TOO MUCH MONEY CHASING TOO FEW ASSETS SPELLS DANGER!

Tim Congdon

Does high money growth matter for the future rate of inflation? The question – over which so many intellectual battles have been fought – has again been made topical by the surge in UK money supply growth in the last two years. In September 2004 the M4 measure of money, which includes nearly all bank and building society deposits, was 9% up on a year earlier; in September 2006 the corresponding figure was over 14%. A naïve but not silly hypothesis is that national income and the price level follow money supply growth on a one-for-one basis. If so, the message of the 5% jump in the rate of M4 growth is very worrying: it is that inflation will accelerate sharply in 2007 and 2008.

Fortunately, the hypothesis of a one-to-one link between money and prices is over-simplified. The money/inflation relationship is medium-term and rather imprecise. It works through a so-called 'transmission mechanism' of some complexity. In the short run a better guide to the likely direction of inflation comes from 'the output gap': the difference between the actual and trend levels of output. At present UK output may be above trend, but rises in unemployment in the last 18 months suggest that any excess over trend is small. It follows that there is no big and immediate threat to the official inflation target.

But – as the late Milton Friedman insisted – money does matter. A repetitive feature in the UK's past cycles is that an upturn in money growth has taken several quarters, or even a few years, to have its full impact on consumer prices. Instead, one of the earliest responses comes in asset prices. People try to get rid of excess money by buying more unit trusts and life insurance, so putting it in the hands of financial institutions, and financial institutions in turn try to get rid of excess money by purchasing shares.

But, if one institution buys, another has to sell. The seller's bank balance goes up by the same amount that the buyer's goes down. However, the purchases and sales of shares are not futile, despite their resemblance to a game of musical chairs. The excess supply of money implies an excess demand for shares and a rise in share prices. The effect of rising share prices is to lower the ratio of money in portfolios, so bringing investors back to a situation in which their money holdings are not too large relative to non-money assets.

Many commentators write as if the stock market were remote from the day-to-day realities of business life, and as if share price movements had no effect on consumption or investment. That view is false. Investors are constantly buying and selling assets in a search for better returns. If share prices rise and dividend income is unchanged, the rate of return falls. So investors sell shares and buy houses or commercial property or other assets. A sustained upturn in money growth is therefore associated not just with a buoyant stock market, but with asset price strength in general.

As far as 2005 and 2006 are concerned, this sort of analysis has an obvious ring of truth. The FTSE All-Share Index stands about a third higher than it did in autumn 2004, whilst the average yield on UK commercial property has fallen to under 5% (for the first time since the late 1980s). Even house prices – which, according to some pundits, were due for a crash – have moved ahead once more. The UK may not suffer from a situation in which 'too much money is chasing too few goods', but it does seem to have 'too much money chasing too few assets'.

Unduly high asset prices do eventually affect expenditure on goods and services. The economy's pattern in the boom–bust cycles of the 1970s and 1980s was that excess money caused surges in asset prices, in turn causing increases in spending and – with a long lag – rises in consumer price inflation. Recent monetary trends are consistent with a similar story. A reasonable forecast is that asset prices will stay buoyant for the next few quarters, demand will grow rather rapidly in 2007 and inflation will move above target in, say, 2008. The Bank of England may have time to stop the process, but interest rates may have to climb to unpleasantly high levels if it is to do so.

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