Global Money Supply

While controlling the money supply is less topical than it use to be 20-30 years ago, the elevator pitch from any monetarist would still include control money growth. Many of the US's recent and current problems can, in part, be traced back to lax monetary policy at the start of the millennium.

In seeking to prop up the US economy after the dot.com crash and the terrorist attacks of 9/11, the head of the Federal Reserve, Alan Greenspan slashed interest rates and pumped liquidity into the US economy. The European Central Bank, the Bank of England and the Japanese all followed suit to varying degrees.

The resulting frothiness of bubbling financial markets has been linked to the excessive liquidity offered to the world economy by the central bankers of the developed world. The Yen carry trade is an example of how low interest rates in Japan enabled global investors to borrow in Yen and invest elsewhere in the world economy. Global flows of cash into US treasury bonds pushed up prices and lowered yields which helped to lower borrowings across the economy. This cheap credit then fuelled the consumption of homes, cars and various other goods and services.

Expansion of the money supply in the US hit 6% per annum, with the Euro area managing 11%. But these figures are massively overshadowed by money growth rates of 51% in Russia and 20% in India and China.

Money growth rates in emerging economies can be expected to be higher simply because their growth in GDP is also higher. But the growth in money supply is far higher than the growth in these countries' GDP. Fairly benign inflation rates would suggest that much of this extra cash is flowing overseas and being invested in the developed economies of the world. An excess supply of funds pushes down the cost of funds and makes borrowing in economies like the US much easier.

Of growing concern is that the expansionary monetary policies of emerging economies are unlikely to be corrected for economic reasons. Unlike many central banks in the developed world which are independent of politics, central banks in the emerging economies tend to operate under political guidance. The political quest for higher rates of economic growth, with less concern for inflation, is likely to result in a continued

expansion of money. The additional need to manage a fixed exchange rate may only add additional currency into the economy.

So the days of being able to watch the Fed, the ECB or the Bank of England in order to gauge levels of liquidity and monetary growth may be over. The growth of money from emerging economies into the global economy is proving to be an important aspect of monetary conditions, assets prices and the cost of credit.

Questions

1. According to monetarists, what is the link between money supply and inflation?

2. Explain how monetary policy can regulate economic activity?

3. How does an increasing supply of liquidity from the emerging economies of the world impact the monetary transmission mechanism in the developed world?

4. If the US sought to tighten monetary policy, what would happen to the flow of funds from the rest of the world?