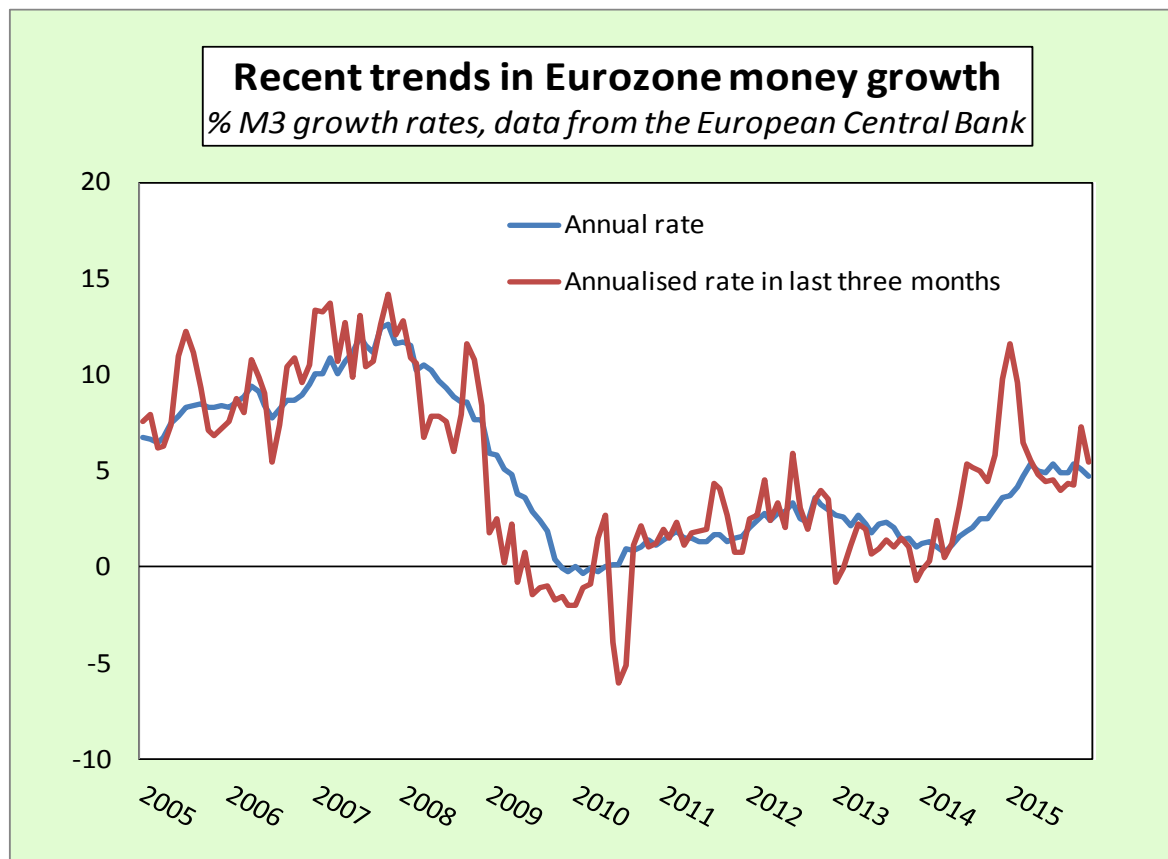
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Eurozone/Euroland

	% annual/annualised growth rate:	
	M3	Nominal GDP
1995 – 2014	5.3	3.1
Four years to 2014	2.6	1.3
Year to December 2015	4.7	n/a
Three months to December 2015 at annualised rate	5.4	n/a

Sources: European Central Bank and International Monetary Research Ltd. estimates



Satisfactory money growth to end 2015

Summary: In the final quarter of 2015, M3 in the Eurozone grew at an annual rate of 5.4%. Although down on the 7.2% annualised growth rate recorded in the three months to November, it is still satisfactory. The reason for the lower growth rate was a fall in the quantity of money of €3b. during December, following increases of €67b. and €61b. in October and November, respectively. However, with the annual M3 growth rate standing at 4.7% at the end of the year compared with 3.6% at the end of 2014, there is no doubt that the European Central Bank's "quantitative easing" programme has made a difference to broad money growth in the Eurozone. Apart from December's figures and a brief slowdown in the late spring and summer, broad money growth has now returned to the levels recorded at the beginning of the asset purchase scheme, where growth averaged more than €50 billion per month.

In a speech on 1st February, Mario Draghi, the ECB's president, observed that inflation across the 19-nation bloc was "tangibly weaker" than the ECB had expected. Back in December the ECB announced a six-month extension to its QE programme, taking it to March 2017. The rate on banks' cash reserves was also cut to -0.3%. While unlikely that any drastic additional measures would be announced so soon after these changes, Draghi said in the speech that monetary policy would be reviewed again in March. Broad money has been growing at a satisfactory rate in recent months, December's decline notwithstanding.

The key influence restraining money growth has been the weakness of bank credit to the private sector. As recently as September "credit to other (i.e., non-government or private sector) euro area residents" fell by an alarming €30b. October and November saw bank credit to the private sector increase by €17b. and €19b. respectively, but December saw another decrease of €30b. The demand for loans from households was strong enough in 2015 for the stock of mortgage lending to grow by 2.1%. Business lending remains disappointing. In December itself lending to both households and businesses dropped..

The ECB's reaction to the sluggishness of private credit growth has been the adoption of QE. Since March last year it has been purchasing securities from domestic non-banks (as well as banks and the foreign sector), and broad money growth has risen. But the lags are such that QE is unlikely to have a measureable and identifiable impact on inflation in a period of less than 18 months. Deflation is still affecting Spain, Greece and Cyprus. (However, Greece is seeing an improvement in its money figures, with annualised M3 growth up to almost 10% in the final quarter of the year.) It is too early to say if December's data is merely a blip. Draghi will most likely take further action in March if money growth does not recover, possibly increasing the scale of the asset purchases. There remain concerns about the vulnerability of banks to tighter bank regulation.

*John Petley
3rd February, 2016*

	% annual growth rate:	
	M3	Nominal GDP
1995- 2014	5.3	3.1
1995 – 2000	4.5	4.0
2001 – 2010	6.7	3.4
Four years to 2014	2.6	1.3

Money growth provides no explanation for January's market panic

Summary: Chinese M2 grew by 10.7% in the three months to November, a slight rise on October's figure, albeit significantly lower than the 21.6% in the third quarter of the year. It should be pointed out that November's figures were only posted to the People's Bank of China website at the very end of January, even though the website states that the monetary statistics were prepared on 20th December 2015. Expectations that the delay in their appearance were due to a further fall in money growth proved unfounded. Money growth is lower than it was three months earlier, but the recent delays in the publication of figures by the PBoC does not imply that growth levels are likely to fall further.

Last August stock market turbulence was countered by the PBOC making substantial loans to state-owned financial intermediaries such as the China Securities Finance Corporation. The money was used to fund purchases of equities. Newspaper reports suggest that precisely the same thing happened in January. Whenever equities are bought from non-banks, the result is an exactly equivalent increase in broad money. It is therefore probable that M2 growth may pick up at the start of 2016. However, the details of any dip in December 2015 cannot be known in the absence of further data from the PBOC. In spite of the government's continued efforts to rein in the shadow banking sector, bank lending has remained buoyant. A regulatory attack on banks – even on shadow banks – is deflationary in its wider macroeconomic effects.

Against that, October saw the prime lending rate cut for the fifth time, to a record low of 4.35%. In November, the stock of bank lending was 13.9% higher than a year earlier. The rate cuts had the desired effect in particular of reviving the flagging housing market, which had seen prices falling for much of 2015. Following a modest rise of 0.9% in the year to November, prices were rising at an average annual rate of 1.6% by the end of the year. 39 of the biggest 70 cities are now seeing prices rise, with the annual increase for Shanghai being 18.2%. Another area to have felt the beneficial effects of the rate cuts is the automobile industry. New car registrations hit a record 2,442,100 in December, almost double the number recorded in July.

There is nothing in the money figures to justify the turbulence in the stock markets last month. The authorities do not want a recession and have a number of tools at their disposal to prevent one. For example, given the low expectations for inflation in 2016, which is likely to remain well below the Government's 3% target, further monetary easing can be expected if the economy slows down.

John Petley
4th February, 2016

	% annual growth rate:	
	M2	Nominal GDP
1991 - 2000	20.3	15.8
2001 - 2010	15.2	12.8
Four years to 2014	14.1	11.6



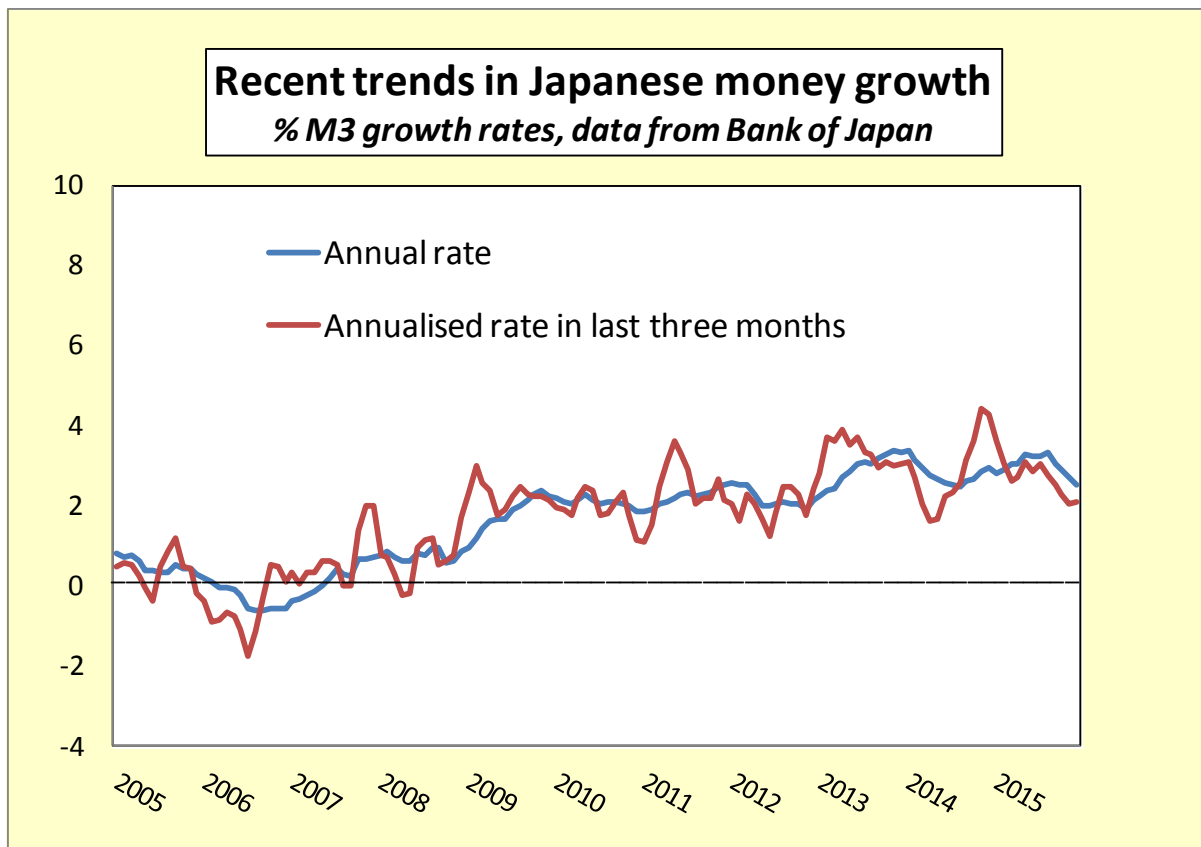
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Japan

	% annual/annualised growth rate:	
	M3	Nominal GDP
1991- 2014	1.9	0.4
2010 - 2014	2.5	0.8
Year to December 2015	2.5	n/a
Three months to December 2015 at annualised rate	2.1	n/a

Sources: Bank of Japan for M3 and IMF for GDP



Broad money growth remains sluggish

Summary: In the final quarter of 2015 Japanese M3 grew at an annualised rate of 2.1%. This is virtually identical to the 2.0% recorded in the three months to November, which was the lowest three-month growth rate for 18 months. A year ago the annual growth rate stood at 2.9%. For all the flaws in the so-called ‘quantitative and qualitative easing’ launched by the Bank of Japan in April 2013, it did raise broad money growth a bit, perhaps by 1% - 1½% a year. Even that effect appears now to be fading. The BOJ says that it continues to pursue a QE programme.

The BOJ focus in their QE announcements have been on the monetary base and bank credit, not on the quantity of money, broadly-defined. But any unbiased observer – unbiased by the clutter of pseudo-theoretical nonsense that has poisoned central bank research over the last 20 years - can see from the evidence that broadly-defined money is the relevant aggregate in the determination of Japan’s national income in nominal terms, just as it is in all countries. After the 2001 – 06 QE exercise Japan remained trapped in deflation. This time round, the monetary base has grown by 135% since April 2013 and deflation has been kept at bay, but only just. Once the effects of April 2014’s 3% hike in the sales tax had worked its way through the figures, the annual consumer price inflation rate drifted downwards from 0.6% in April to zero in September. At the end of 2015 it stood at 0.2%. January’s figure is unlikely to be any higher, given the recent fall in the price of oil, a commodity on which Japan is very dependent.

Japanese bank lending has been not been responsive to the excessive bank cash reserves created by QE. Throughout the programme Japanese banks have been sitting on their greatly-increased additional cash assets instead of regarding these assets as justification for faster growth of loan portfolios and securities holdings. Just before it began, in the year to March 2013, Japan’s banks were expanding their loan assets by 2½ %. Since then the typical figure has been 3%, a touch higher, but far from revolutionary. Neither businesses nor households seem to be showing any increased appetite for risk, in spite of the allegedly accommodative monetary environment. In the summer there had been an increase in the number of housing starts, but the year ended with numbers falling. Having said that, loan growth did pick up in December. It remains to be seen whether this was a flash in the pan.

It is no surprise that the BOJ announced additional monetary loosening measures last month, introducing a negative interest rate for commercial banks’ current accounts. The money numbers do not point to any improvement in Japan’s lacklustre economy any time soon, but they are not disastrous. Without QE the macroeconomic prospects would be worse.

John Petley
3rd February 2016

	% annual growth rate:	
	M3	Nominal GDP
1981 – 1990	9.2	6.2
1991 - 2000	2.4	1.3
2001 - 2010	1.1	-0.5
Four years to 2014	2.6	-0.3



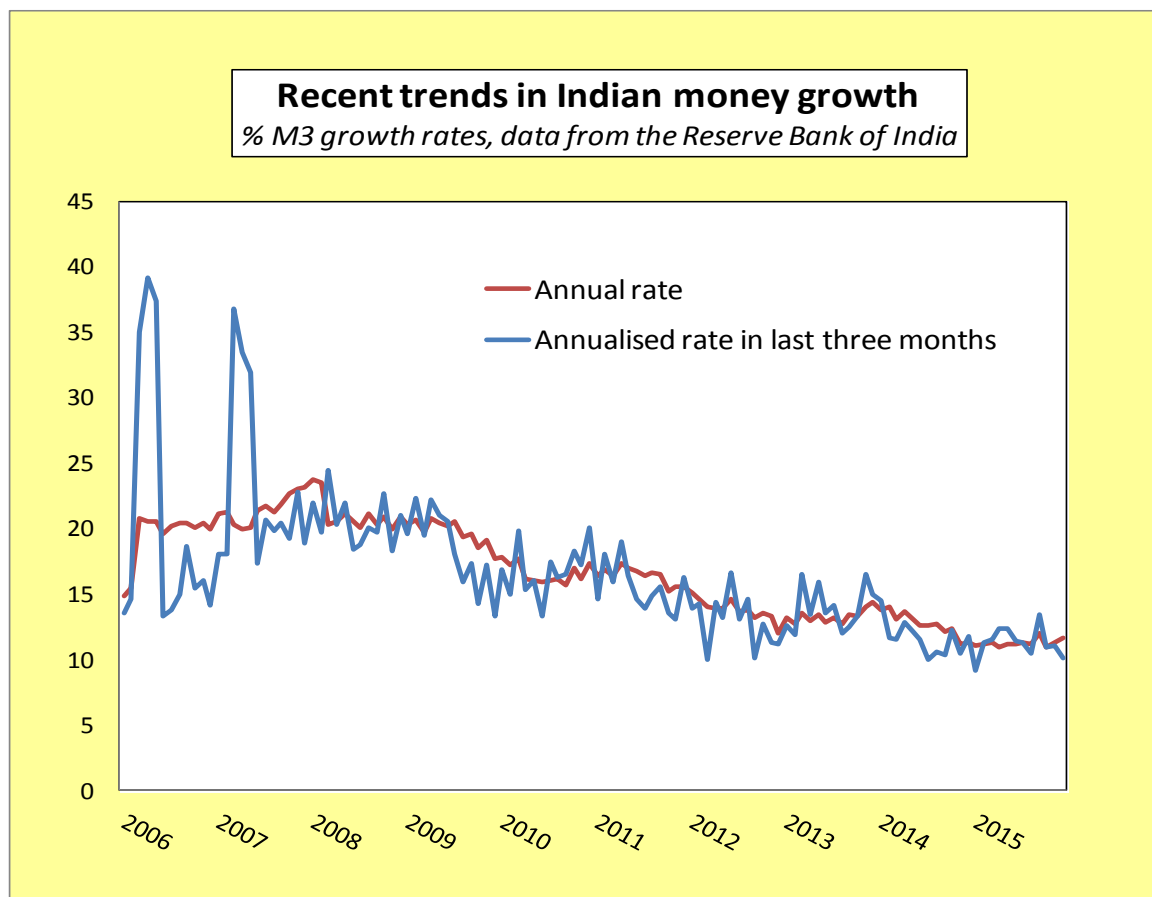
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India

	% annual/annualised growth rate:	
	M3	Nominal GDP
1991- 2014	16.5	13.8
2010 - 2014	14.2	14.4
Year to December 2015	11.6	n/a
Three months to December 2015 at annualised rate	10.1	n/a

Sources: Reserve Bank of India for M3 and IMF for GDP



M3 growth slows in final quarter, but remains stable

Summary: In the final quarter of 2015 Indian M3 grew at an annualised rate of 10.1%, the lowest quarterly increase in a year. Annual growth ended the year at 11.6%, higher than the 11.3% increase recorded at the end of 2014. This decline in broad money growth in December may be only a blip, interrupting a run of data which, during the past year have been pretty stable, fluctuating within very narrow bands. As the graph above shows, the recent pattern for roughly 10% - 11% a year Indian M3 growth is down on the levels seen in 2013 and 2014. When coupled with relatively low inflation by Indian standards over the past decade, 10%-a-year broad money growth seems more or less ideal.

Annual consumer price inflation recorded its fifth consecutive monthly increase in December. After falling to 3.7% in July, it ended the year at 5.6%. This is nonetheless still well down on the 8% annual CPI which was recorded less than two years ago. The adverse numbers have been largely driven by higher food prices, reflecting a poor monsoon. However, neither this nor the recent weakening of the rupee by some 6% (from around Rs. 64 to over Rs. 68 to the US \$) since August look likely to stoke inflation back to the levels of 2013 and early 2014. Furthermore, producer prices have been falling sharply in India for over a year. That has led to a major debate about the significance of different price indices.

The Reserve Bank of India appears to be under little pressure to ease rates further after four reductions in 2015. Although inflation has risen since the most recent rate cut in September, the latest monetary policy statement from RBI governor Raghuram Rajan, dated 2nd February 2016, suggests that inflationary pressures should ease off in the coming months. The most recent data from the banks indicate that the monetary loosening has had a slightly positive effect on balance-sheet growth. Deposit growth, which stood at 10.7% in the year to September, increased to 11.1% by the end of November, the most recent month for which figures are available.

The annual growth of the stock of bank lending has also been growing. In June, it fell to 9.3%, its lowest level in three years. Since then it has recovered gradually, rising to 11.3% at the beginning of January. This is still down on the annual 14% loan growth recorded as recently as February 2014, but an indication that the RBI's monetary loosening has achieved its desired effect. It took until October for the commercial banks to respond by cutting their rates, but the result was a sudden rise in the stock of bank lending at the beginning of December. Non-performing loans remain a cause for concern, however, with some estimates suggesting they amount to over 11% of total bank lending.

Better macroeconomic management has succeeded in overcoming some of the problems that were causing so much concern two years ago, notably high inflation rates. While the modest deceleration in money growth may continue into early 2016, India begins the year with broadly positive macroeconomic prospects.

John Petley
4th February, 2016

	% annual growth rate:	
	M3	Nominal GDP
1991 - 2000	16.9	14.4
2001 - 2010	17.3	13.6
Four years to 2014	13.4	12.9



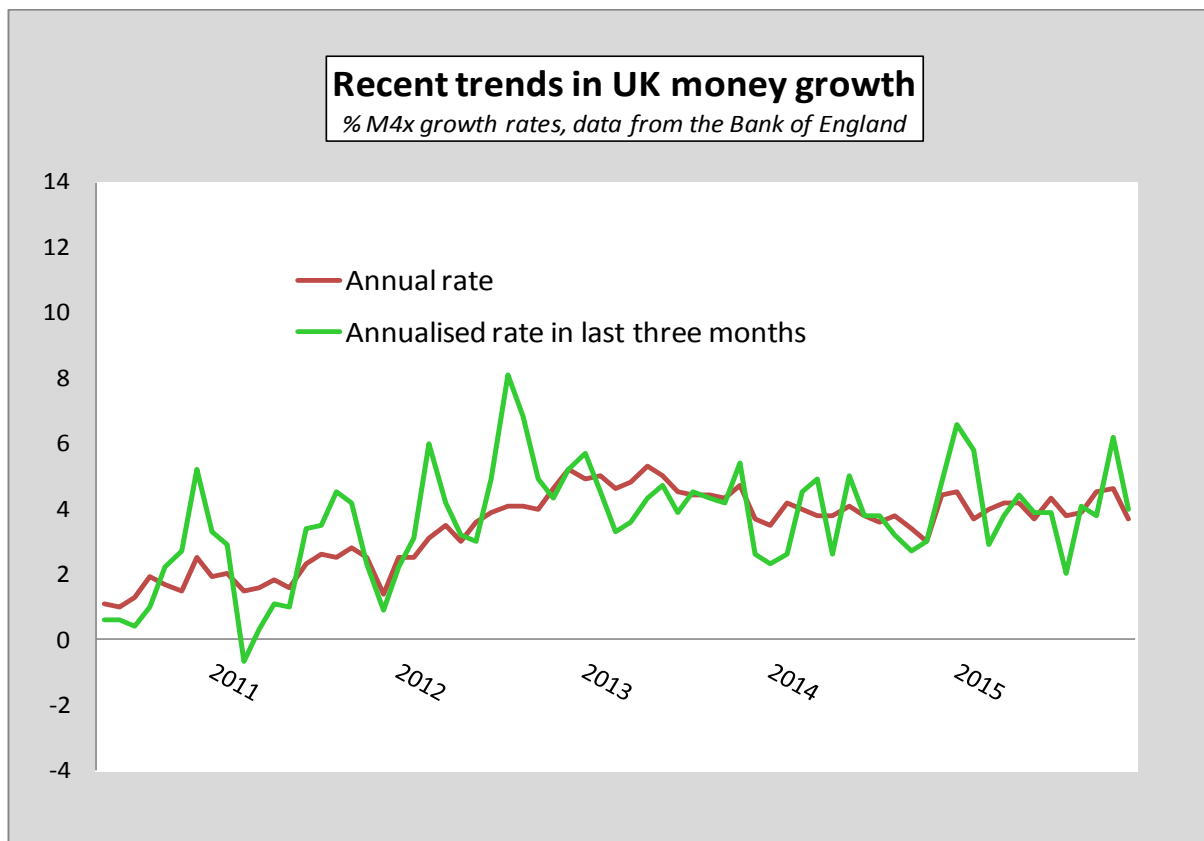
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UK

	% annual/annualised growth rate:	
	M4x/M4 before 1997	Nominal GDP
1964 – 2014	10.1	8.3
Four years to 2014	3.7	3.4
Year to December 2015	3.7	n/a
Three months to December 2015 at annualised rate	4.0	n/a

Sources: Bank of England and Office for National Statistics.



Modest money growth to end 2015

Summary: In December, the quantity of money, broadly defined on the M4x measure, increased by less than £4b. This was the smallest monthly increase since August 2015, when the quantity of money fell. In the final quarter of 2015 the annualised rate of broad money growth dropped to 4.0%, down on the 6.2% recorded in the three months to November. In the twelve months to December M4x was up by 3.7%, in line with the average growth rate in the previous four years. As the chart above shows, money growth in the UK has been running at a modest, but respectable level since the end of quantitative easing in 2012. There are no compelling signs of acceleration or deceleration.

For much of the period since the end of QE the annual rate of M4x growth has been remarkably stable, fluctuating within a narrow band between 3% and 5%. (Exceptions were in December 2012 and May 2013 when the annual growth rate rose above 5%.) The monetarist argument is that low and stable money growth over the medium term would result in low inflation, with demand and output growth steady. This is what has happened. The increase in the consumer price index has remained below 5% since August 2011 and has not risen above 2% since the start of 2014. In fact, the last few years have seen the lowest increases in both nominal GDP and the price level, over a sustained period, since the 1930s. The UK's sluggish recovery from the Great Recession is unsurprising in view of the weak money figures, but the last five years have in fact been an extraordinarily stable period.

2015 did see a steady and sustained growth in mortgage approvals, which rose from 61,100 in January to 70,800 in December, an increase of over 15%. The increase in the stock of mortgage lending was a more modest 2.6%. The stock of business lending has fared worse, with no increase during the year. In his 2015 Autumn Statement George Osborne announced an increase on the tax to be paid by smaller banks from 2016 onwards, a further deterrent to bank lending and thus a dampener on money growth. (Money is created when banks extend new loans to the private sector.)

The monetary indicators point to a slow recovery continuing into 2016. The annual inflation rate stood at 0.2% at the end of last year. Commodity prices, especially oil, have fallen further since the start of 2016. This strongly argues against a rise in base rates. However, the core annual inflation rate, excluding food and fuel, has been rising steadily, standing at 1.4% at December 2015. Furthermore, the rate of unemployment has been falling steadily through the second half of 2015, from 5.6% in June to 5.1% in November. The Monetary Policy Committee pays more attention to labour market data than to the money supply. It cannot have overlooked that the proportion of working-age people actually in work is now the highest since records began in 1971.

*Tim Congdon and John Petley
9th February, 2016*

	% annual growth rate:	
	M4/M4x	Nominal GDP
1964- 2014	10.1	8.3
1991 – 2000	7.5	5.9
2001 – 2010	7.0	4.2
Four years to 2014	3.7	3.4