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Something To Worry About

eResearch Corporation is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis discusses consumer confidence, money-flows, and Fed action on interest rates and inflation.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Something to worry about**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
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Wednesday, August 30, 2017

Something To Worry About

Back in early 2014, I argued that the return of confidence was something to worry about, since that would mean reduced demand for money, and that, in turn, would make life difficult for the Fed. If the Fed did not respond to declining money demand with sufficient vigor (e.g., by pushing interest rates higher and/or reducing excess bank reserves), that could sow the seeds of rising inflation and eventually lead to another recession.

As I have noted many times on this blog, severe Fed tightening designed to combat rising inflation has been the proximate cause of nearly every recession in the past 50 years. Here is one such post, "How to know if Fed policy is a threat to growth."

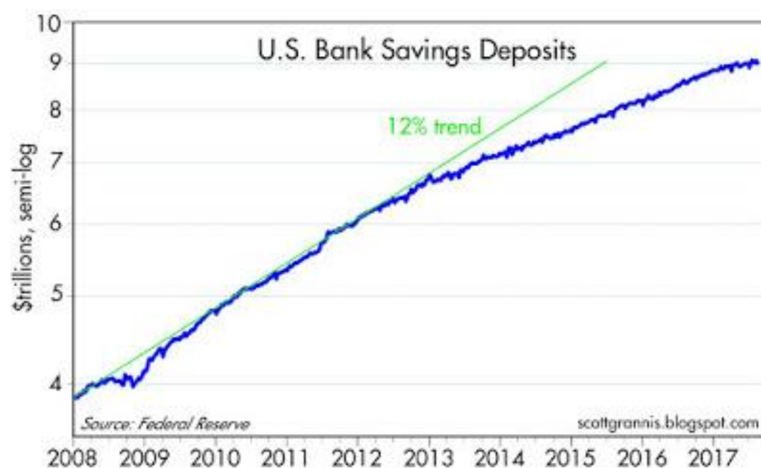
My concern was obviously premature at the time, but it has been in the back of my mind ever since, and I am starting to get worried again. Consumer confidence has jumped in the past year, and the demand for money has weakened more than at any other time in the current recovery. My concerns may again prove premature, but this is not a trivial issue and, thus, it bears close scrutiny.

According to both the Conference Board and the University of Michigan surveys, consumer confidence (chart below) has risen significantly in the past year. It is not yet at all-time highs, but it is certainly a good deal better that it has been for the past 8-9 years.

Small business optimism (see below) has surged since the November election. "Animal spirits" are on the rise.

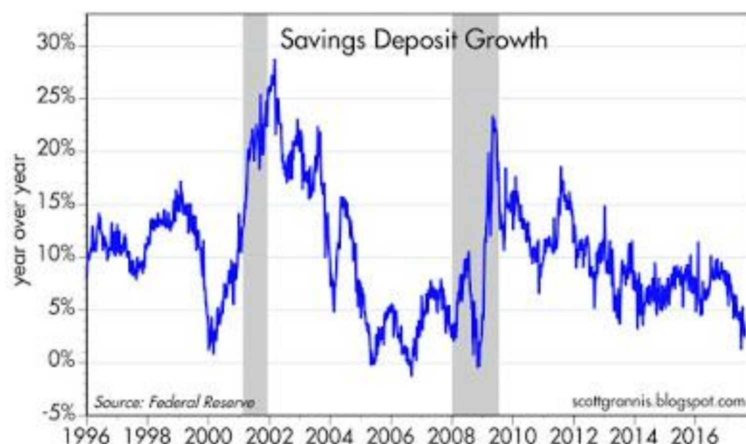
First-time claims for unemployment relative to total pay-rolls have fallen to the lowest levels in recorded history. This means that the chances of a worker being laid off today are lower than ever before. Job security, in other words, has never been higher. And let us not forget that the unemployment rate has dropped to 4.3%, and it has rarely been lower in recent decades. It is not surprising, then, that confidence is rising, and for good reasons.

As the two charts below show, the growth of bank savings deposits has slowed significantly in the past 6-7 months, after growing strongly ever since early 2009. Recessions and economic turmoil almost always make bank savings deposits attractive, especially relative to riskier alternatives. Demand for safety typically declines in the latter stages of an expansion, when people's appetite for risk rises in line with rising confidence. So it is normal for rising confidence to be reflected in slower growth of bank deposits.



BW: *In the chart above, it might be realistic to expect the 12% trend to slow as the base gets ever bigger.*

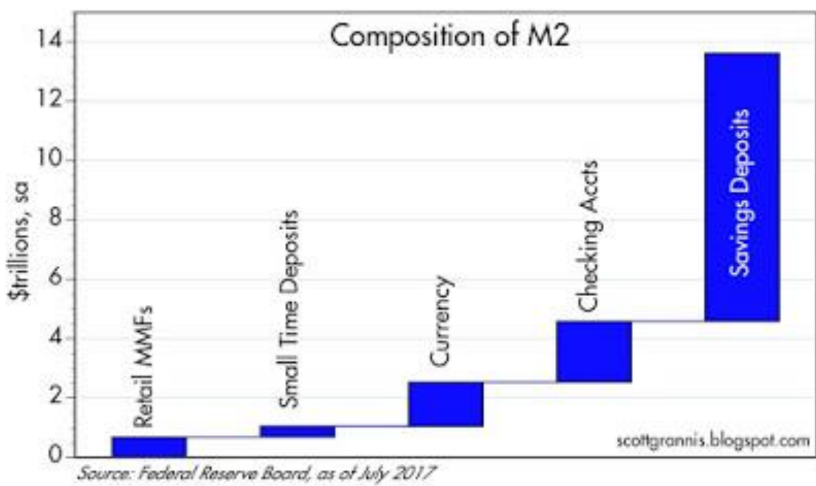
Bank savings deposits in the past six months have risen at an annualized rate of only 2.5%—that is the lowest rate so far in the current business cycle expansion. Since bank savings deposits comprise about two-thirds of the M2 money supply, slow growth in savings deposits has been matched by a slowdown in the growth of the money supply, which has registered annualized growth 5.3% over the past six months, down from the 6-8% rates of growth that have prevailed over the past six years. Declining growth in the money supply does not mean, however, that the Fed has been tightening — more likely it means that the demand for money has been weakening.



The next chart is arguably the most powerful illustration of how strong money demand has been in the past 8-9 years: the ratio of M2 to nominal GDP.

Nominal GDP is a proxy for national income, and M2 is arguably the best measure of readily-spendable money. Think of this chart as a measure of how much money the average person wants to hold relative to his annual income. It has risen from 50% prior to the Great Recession to 70% today. That is huge, and one of the defining characteristics of the current business cycle expansion — a massive increase in the demand for money.

People now have parked an unprecedented amount of their annual cash flow in retail money market funds, small time deposits, currency and bank savings deposits—and the bulk of the increased money holdings are in the form of bank savings deposits. What's even more impressive, however, is that none of these vehicles pays much in the way of interest. People are holding lots of money not because they like the return on money, but because of its safety.

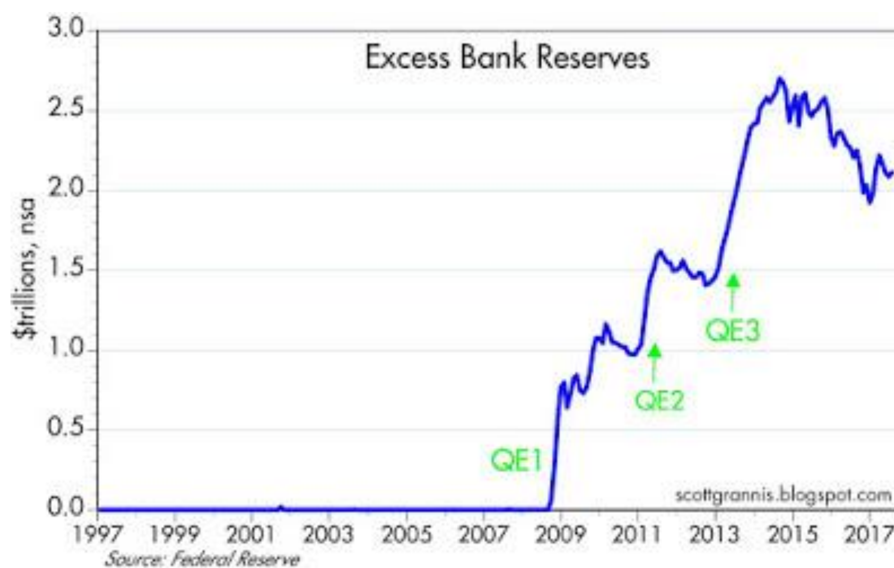


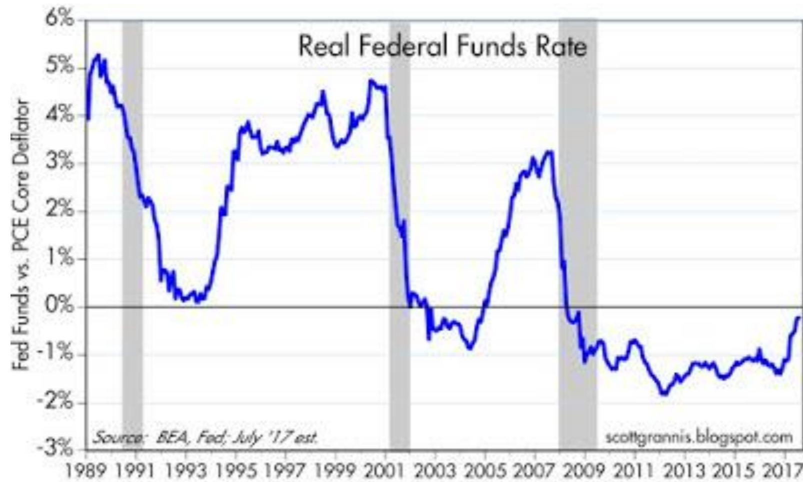
This huge increase in the demand for money also explains why QE was not inflationary. The banking industry, faced with huge infusions of deposits, was happy to lend all that money to the Fed in exchange for the new bank reserves that the Fed created via its QE operations. People wanted more money, and banks wanted more reserves (banks were very risk-averse, just as most people were), and QE effectively accommodated that change in preference. If the banks had not wanted to lend all that money to the Fed, but instead to the private sector (and assuming the private sector had wanted to borrow a lot more), the result would have been a massive expansion in the amount of money in the economy, and a lot more inflation. But that did not happen, thanks to increased money demand.

We now may be on the cusp of a reversal in the huge increase in money demand. With increased confidence, the public is becoming less desirous of accumulating money balances. The growth of bank savings deposits has slowed significantly, and it is now less than the growth of incomes.

People may now be desirous of decreasing their holdings of cash relative to incomes. But, since cash cannot disappear, the public can only accomplish a reduction in their relative holdings of money by bidding up the prices of other things. Less demand for money means a lower price for money and a higher yield on money, plus higher prices for things and, eventually, higher nominal incomes. That is another way of saying that a decline in money demand is likely to result in an increase in inflation—unless the Fed takes offsetting measures.

Fortunately, the Fed is already in the process of accommodating this new shift in the demand for money. They have raised nominal and real interest rates on money (though the real interest rate on bank reserves is still less than zero, as shown on the chart on the next page), and they have allowed excess bank reserves to decline from a high of $2.7 trillion to now $2.2 trillion (on chart below). But these are still baby steps.





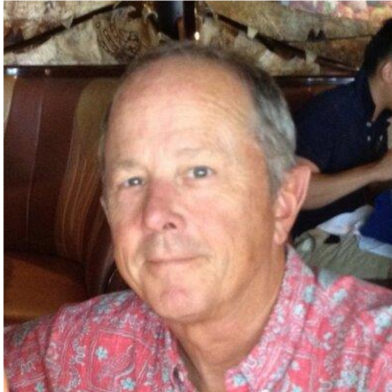
I note the recent rise in gold prices and the decline in the value of the dollar. Both are symptomatic of an excess of money relative to the demand for it and, thus, they could be evidence that the Fed is falling behind the inflation curve.

Much hangs on just how much and how fast the public's demand for money declines, and how fast and how much the Fed is able to offset that by raising interest rates and reducing excess reserves in the banking system.

So far things look OK, but it certainly pays to keep an eye on these developments.

BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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