

# BARRON'S Online

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## The Case for Credit

Traditional monetary theory has become irrelevant. Time for a new measuring stick.

By **ROBERT MARKS**

**IT'S TIME TO OVERHAUL TRADITIONAL** monetary theory. Generations of economists have told us that the Fed controls the monetary base and, through it, the money supply. In theory, the Fed buys (or sells) government securities in order to increase (or decrease) bank reserves. Banks then make (or

reduce) loans in a multiple amount of the change in reserves, and the deposited proceeds (or withdrawals) of those loans expand (or contract) the money supply.

Because of far-reaching institutional changes, financial innovations, and altered savings habits, however, theory and reality have differed for decades. Since 1963, for example, the Fed's holdings of government securities rocketed from \$34 billion to \$687 billion, while bank reserves -- which should have increased by a similar amount -- rose from \$21 billion to only \$46 billion (see rows 1 and 2 in the table). And reserves have declined by \$18 billion during the last 16 years, despite the Fed's purchases of \$449 billion of Treasury securities.

In other words, a big part of the theory's foundation has crumbled. Not only do reserves not rise and fall in line with the Fed's holdings of government securities, but they also have become essentially irrelevant. Total reserves have fallen by 28% since 1988, while all measures of money and credit have grown by leaps and bounds (see rows 5 through 9 in the same table).

In contrast to the monetarists' outdated belief, the Fed buys government securities mainly as collateral for issuing Federal Reserve notes -- otherwise known as dollars. In the last 40 years, domestic and foreign demand for U.S. currency soared from \$34 billion to \$703 billion (row 3). The Fed readily accommodates all global dollar demands. And all those Federal Reserve notes are Fed liabilities that by law have to be backed by certain assets -- including Treasury securities.

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**Currency Held Abroad**

Currency now makes up nearly 95% of the monetary base (compare rows 3 and 4). Although the Fed doesn't regularly report how many dollars circulate abroad, it has estimated in years past that the share is more than 60%. There's no way, however, that more dollars held in Iraq, Russia, Colombia, Hong Kong and elsewhere somehow help the Fed control the domestic money supply. Nor is it clear how more currency in anyone's pocket anywhere expands M2 and M3, the two broader measures of the money supply.

All in all, then, the prevailing theory has long lacked factual support. Purchases of government securities don't increase reserves; reserves have become irrelevant; the currency-bloated monetary base is meaningless; and the money multipliers don't compute. But the theory is still widely taught, is deeply entrenched in conventional wisdom, and is embraced by Fed officials.

There is, however, another view, grounded in reality and better adapted to continuing institutional changes and financial innovations. It focuses on total domestic credit (Row 9) from the Fed's "Flow of Funds" accounts. That credit aggregate includes the outstanding debt of all nonfinancial businesses, households, and the federal, state, and local governments.

### Clear Link

Why credit? There always has been a clear link between money and credit through the lending process. Although those loans were typically glossed over in descriptions of how the money supply expands, they provide more timely, comprehensive, and relevant financial and economic information than any version of money.

Nearly all borrowed funds are used right away to buy something, whereas big parts of the higher-order money measures represent savings (the store of value components) that aren't buying anything. So there is a more direct and stable relationship between the growth rates of credit and national income than the changing lags between the growth rates of different money measures and gross domestic product.

Moreover, at \$23.4 trillion, credit's magnitude dwarfs money (with M1, the narrowest measure of the money supply, at only \$1.3 trillion, M2 at \$6.3 trillion, and M3 at \$9.3 trillion). All that purchasing power ripples well beyond the output of goods and services. Corporate share repurchases and mergers are often credit-financed, for example, and rapid growth in mortgage loans can validate higher prices for existing homes -- a manifestation of inflation that isn't recorded by the consumer-price index or GDP deflator.

By switching the focus from money to credit, only one word need be changed in the traditional monetarist definition of inflation: too much credit chasing too few goods and services. In fact, we will find a simpler and stronger correlation between excess credit and measured inflation than that shown by prevailing monetary analysis.

<p><b>Table:</b> <a href="#">Credit Replaces Money</a><sup>1</sup></p>
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Furthermore, a credit orientation encourages more awareness of the balance sheets of lenders and borrowers. Most of the components of M1, M2, and M3 represent the liabilities of financial intermediaries (including checkable deposits and

savings accounts). Because monetarists pay relatively little attention to the loans funded by those liabilities (i.e., to the assets of those intermediaries), they tend to ignore the financial health of both lenders and borrowers. For monetarists, inflation is the only relevant consequence of rapid money growth. For credit analysts, excessive money and credit growth may also increase deflation risks if too many loans go bad, wipe out the lenders' capital and erode depositors' wealth, as happened in Japan.

There are sound reasons for policy makers and economists to concentrate more on credit and less on the outdated assumptions and relationships of traditional monetary theory. Although the narrow measure of money matters as the final medium of exchange, total credit counts for understanding the business cycle, inflation and the financial markets.

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## Credit Replaces Money

Inflation often is defined as too many dollars chasing too few goods and services. Historically, one way to gauge inflation risks was to track the Fed's expansion of the monetary base and money supply measures. But over the past 40 years, as the table shows, those traditional indicators have become increasingly less relevant. Nowadays, the economy runs on credit—about \$23.4 trillion worth at present. And too much credit, relative to real economic growth, provides a much better guide to inflation pressures, as shown by the chart, than does any measure of money.

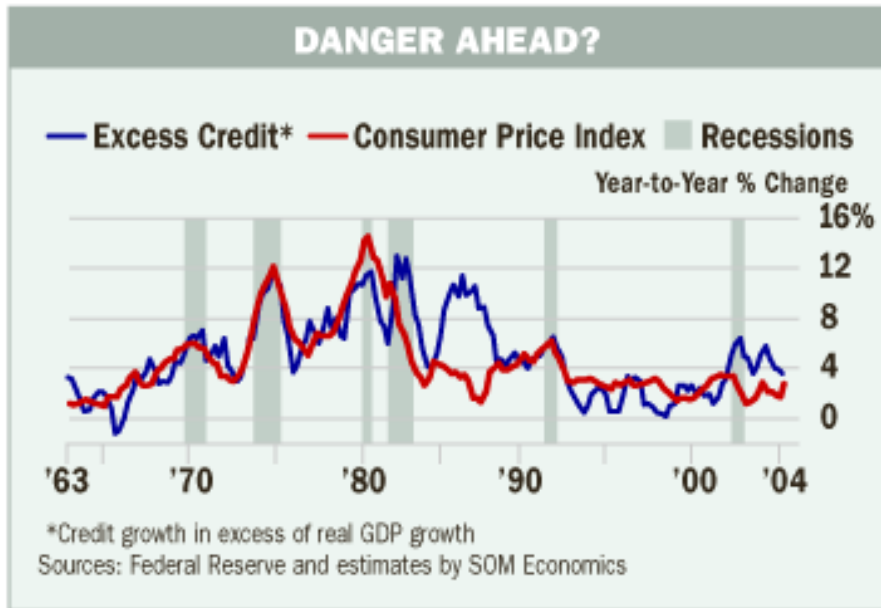
### Selected Monetary & Credit Measures

	Change*				
	Dec. 1963*	Dec. 1988*	June 2004*	1963- 2004	1988- 2004
<b>1. Fed's Govt.</b>					
<b>Securities</b>	\$34	\$238	\$687	\$653	\$449
<b>2. Bank Reserves</b>	21	64	46	25	-18
<b>3. Currency</b>	34	219	703	669	484
<b>4. Monetary Base</b>	55	283	749	694	466
<b>5. M1</b>	153	786	1,330	1,177	544
<b>6. M2</b>	393	2,994	6,290	5,897	3,296
<b>7. M3</b>	406	3,928	9,260	8,854	5,332
<b>8. Bank Credit</b>	251	2,435	6,560	6,309	4,125
<b>9. Total Nonfin'l Credit</b>	879	9,514	23,410	22,531	13,896

\* Billions

### Danger Ahead?

Inflation is primarily a reflection of too much credit relative to real GDP growth.



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