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The fight over money supply

The Fed's high interest rates have an extremely interesting relationship to M2-B growth.

The Federal Reserve Bank of New York, in its latest quarterly review, has kicked off a storm of controversy over the Fed's ability to control money supply. The New York Fed's publication cited a study by Almarin Phillips of the University of Pennsylvania claiming that during a period of high interest rates and high inflation, the velocity of money will accelerate greatly, thus supporting a much greater level of GNP growth.

The Fed's study claims that on a revised basis, M1-B money supply actually grew by only 1.1 percent annual rate of growth, while the velocity of money increased by 18 percent during the first quarter. Indeed, using the data provided by Phillips, it can be shown that the turnover rate of demand deposits in major New York City banks rose by nearly 16-fold, from about 50 times a year in 1955 to about 800 times a year in 1980. In 1955, an average balance of $100,000 in a checking account resulted in total check payments of $5 million, but in 1980 the same balance resulted in total check payments of $80 million. In practice, during high inflation and high cost of money, people cash checks as quickly as possible.

Professor Phillips, himself a monetarist, concludes that the high inflation and interest rates of recent years "have made the control of inflation through the use of monetary restrains an impossibility." Monetarist Phillips convincingly demonstrates that monetarism doesn't and can't control inflation.

But while the Phillips study is extremely useful, there is more than a bit of duplicity in the attempt to use the study to pass off on the public, as the New York Fed piece attempts to do, that money supply M1-B actually grew by only 1.1 percent in the first quarter.

Why has there been such a major attempt to revise downwards the money supply growth figures from 15 percent to just 1.1 percent? The answer is that for parallel reasons the Federal Reserve System and President Reagan would like to calm the money markets through the story that money supply is under control, when in fact is isn't. President Reagan needs to convince people that money supply growth is abating, because otherwise he will have trouble getting his own tax cut package, or even a compromise, through Congress.

Hence, according to a Mont Pelerin Society member who dined with quack economist and monetarist Milton Friedman immediately after President Reagan and Federal Reserve Board Chairman Volcker had their "showdown meeting" May 18, "both agreed that they needed to allay the fears and suspicions of the market about the growth of money supply." This individual, who worked on the Reagan emergency economic package, is himself writing a study intended to show all the "technical causes" why money supply is out of control. For example, his study shows that there was money transferred both out of checking accounts, which is included in M1-B, but also savings accounts, which are counted as part of M2-B, into interest-bearing NOW/checking accounts. As the latter are counted in M1-B, this would tend to explain some of the swelling of M1-B. But why did M2-B grow at a greater than a 13 percent rate?

The answer is straightforward. The high interest rates are both attracting flight capital from Europe and encouraging foreign borrowings by American firms through legal and unorthodox channels. The dollar, artificially buoyed by the interest rates, is attracting additional money into dollar paper. Thus, *Volcker's high interest rates are swelling the money supply*—a conclusion that neither Reagan nor Volcker is willing to issue.

The fight over money supply is mirrored in the expectations over interest rates. To calm the markets and build support for the Reagan economic package, Treasury Undersecretary Beryl Sprinkel told Congress May 28 that "interest rates have peaked. They will come down soon."

But, claims Henry Fowler, Johnson's Treasury Secretary and a senior partner of Goldman Sachs, "I know what Sprinkel means. Interest rates will come down very little and then go up again. I no longer give interest-rate disarmament a chance." Fowler's "prediction" represents a political commitment to stop Reagan's economic package from succeeding. Given the real explosion of money supply, Fowler's "prediction" is probably close to the truth.

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