Money Supply Is On The Rise

The UK economy has been growing for over a decade. Growth has been stable and so too has inflation. This benign economic environment has been attributed in large part to the role and success of the Bank of England in targeting consumer price inflation through interest rate policy.

Despite the positives there is concern that inflation may be about to gather pace. Money supply figures are growing and monetarists think that means inflation. More precisely the UK M4 measure of money is on the rise. Last year's growth rate in M4 was 13.8%. Milton Friedman, the figurehead of modern monetarism argued that inflation is always and everywhere a monetary phenomenon. However, since the mid-1980s, stating a money supply target has been unpopular. Rather, governments have targeted exchange rates and more latterly inflation. But the deputy governor of the Bank of England has said that monetarism, cast into the wilderness after the rocky ride of the Thatcher years, was “not dead but only resting”.

Although the deputy governor prefers inflation targeting, he is concerned that the rate of growth of money and credit is too high and he is not alone - the governor also stated the same to the treasury select committee of Parliament.

Why has money returned to the policy debate? M4 as a measure of broad money can be seen to be driven by credit. While including notes and coins, M4 also includes bank accounts. So, controlling M4 is as much about controlling cash as it is about controlling lending. Increase interest rates and you should be able to control M4.

The quantity theory of money would suggest that a 14% rise in the money supply, with only a small rise in real GDP will be disastrous for inflation. Fortunately, the velocity of circulation has not been constant and in fact has been falling. In the last 15 years M4 has increased 200%, while inflation has only increased 45%.

But the concern persists. M4 measures something in our economy and so it should also determine something in our economy. One link is through asset prices. Lax lending has fuelled investment in property and shares, something which has also occurred in the US. As asset prices rise, there is a risk that extracted gains may fuel additional consumption and lead to an increase in consumer price inflation.

Questions

1. What are the key differences between Keynesian and Monetarist economists?

2. Which camp of economists do you feel are more correct in their assumptions?

3. What evidence in the UK is there to support the monetarist’s view of macroeconomic relationships?