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Inflation Fears Offers the Fed a Chance to Modernize with Money

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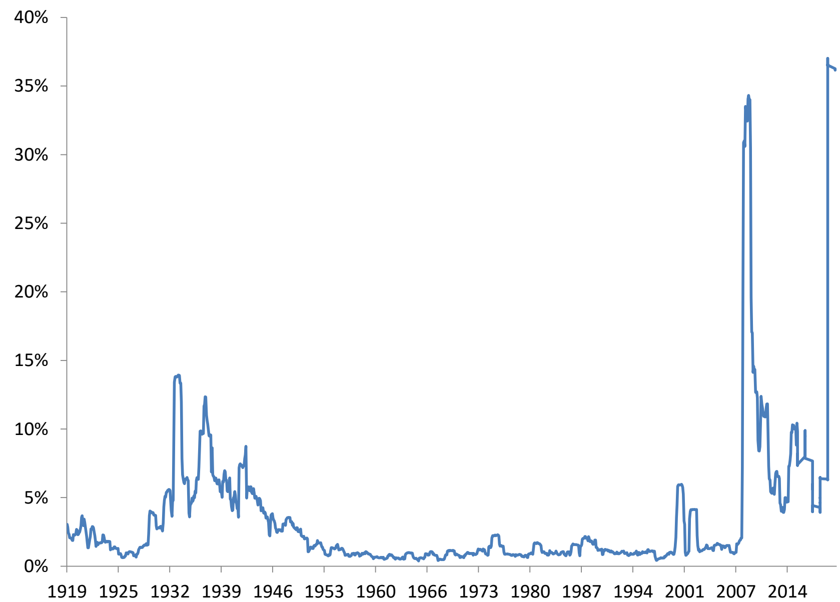
Investors and the public are right to worry about inflation. Yet, measures to predict the impact of Fed policies on inflation, the economy, and financial stability are of deteriorating quality and being disregarded.

Market participants and especially officials must recognize that quantities of money matter now more than ever. Expansion of the Fed's balance sheet is 200% more than what was needed to rescue the economy from a Great Depression and fight a world war ending in 1945. Similarly, **gyrations of the Fed's balance sheet are at heights not witnessed in over 100 years.** Balance sheet volatility jumped from averaging 2% per year between 1913 and 2007 to 10% between 2008 and the pandemic, and 33% since March 2020 (see Figure 1).

Figure 1. Annualized Volatility of the Fed's Balance Sheet hits a 100-year Record



Source: Federal Reserve Bank of St. Louis and Center for Financial Stability.

So, if one were to look solely at interest rates, such as the Federal funds rate, one would conclude that monetary policy has been relatively inactive. This would be a big mistake.

After many twists and turns in the formulation and communication of monetary policy strategies over the last 13 years, resolution of two ironies offers the Fed a path for modernization.

With thanks to William A. Barnett, Sheila Bair, William R. Rhodes, and John B. Taylor for comments. Views and mistakes are my own.

First, as money is increasingly driving economic and financial market activities, the Fed seems less committed to actually measuring monetary quantities – let alone, incorporating money into policy. This is deeply ironic in an era where big data offer society great advances and officials the capacity to broaden their vision.

Second, another irony is that Congress mandates in Section 2A of the Federal Reserve Act that the Fed "shall maintain long-run growth of the monetary and credit aggregates commensurate with the economies long run potential." Here, the Fed is moving in the opposite direction of the mandate in section 2A by increasing the money supply far in excess of long-run growth.

Since 2012, the Center for Financial Stability (CFS) has partially filled this void by offering the public alternative monetary measures – pioneered by Professor William A. Barnett.[1] CFS monetary aggregates recognize that varying forms of money provide users with differing abilities to transact. For instance, cash can be readily used to buy a cup of coffee, whereas a Certificate of Deposit or Repurchase Agreement cannot. Yet, the later are vital for economic activity and financial stability. Here, CFS Divisia adds and weights different types of money by the value of the service each provides the economy. The indicators provide a more complete perspective by covering a broad range of money-like instruments offered by banks and nonbank financial institutions alike.

From this work, we now know that measuring activity in the financial system and putting money on the Fed's dashboard would <u>better predict</u> both inflation as well as financial instability risks.[2]

In 2006, the Federal Reserve halted publication of its broadest monetary aggregate (M3). The timing was terrible. **The Fed's M3 included repurchase agreements – financing vehicles at the epicenter of the Global Financial Crisis in 2008.** Hence, critical data were no longer available for the public or the Federal Reserve itself. Our calculations show that M3 growth accelerated in a nearly linear fashion between 2003 and 2008 from 5% to over 15% year-to-year.

On March 9, 2006, the Fed noted that:

> *"<u>M3 does not appear to convey any additional information</u> about economic activity that is not already embodied in M2 and <u>has not played a role in the monetary policy process for many years</u>. Consequently, the Board judged that <u>the costs of collecting the underlying data and publishing M3 outweigh the benefits</u>."*[3]

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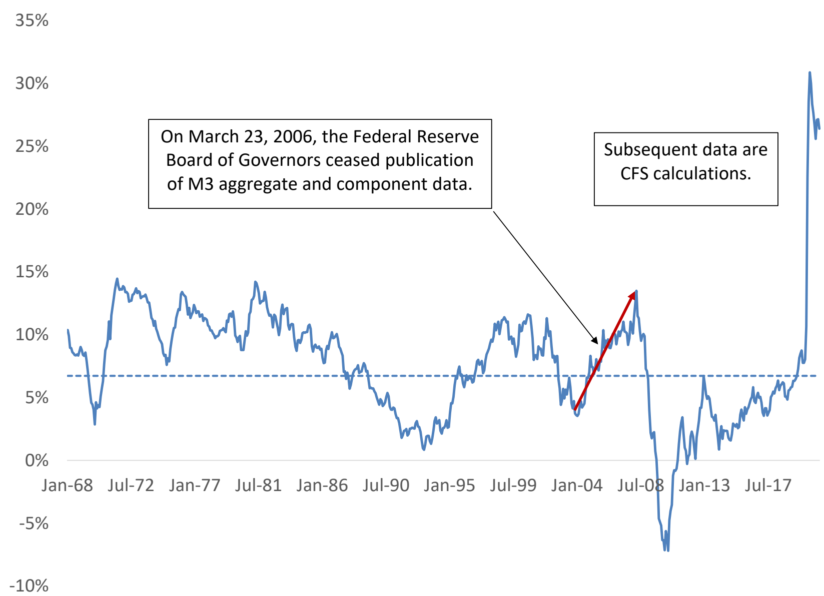
[1] William A. Barnett, "Getting It Wrong: How Faulty Monetary Statistics Undermine the Fed, the Financial System, and the Economy, MIT Press, 2012.

[2] Goodman, Lawrence, Why CFS Divisia Money Matters, Now!, Remarks at The Society of Economic Measurement Conference, Thessaloniki, Greece, July 8, 2016 - http://the-cfs.org/research/why_cfs_divisia_071316.pdf.

[3] Federal Reserve Statistical Release, Discontinuance of M3: Money Stock Measures, March 9, 2006 - https://www.federalreserve.gov/releases/h6/discm3.htm.

Warning lights were flashing! It is no wonder that the Fed missed the financial crisis (see Figure 2).

Figure 2. M3 Data were Suspended; When Needed before the 2008 Crisis



Source: Federal Reserve Board and Center for Financial Stability.

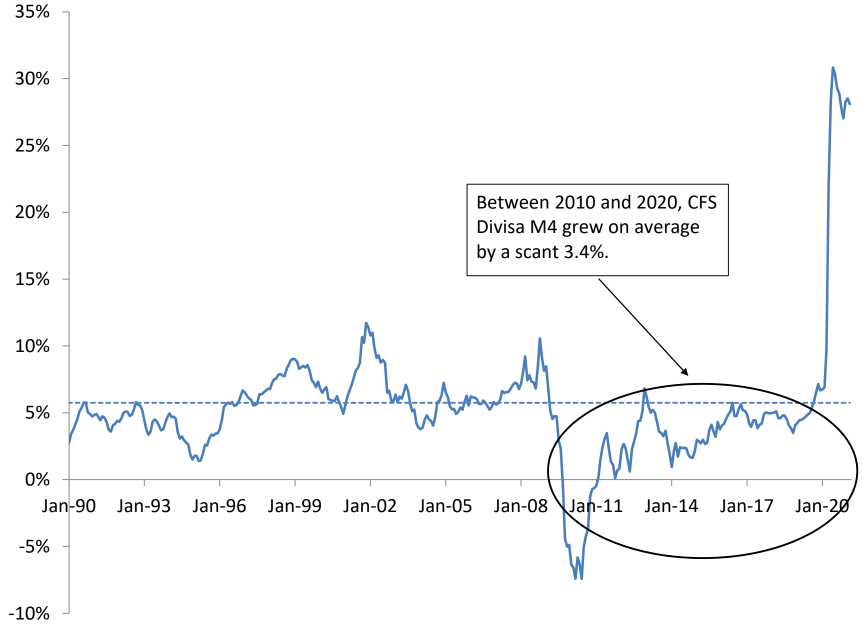
Between 2010 and 2020, many opposed Quantitative Easing (QE) due to inflation risks. Yet, the broadest measure of money and the financial system (CFS Divisia M4) grew by a scant 3.4%. Fed injections of money pushed asset prices higher rather than being channeled into the real economy (see Figure 3). Inflation was nowhere in sight!

Worse, unfulfilled inflation fears over the last decade serve as fodder for many who choose to ignore history and suggest that endless monetary and fiscal expansion will not result in inflation. This story is moot, if those in favor of virtually unrestrained monetary and fiscal ease examine the data.

In recent weeks, Federal Reserve monetary data took another step backwards. "Savings deposits" and "other checkable deposits" are now lumped together.[4] Worse, bank deposits are now reported monthly rather than weekly and with a long lag. So, as the world becomes filled with more granular data and government agencies request ever greater quantities of data from banks and nonbank financial institutions, the Federal Reserve is moving in the opposite direction with its own reporting.

[4] https://www.federalreserve.gov/feeds/h6.html

Figure 3. Inflation was Nowhere in Sight between the 2008 Crisis and Pandemic



Source: Federal Reserve Board and Center for Financial Stability.

Tragically, this comes at a time when quality monetary data are needed more than ever to understand inflationary forces. Warning lights are flashing. CFS Divisia M4 has grown on average by 22% year-to-year since April 2020 and most recently at 28%.[5]

So, yes, investors and the public are right to fear inflation.

Going forward, the Fed must broaden its vision and modernize policy to better understand the transmission of its actions through markets and the economy. Monetary quantities offer the key to better calibrate policy. If the Fed does not provide and use the right data, the public and the Fed itself will have no clue whether this inflation threat is real or not.

[5] http://www.centerforfinancialstability.org/amfm/Divisia_Feb21.pdf