NORTHERN TRUST GLOBAL ECONOMIC RESEARCH

If Some Dare Call It Treason, Was Milton Friedman a Traitor?

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After having endured the most severe recession in the post-WWII era, we now are experiencing the weakest recovery.

Why?

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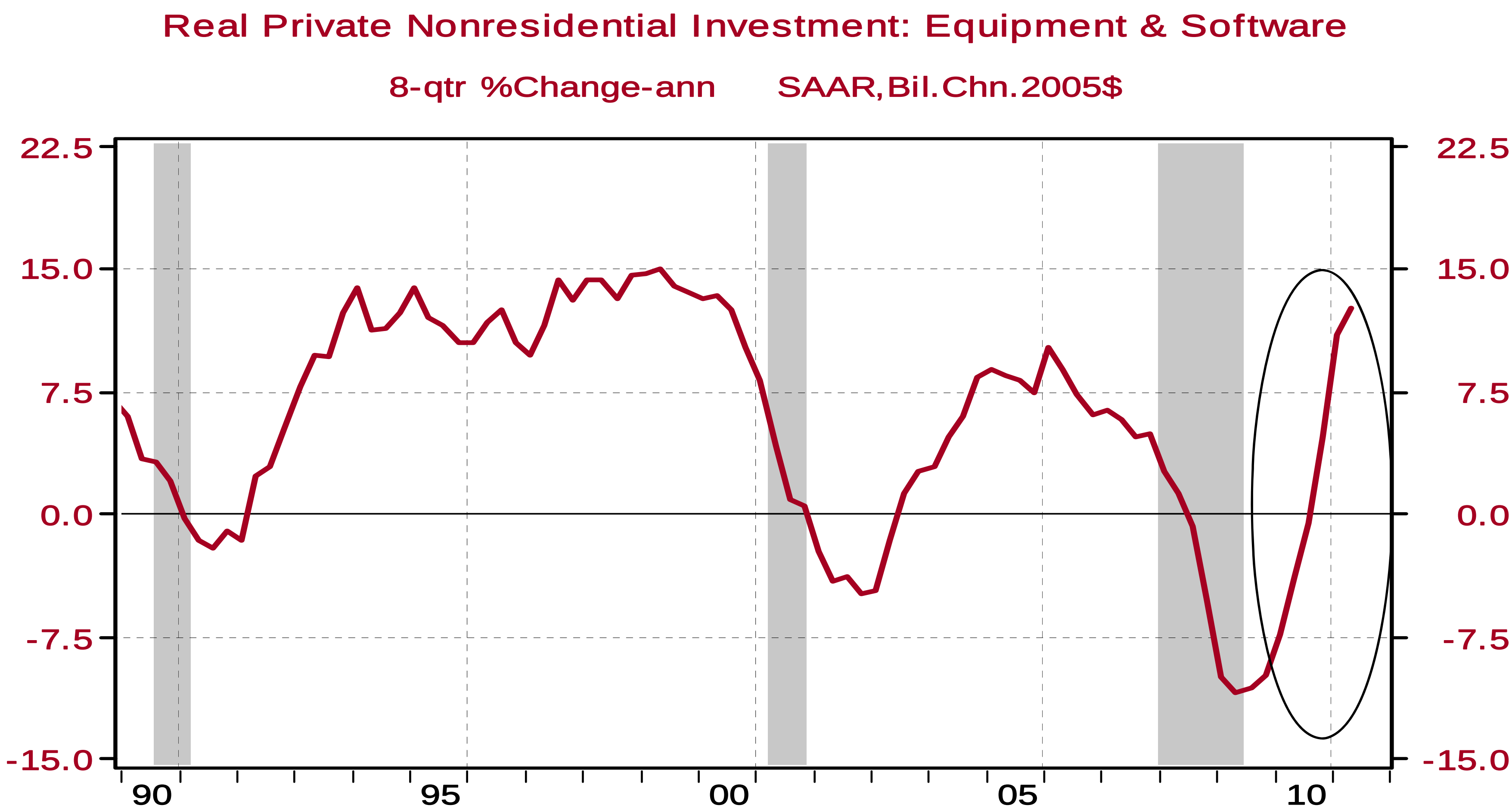
Is it because businesses are "uncertain"? If there has been so much uncertainty, why have businesses been so willing to purchase capital equipment and software?



Source: Bureau of Economic Analysis /Haver Analytics

Is it because U.S. businesses are so uncompetitive due to high taxes and regulation? If so, why have U.S. exports been so strong?

Source: Bureau of Economic Analysis /Haver Analytics

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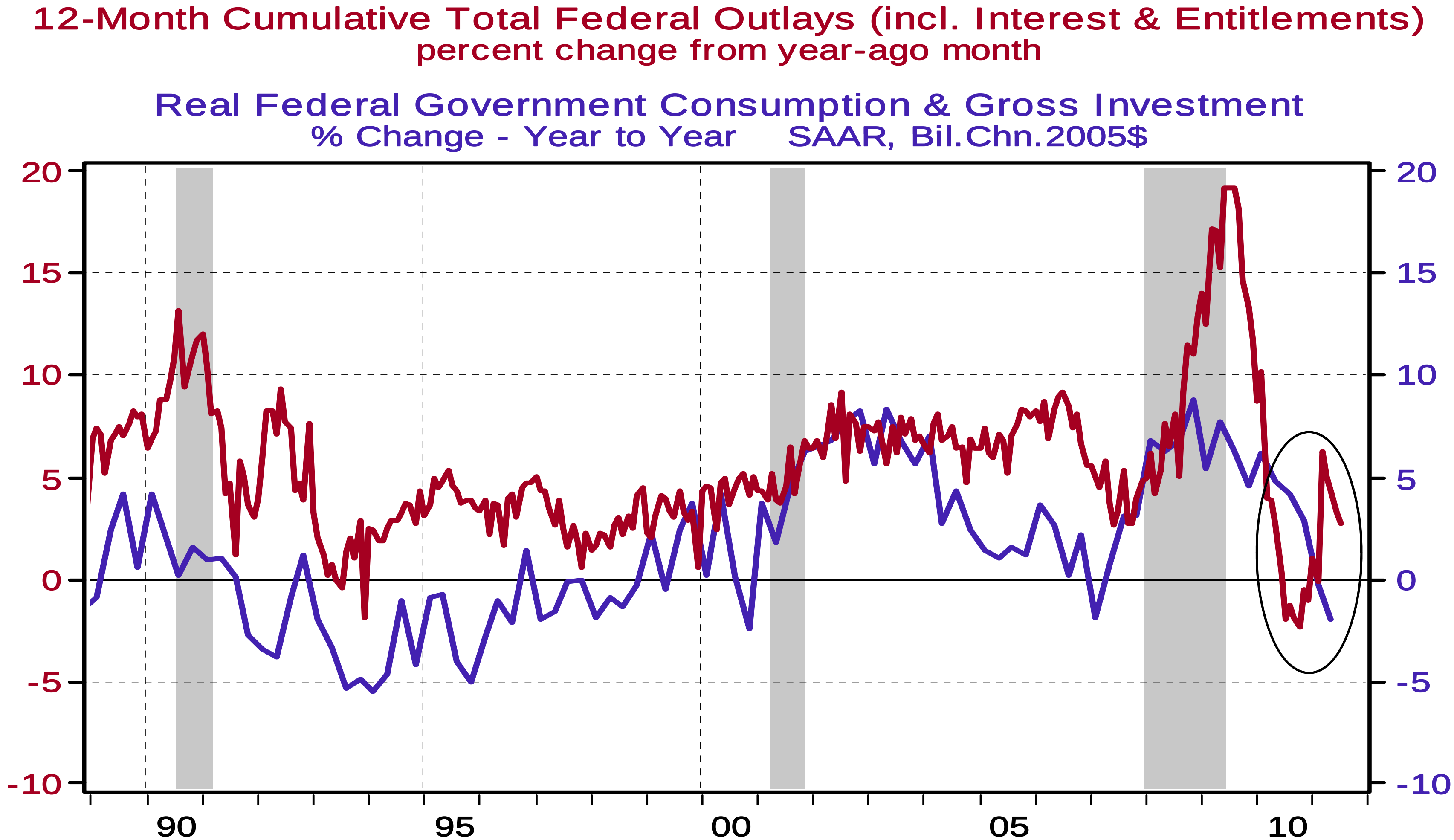
Is it because federal government spending is out of control? Say what?



Sources: U.S. Treasury, Bureau of Economic Analysis /Haver Analytics

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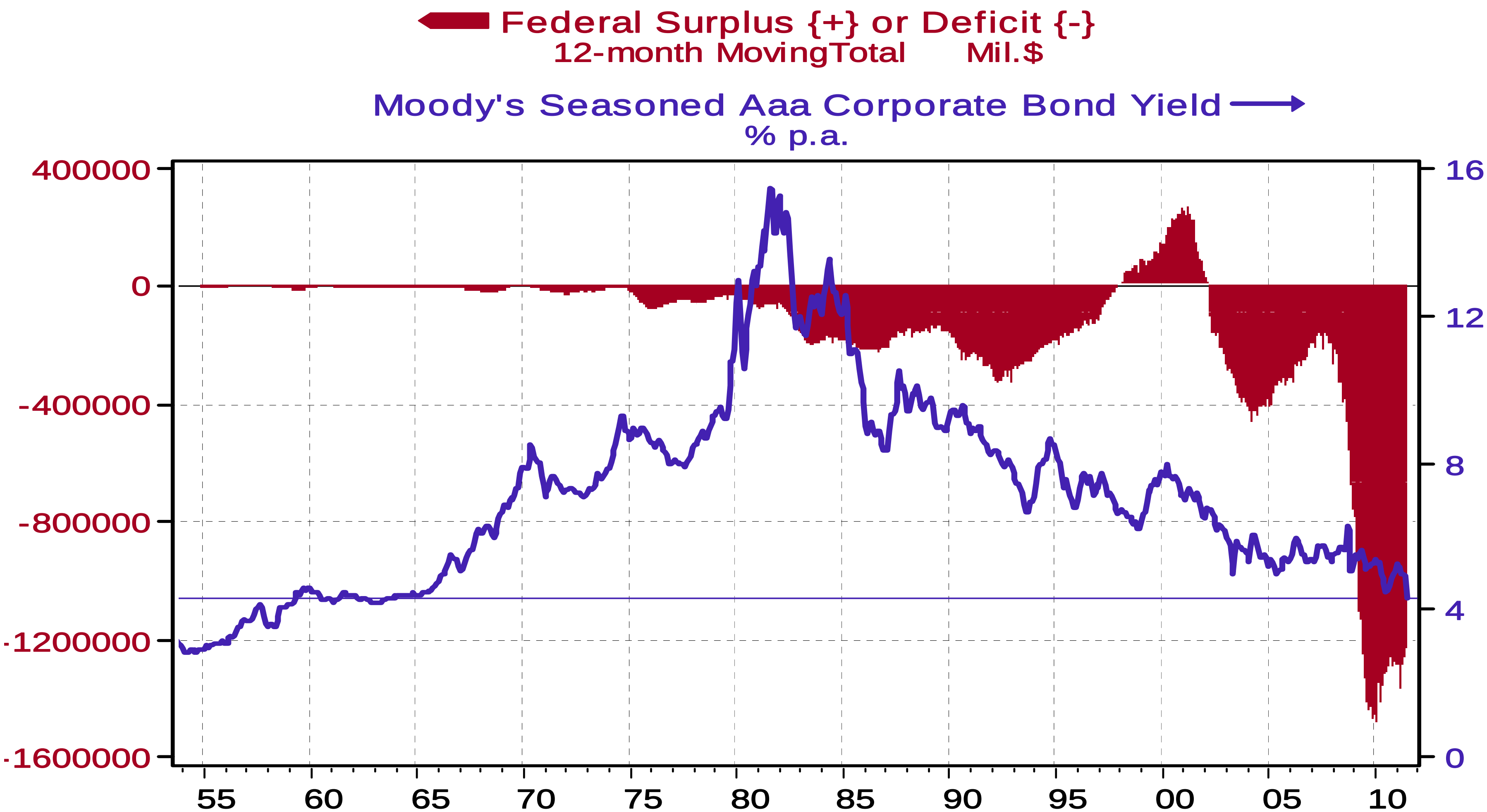
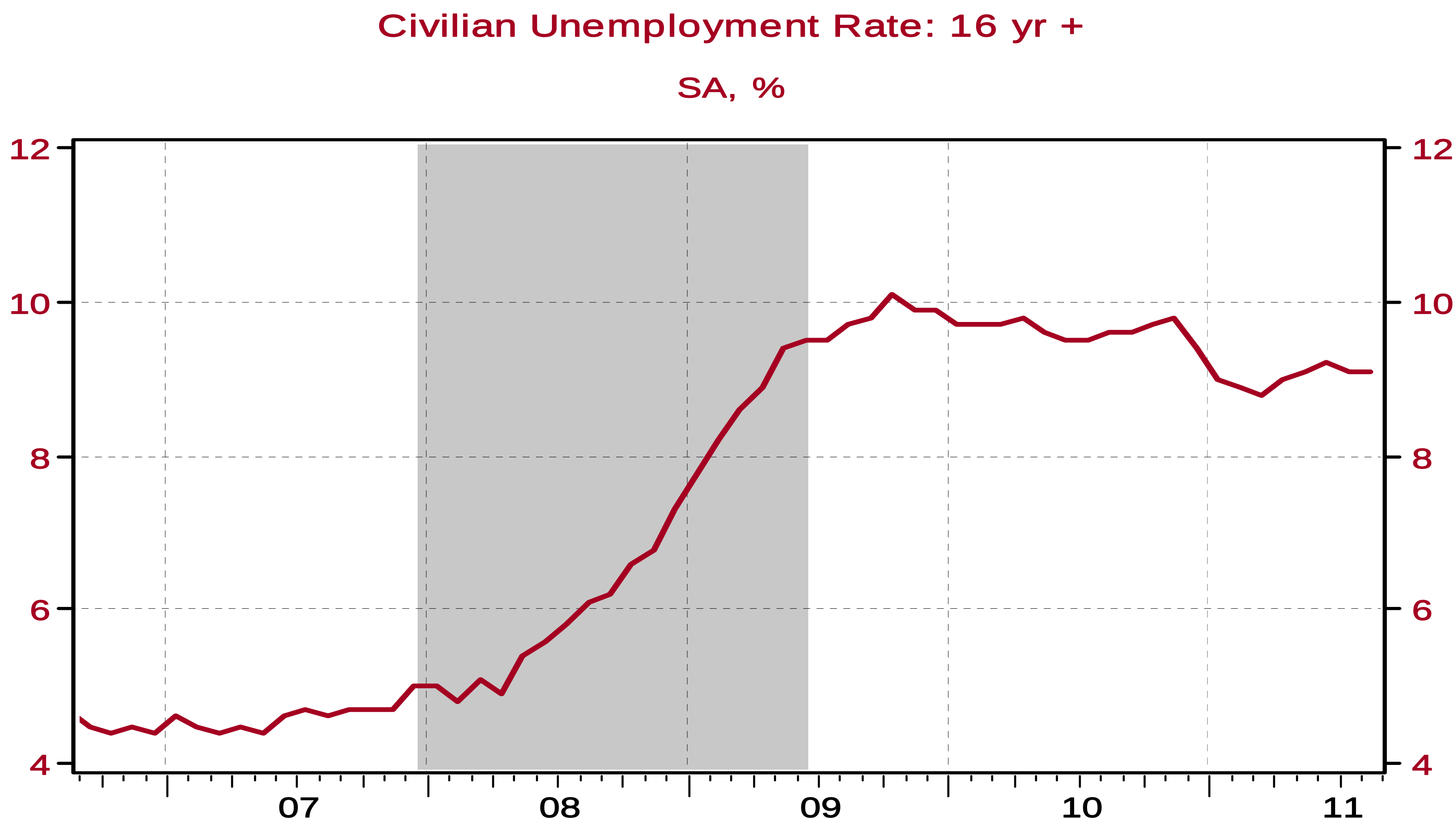
Have recent record federal budget deficits crowded out private spending by pushing up bond yields?



Sources: U.S. Treasury, Federal Reserve Board /Haver Analytics

Is the weak economic recovery and persistently high unemployment rate due primarily to a structural change in the U.S. economy since the end of the last expansion?



Source: Bureau of Labor Statistics /Haver Analytics

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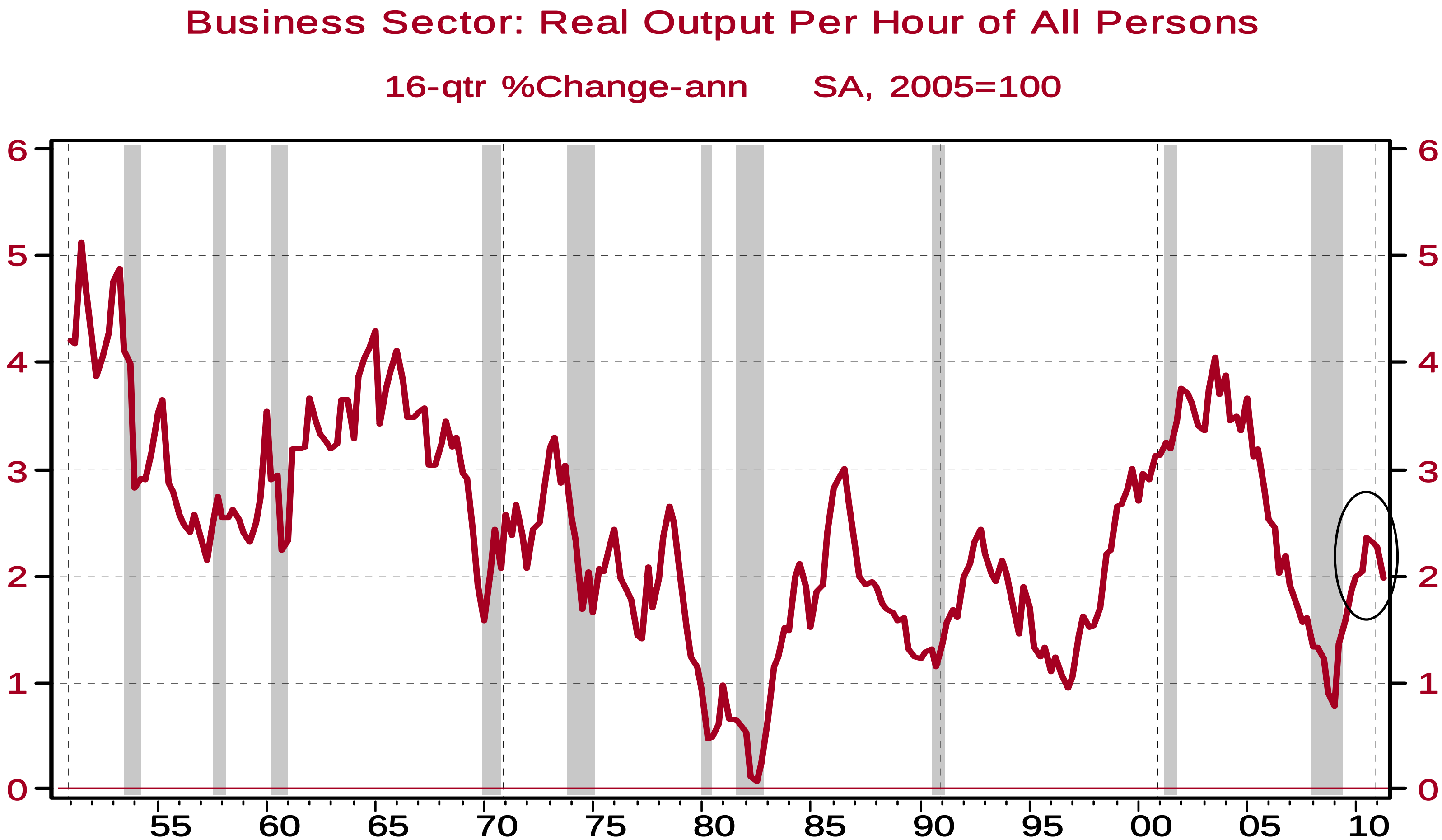
Labor productivity growth has not been abnormally high in the past 4 years to explain the persistent high rate of unemployment.



Source: Bureau of Labor Statistics /Haver Analytics

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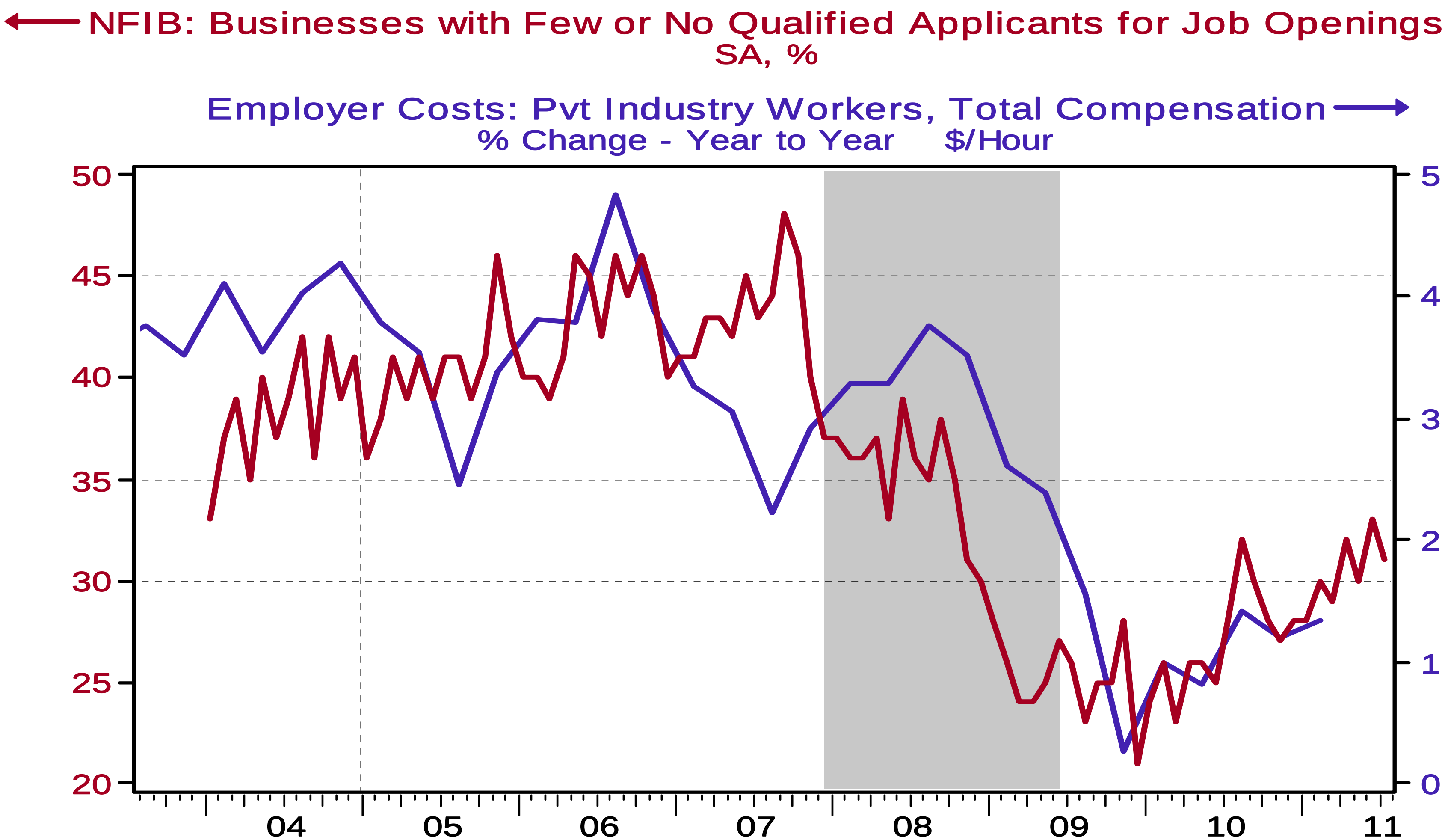
Surveys do not indicate an acute shortage of qualified job applicants nor do labor compensation data.



Sources: NFIB, BLS /Haver

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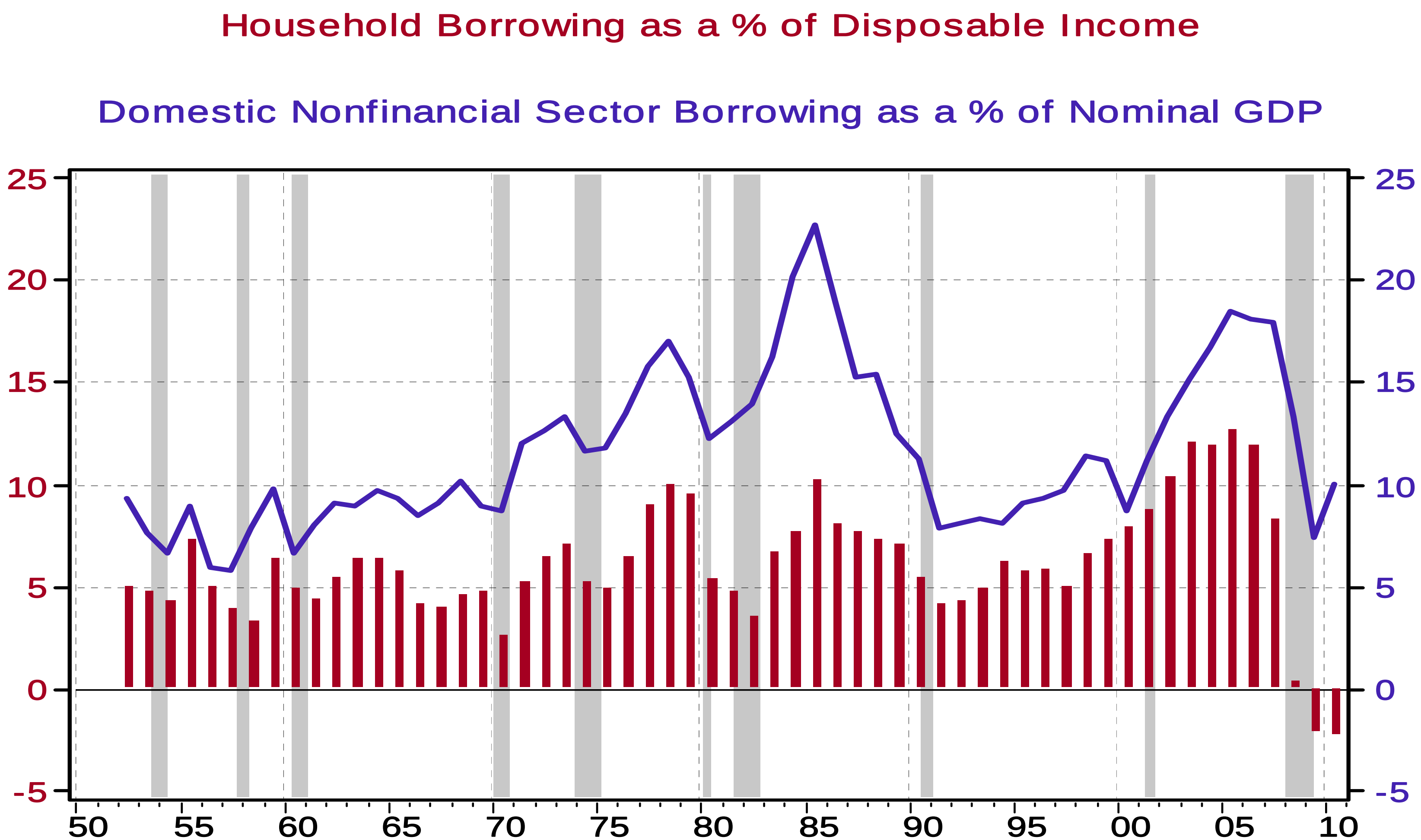
Reinhart and Rogoff document that economic growth is often weak following periods when there has been an abnormally large debt increase. But the most recent expansion was not the first in which there was abnormally high borrowing.



Source: Haver Analytics

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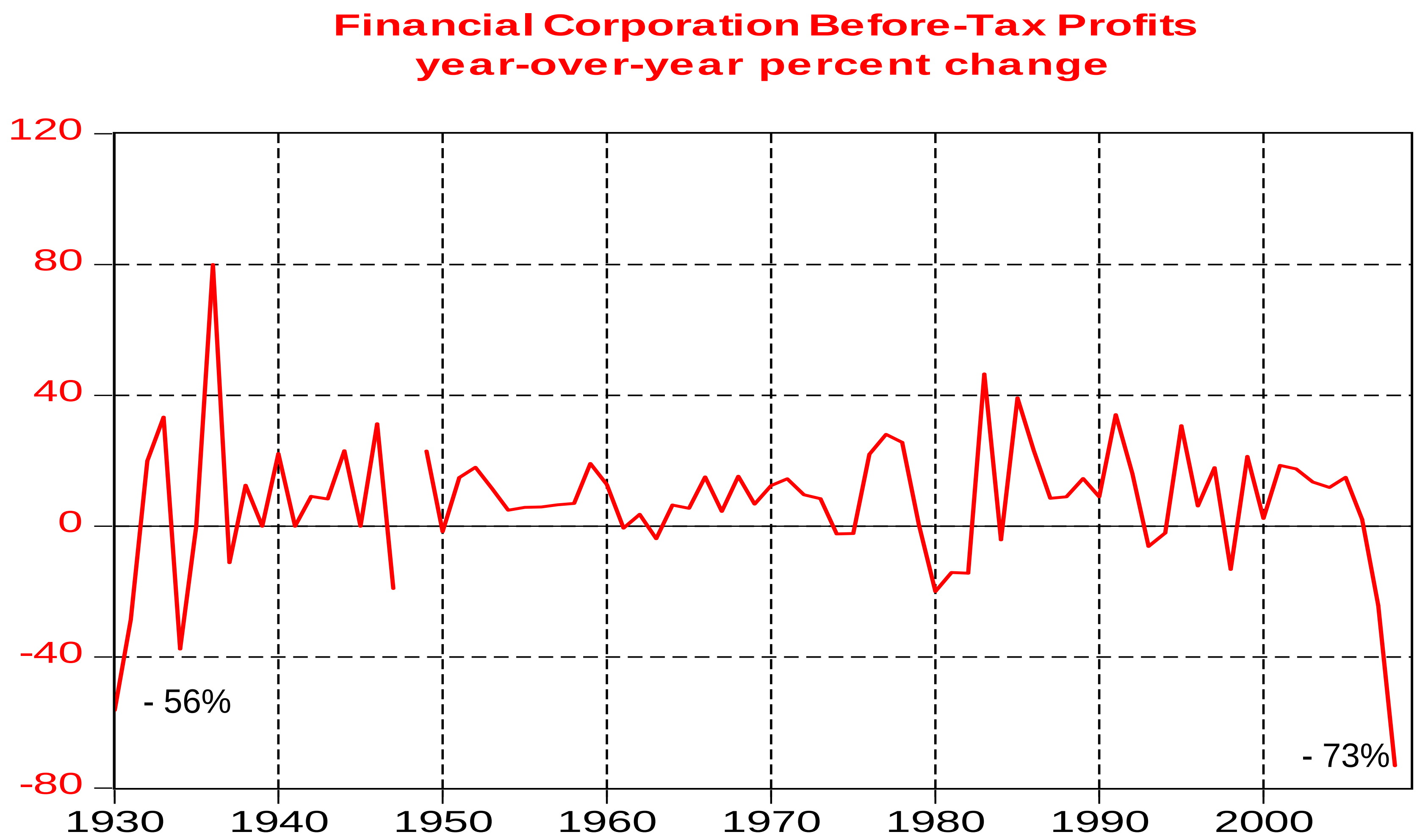
But with the bursting of our recent debt bubble, the financial sector experienced a contraction in profits worse than what occurred in the early 1930s.



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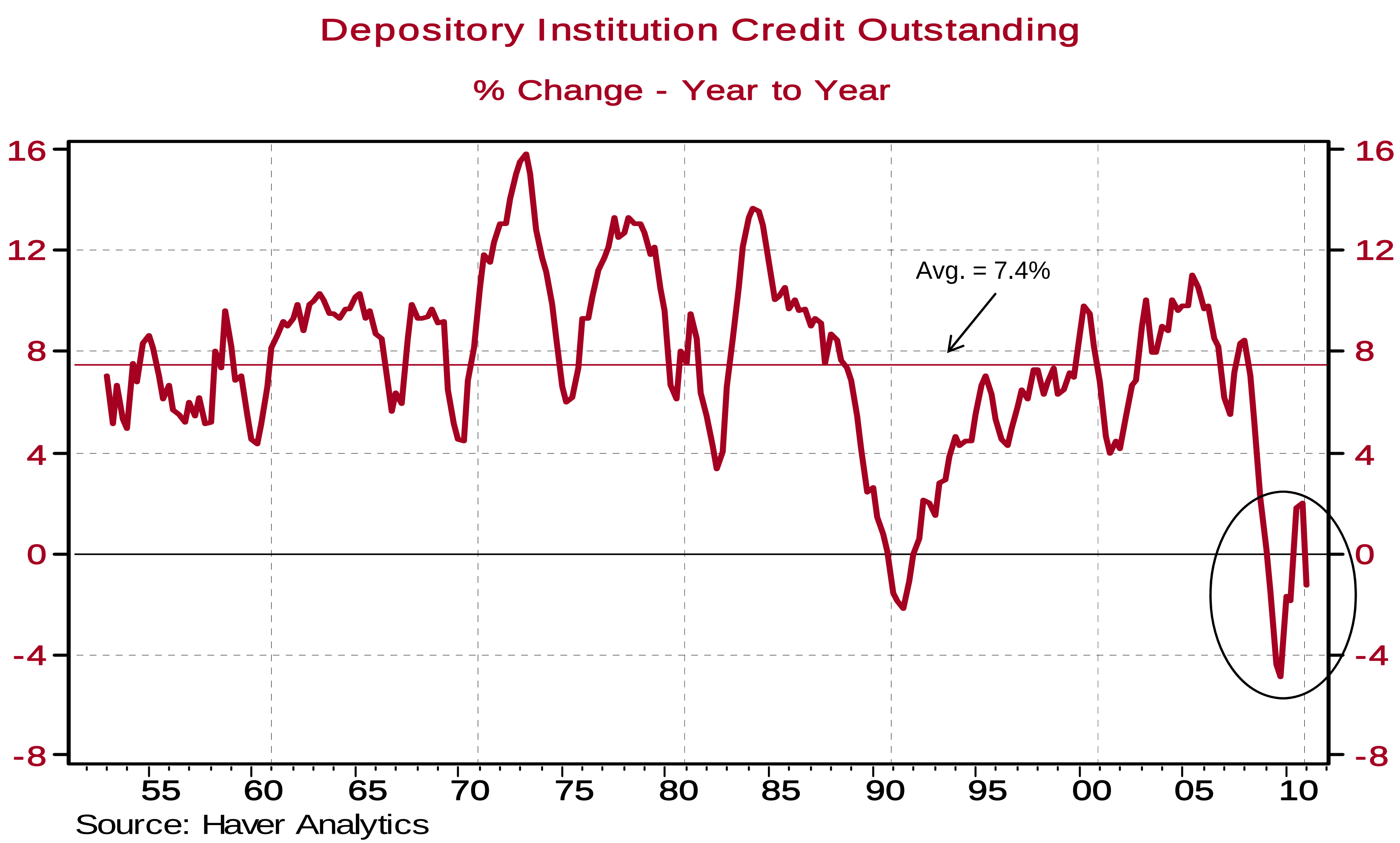
The record losses incurred by the financial sector resulted in a post-WWII record contraction in depository institution credit.



Note: Depository institutions include commercial banks, S&Ls and credit unions.

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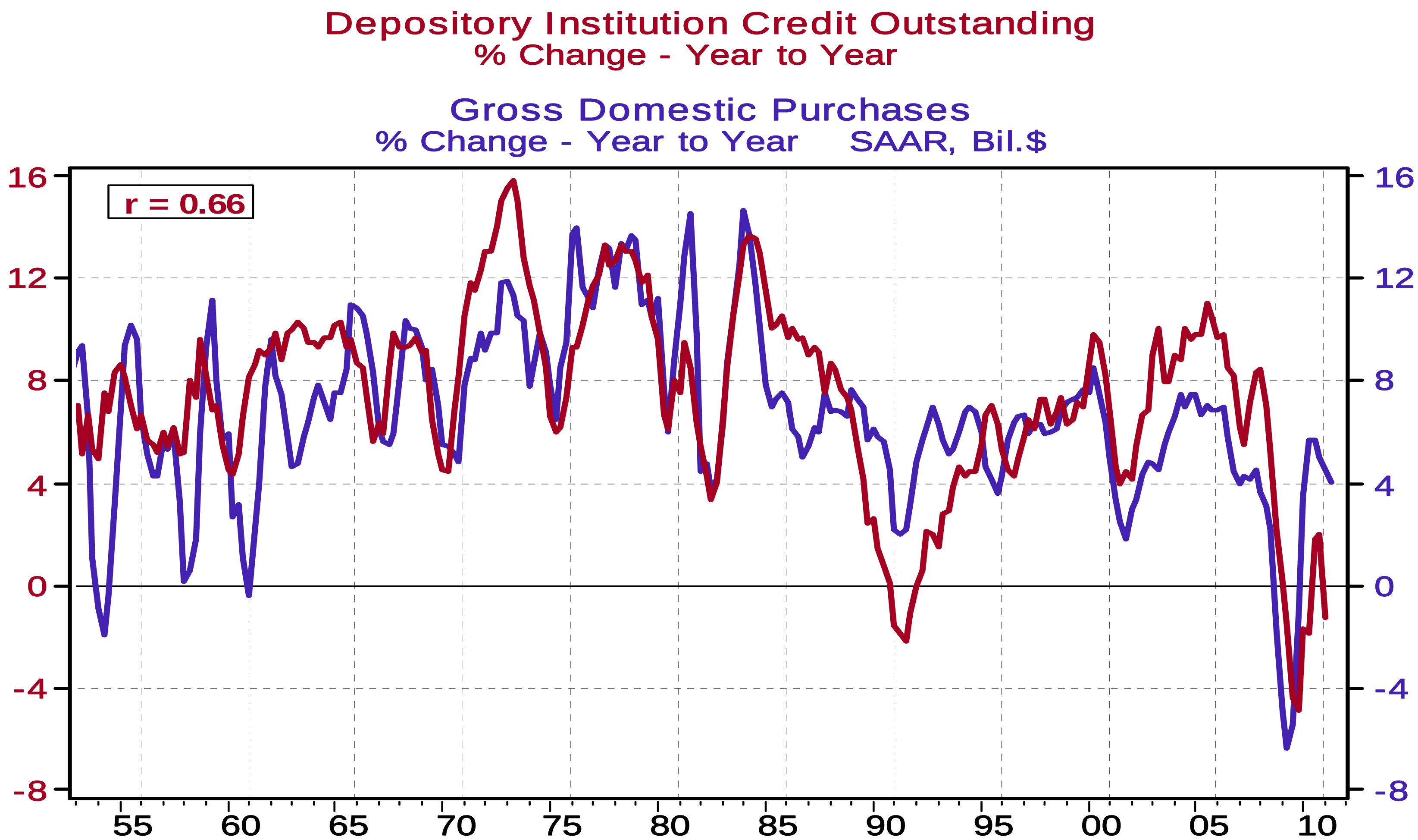
Historically, there is a high correlation between changes in depository institution credit and changes in domestic demand for goods and services (Gross Domestic Purchases).

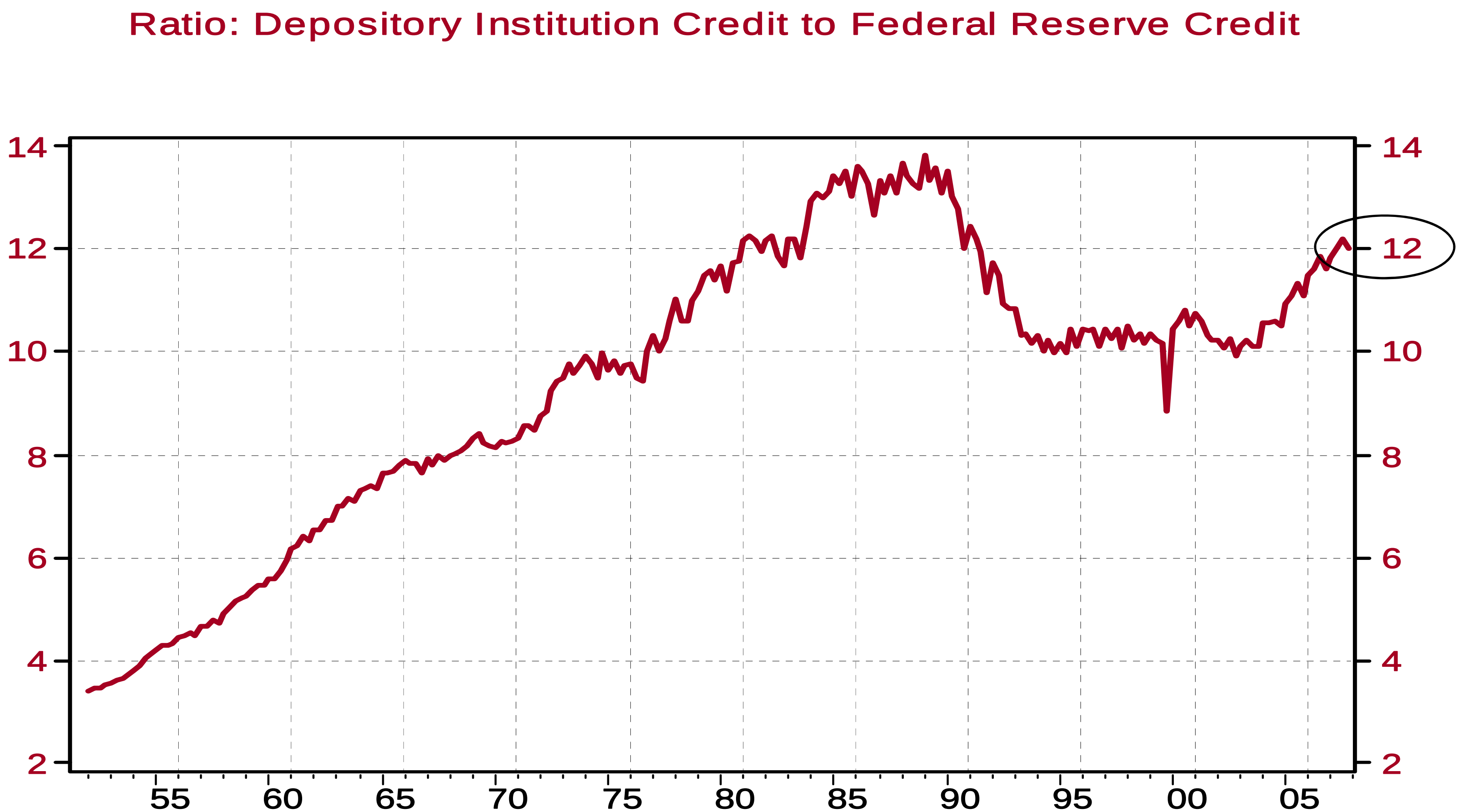


Source: Haver Analytics

To understand why there is a high correlation between depository institution credit and domestic demand, we first must understand the power of creating credit "out of thin air."

- When the Federal Reserve purchases a security in the open market, the Fed pays for that security by crediting the security seller's bank account by the dollar amount of the transaction.
- Where did the Fed get the funds to pay the seller of the securities? It created these funds "out of thin air."
- Not only does the seller of these securities now have higher deposits, but the depository institution system also has more cash reserves.
- Under normal circumstances, the depository institution *system*, not a depository institution by itself, is able to create "out of thin air" additional credit *by some multiple* of the amount of credit created by the Fed under our *fractional* reserve accounting system for depository institutions.

At the end of 2007, the depository institution *system* had created a little over $12 in credit for every $1 of credit created by the Federal Reserve.



Source: Haver Analytics

Why is credit created "out of thin air" closely associated with domestic spending?

- When credit is created "out of thin air," the recipients of that credit are able to purchase something – a good, a service, a real asset (e.g., a house) or a financial asset (e.g., a stock) – without anyone else having to cut back on his or her current spending.
- When credit is created "out of thin air," there is a presumption that total spending will increase.
- When credit is *not* generated "out of thin air," the recipients of that credit can increase their current spending, but the *grantors* of that credit are funding the loans by *cutting back* on their current spending – i.e., the grantors of this credit are increasing their *saving*.
- When credit is *not* generated out of thin air, spending power is *transferred* from the grantor of the credit to the recipient of the credit.
- When credit is *not* generated out of thin air, there is *no* presumption that total spending will increase. Rather, the presumption is that there will only be a change in *who* will do the spending.

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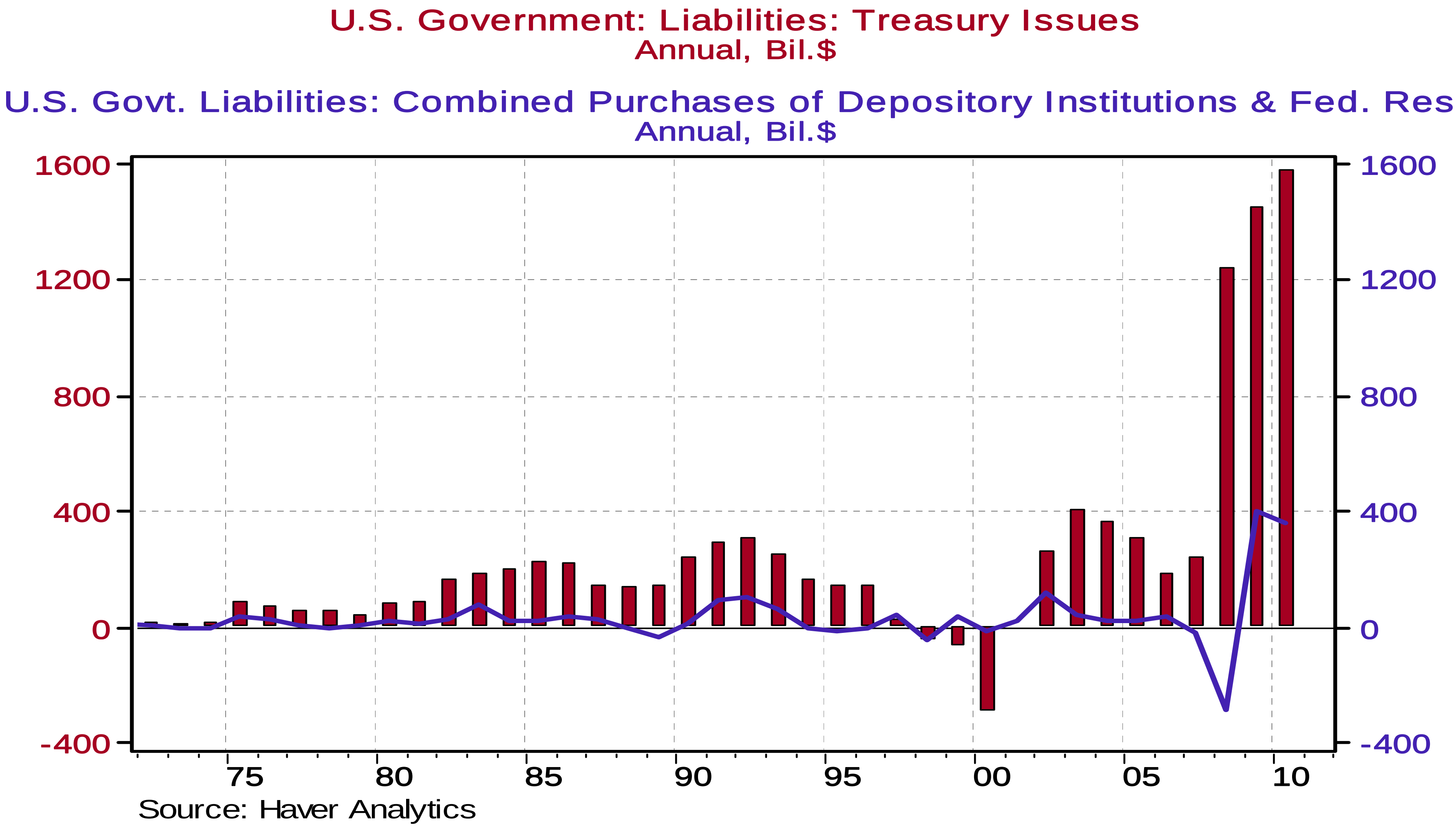
Government stimulus does not stimulate much unless financed by credit created "out of thin air." Rather it just "transfers" spending from the private sector to the government sector.



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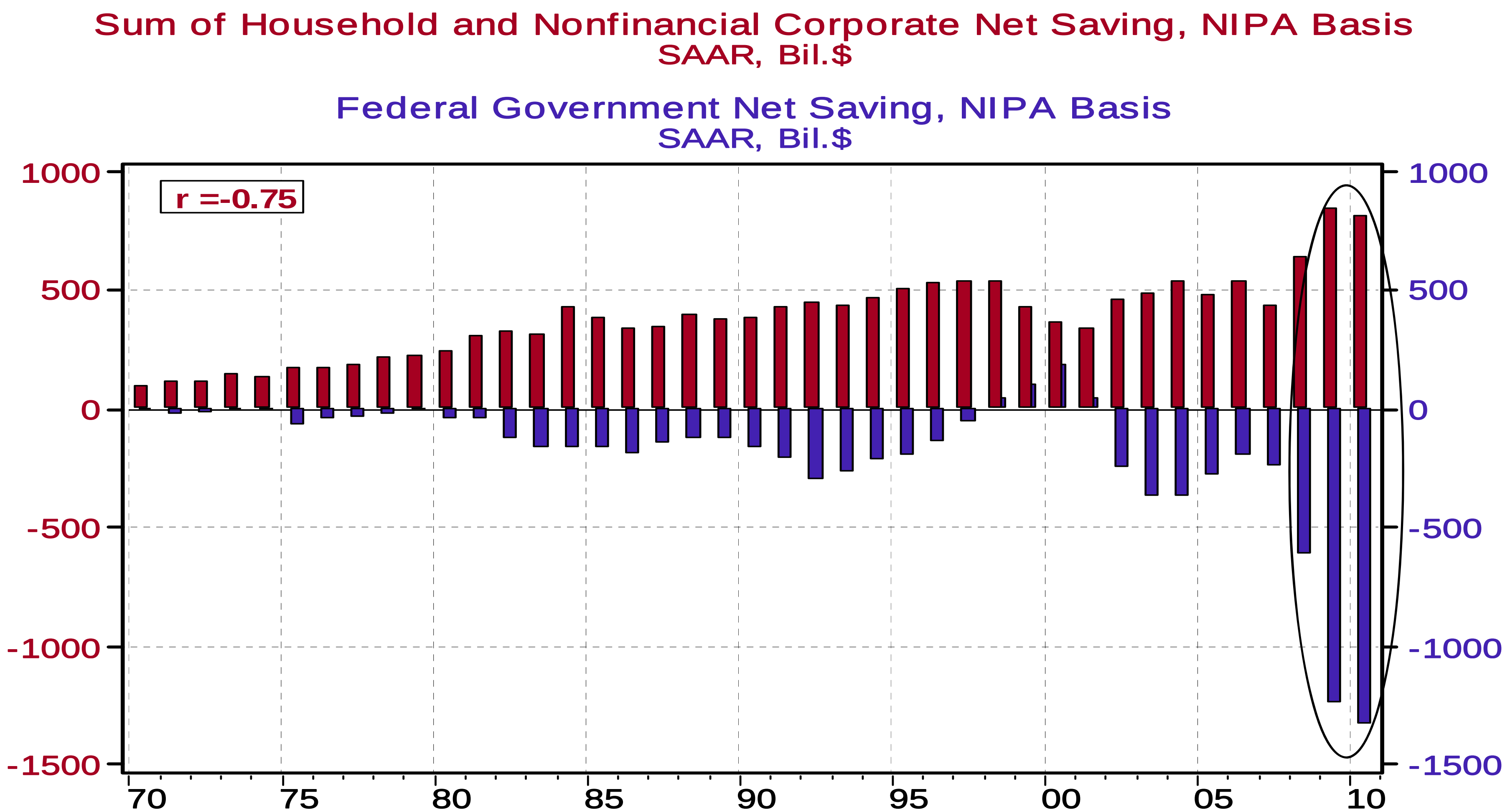
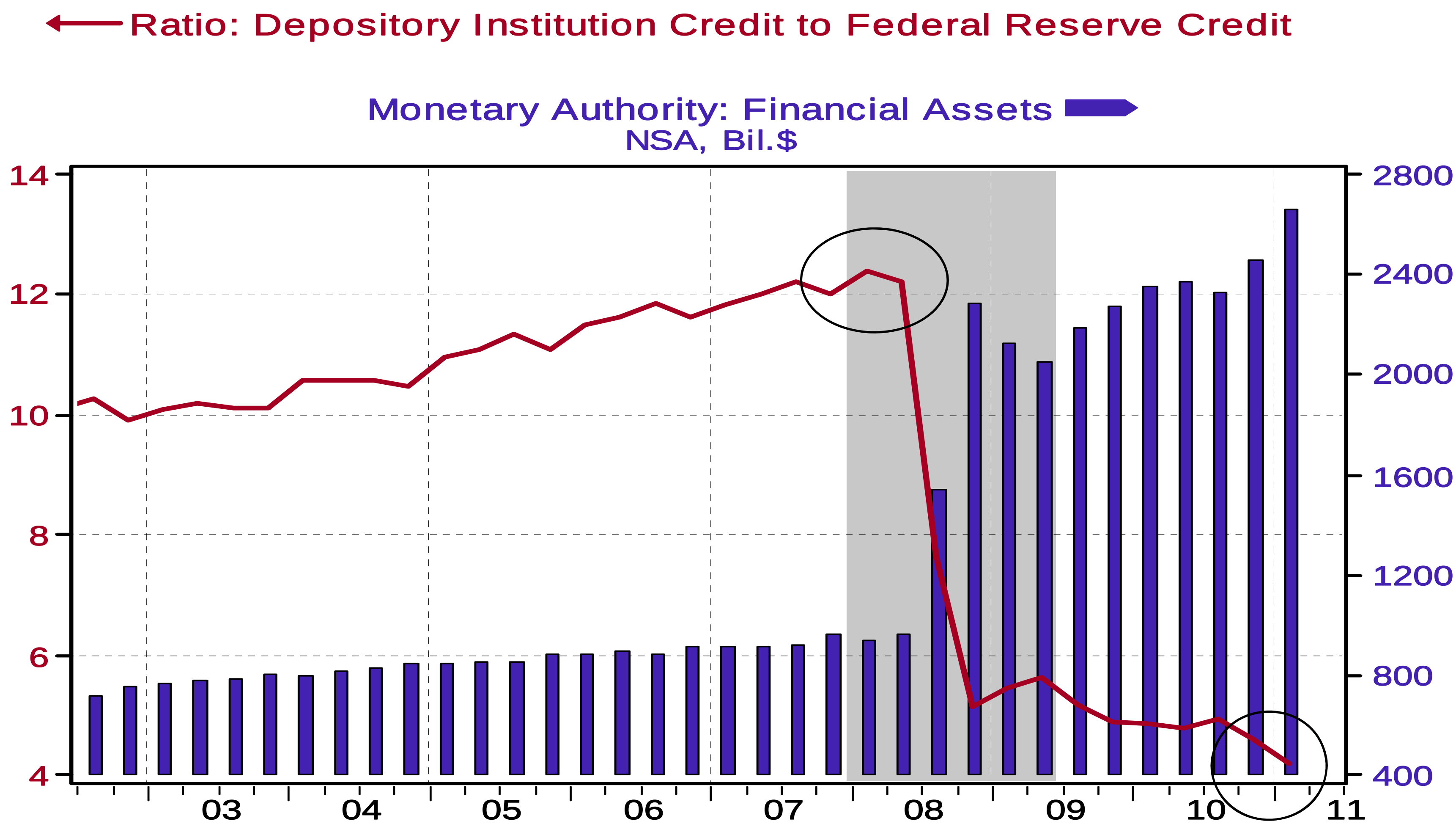
In the short run, would changes in government borrowing/spending tend to change overall spending or merely change the composition of overall spending if financed largely by the nonfinancial sector?



Source: Haver Analytics

After the bursting of the housing bubble and the record losses incurred by the financial sector, despite a sharp increase in Federal Reserve credit, depository institutions dramatically cut back on their credit creation relative to Fed credit.



Source: Haver Analytics

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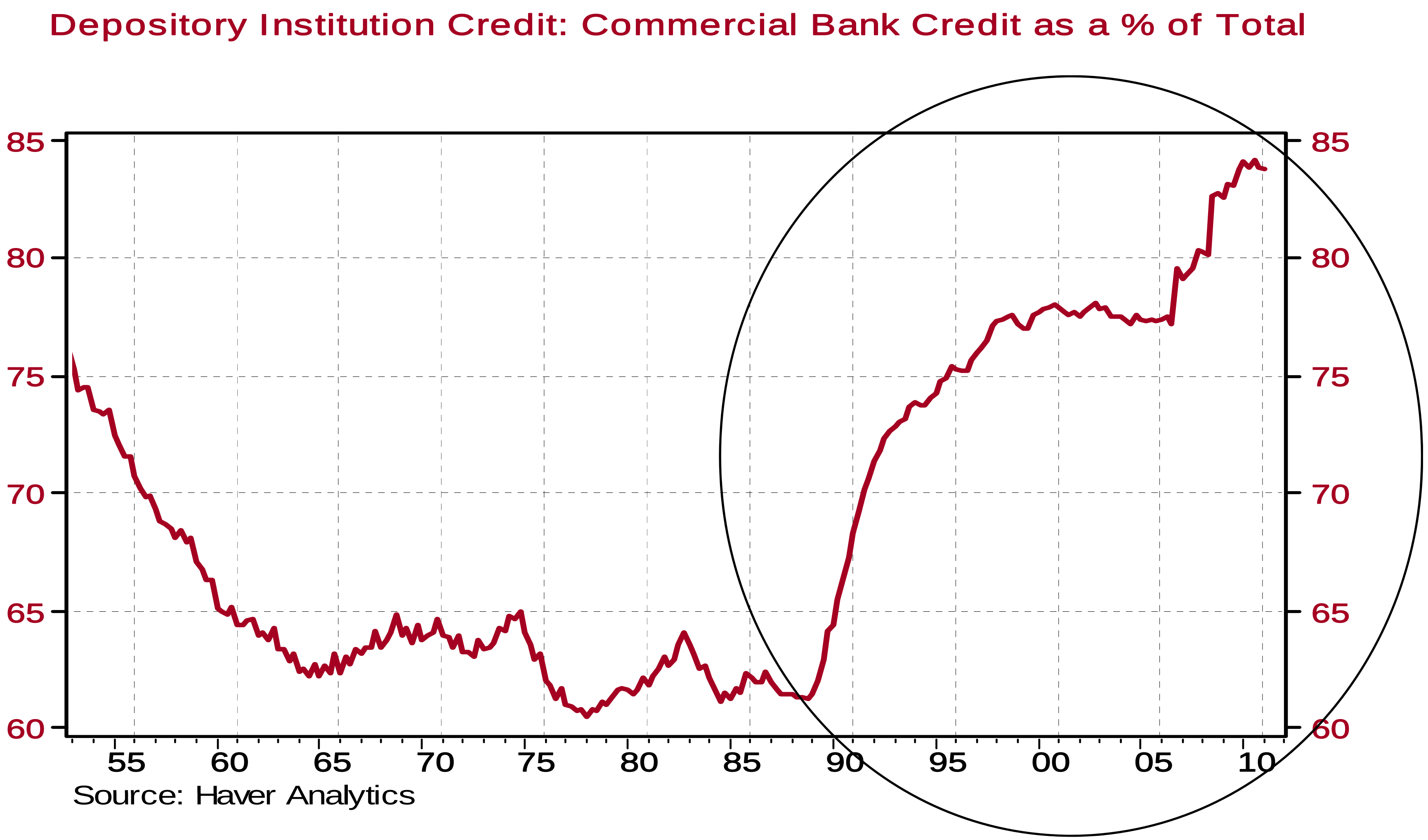
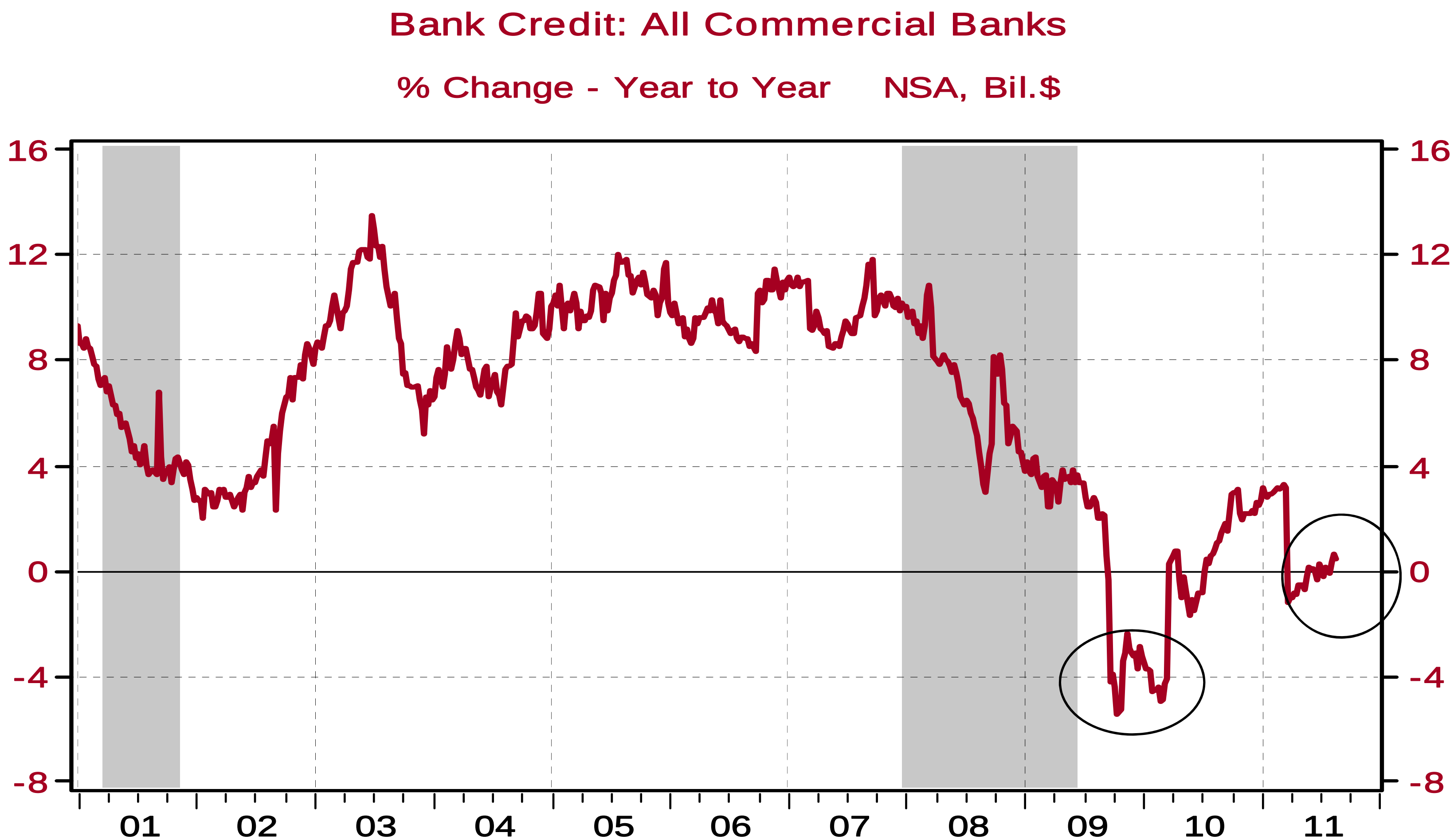
After the S&L debacle of the early 1990s, commercial bank credit has come to dominate depository institution credit, accounting for almost 85% of the total now.



After a post-WWII record contraction in commercial bank credit in 2009, bank credit growth now is less than 1% annualized.



Source: Federal Reserve Board /Haver Analytics

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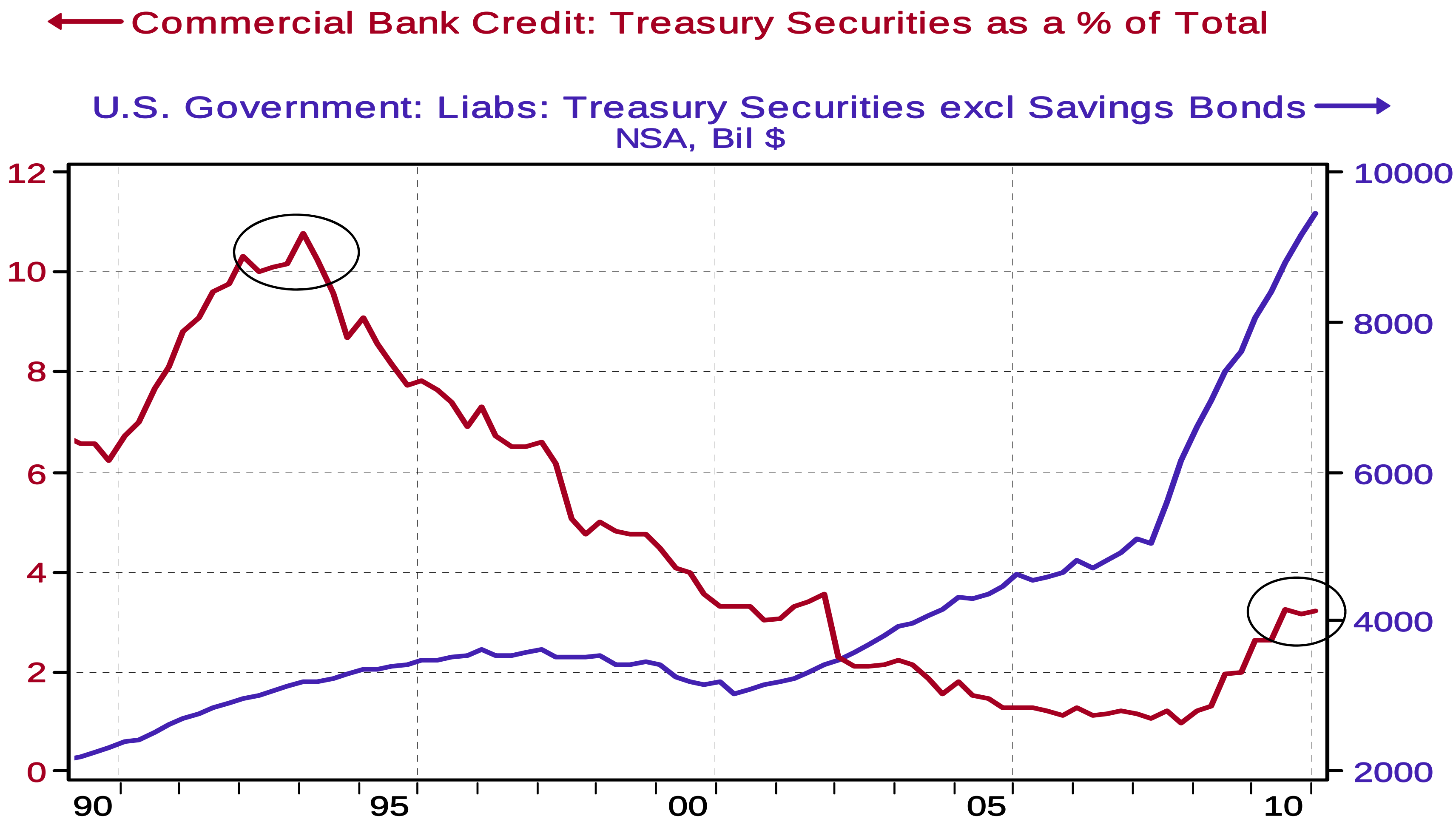
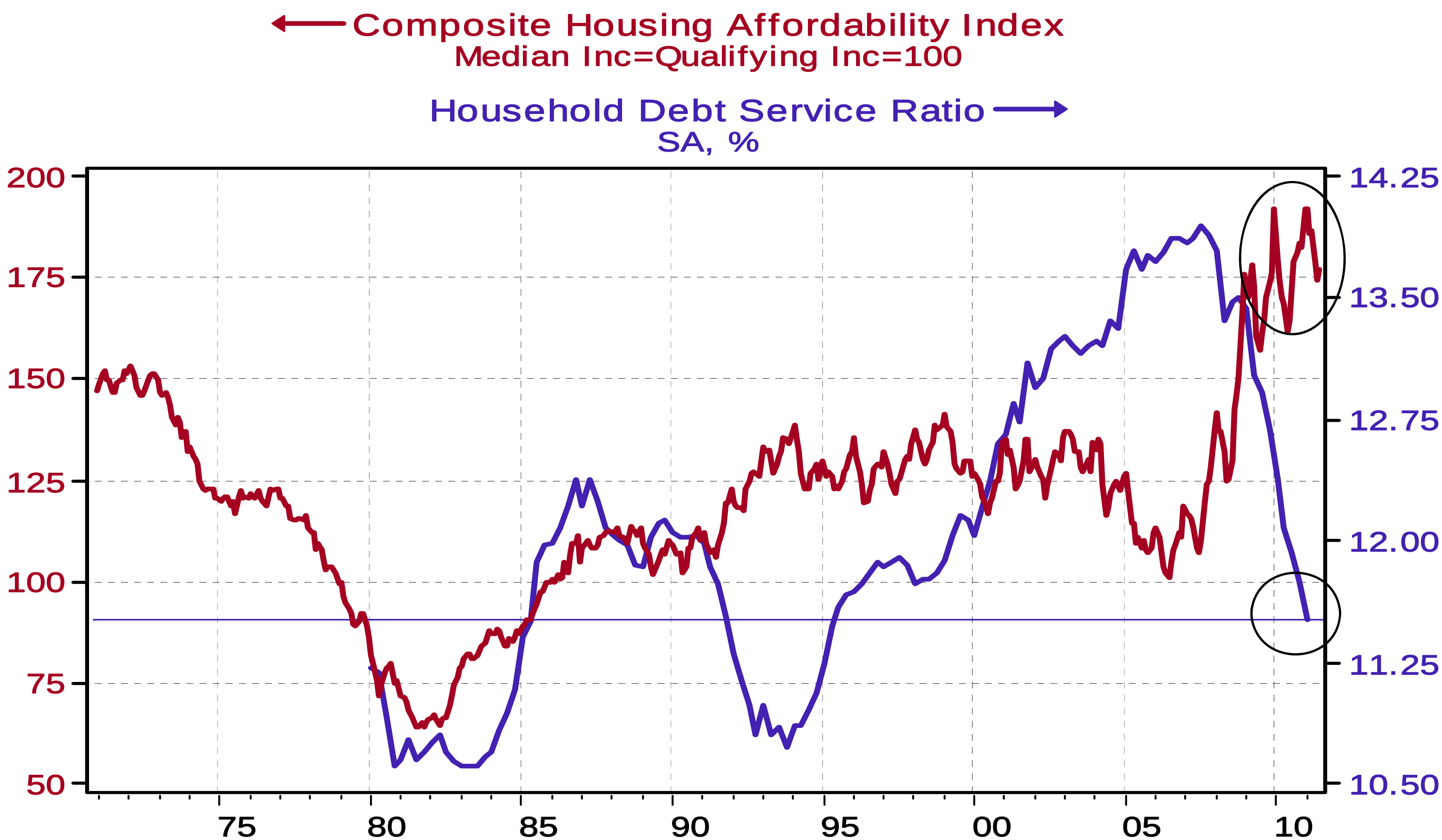
Is it lack of demand for credit that is holding back bank credit creation? Why are not banks lending more to the Treasury?



Source: Haver Analytics

A home purchase is historically very affordable and household debt-service burdens have plunged ...



Sources: NAR, FRB /Haver

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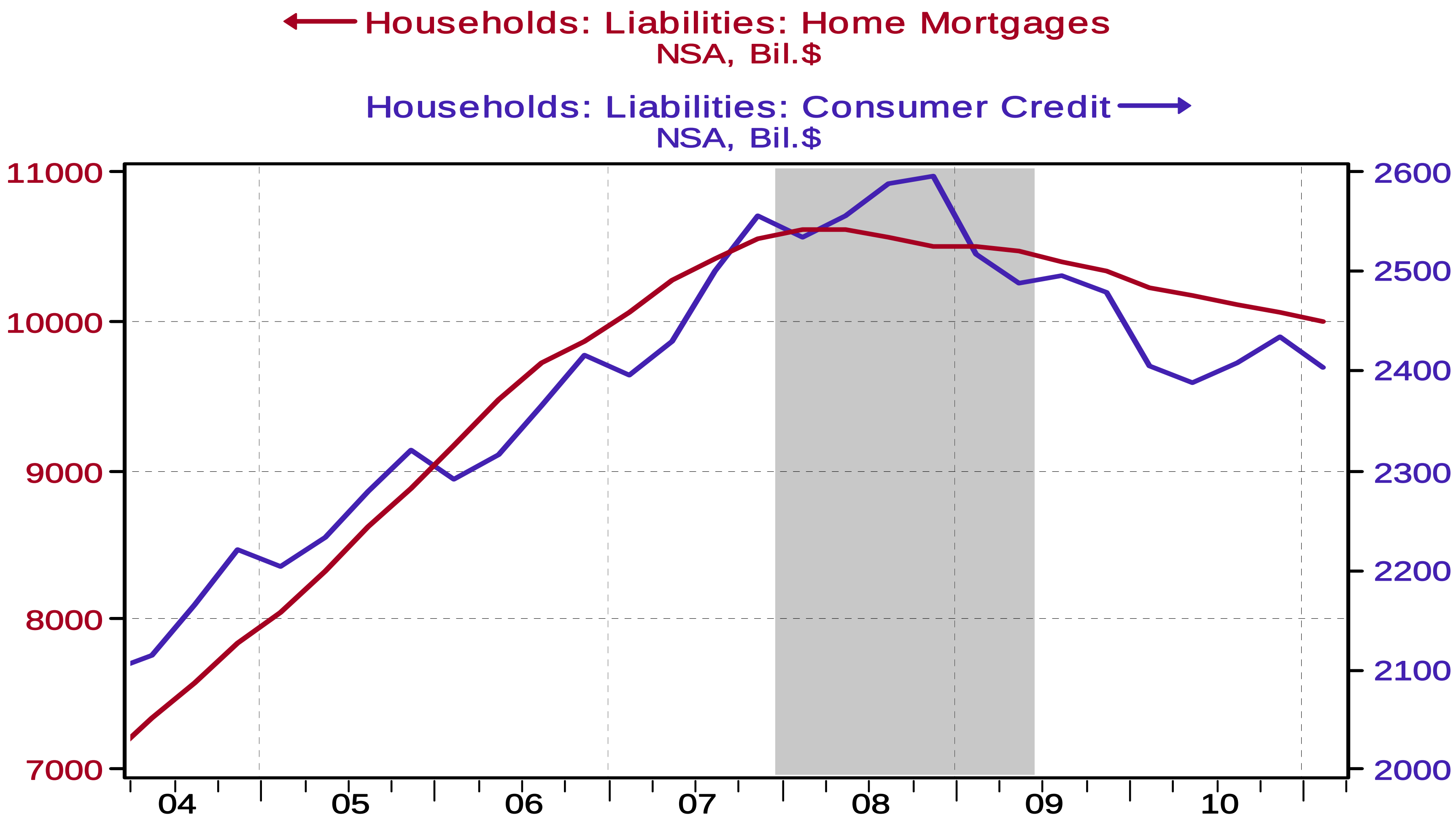
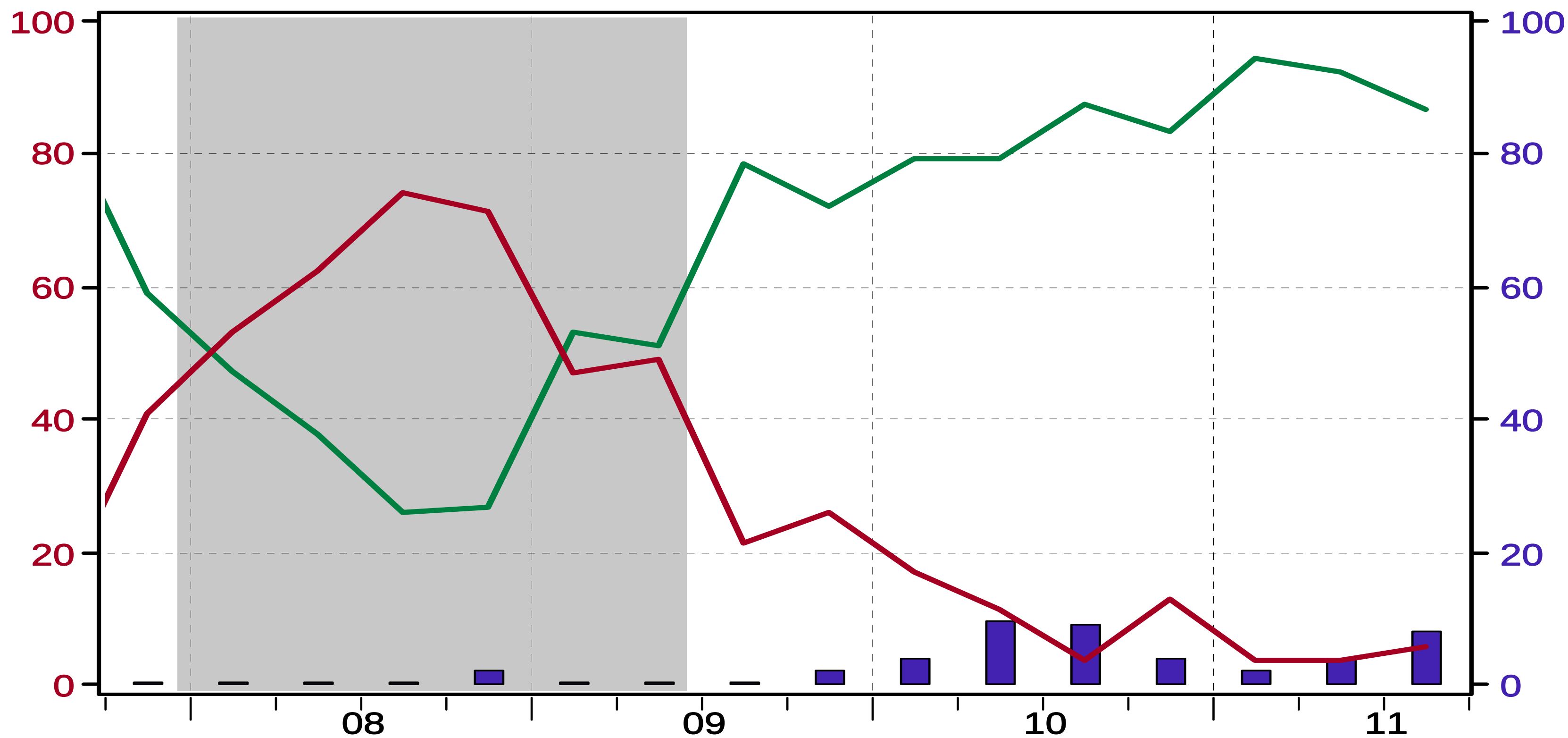
… yet home mortgage and consumer credit continue to trend lower.



Sources: Federal Reserve Board /Haver Analytics

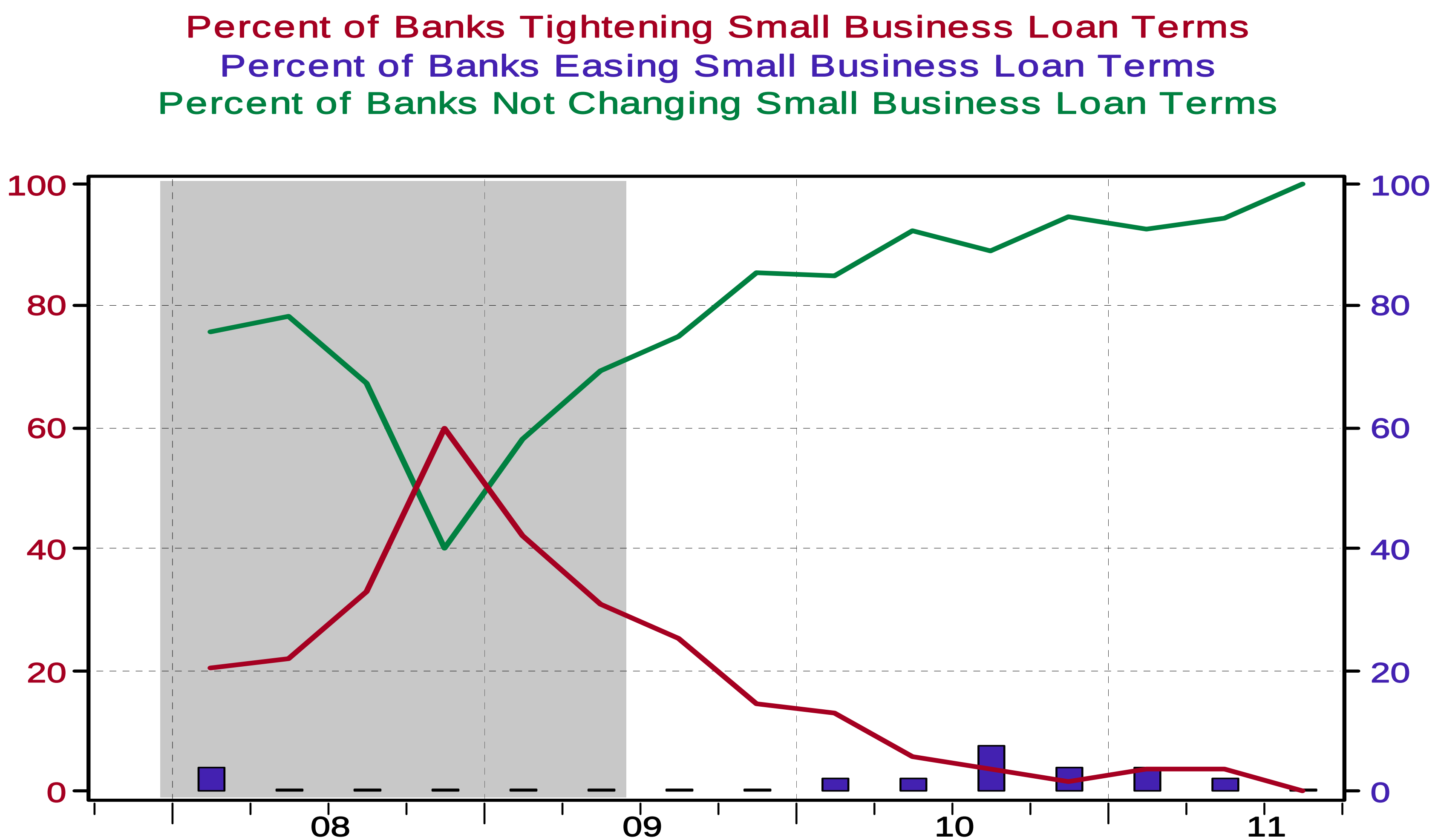
Because of current and/or future capital adequacy concerns, banks tightened their mortgage lending terms during the recession and have not materially eased them since.

Percent of Banks Tightening Prime Home Mortgage Lending Terms
Percent of Banks Easing Prime Home Mortgage Lending Terms
Percent of Banks Not Changing Prime Home Mortgage Lending Terms



Source: Haver Analytics

Banks are the lifeblood of credit for small businesses, but banks tightened lending terms to small businesses during the recession and have not materially eased them since.



Source: Haver Analytics

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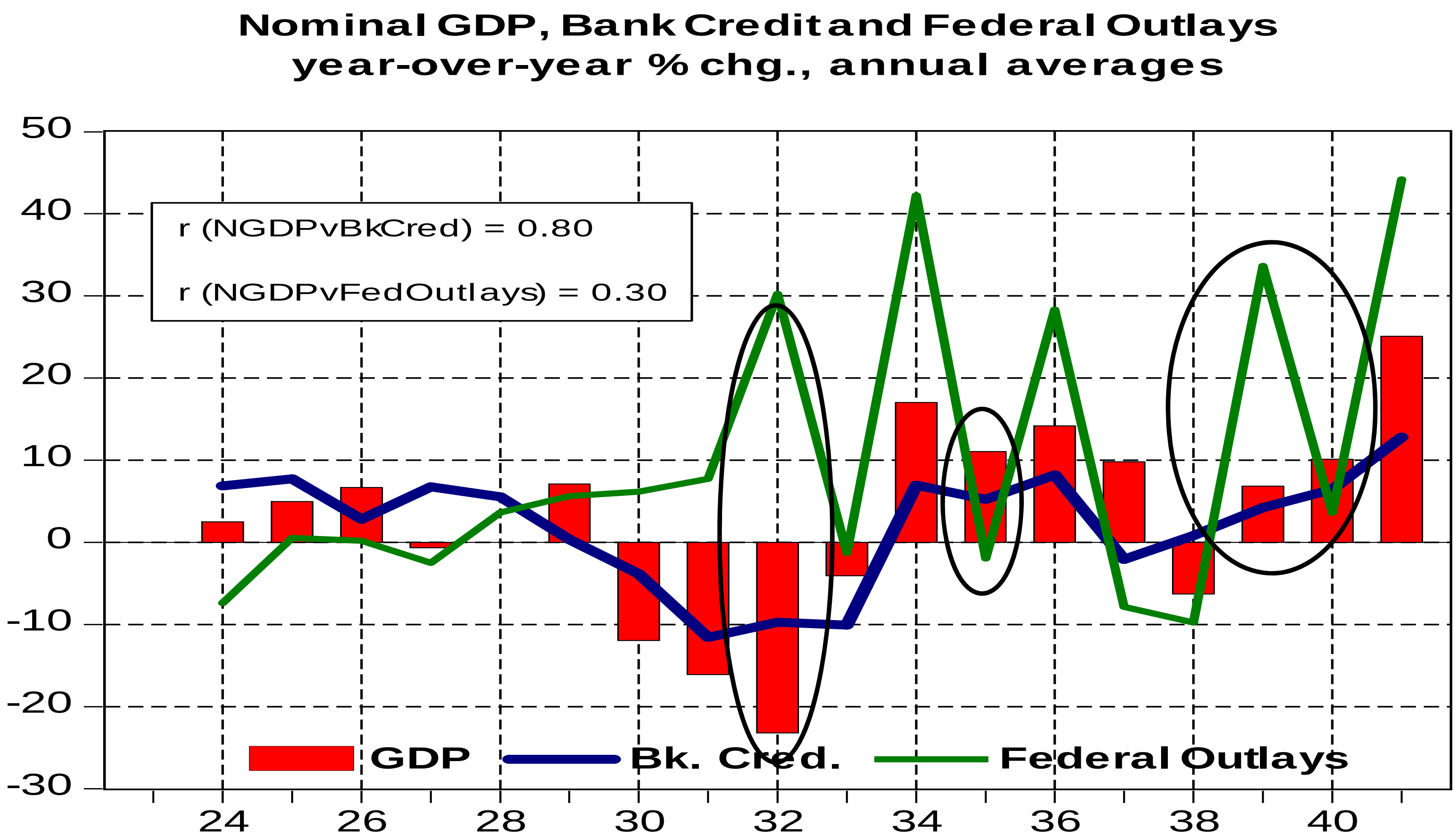
The evidence suggests that it was a rebound in bank credit rather than fiscal stimulus that pulled us out of the 1929-33 recession.



Are we saddled with weak nominal and real domestic demand until banks are in a position to again create credit at a more normal pace? No.

- The Federal Reserve could create the credit that banks and other depository institutions would normally create if they were able to do so.
- This is what a *quantitative easing* monetary policy is all about.
- Some dare call quantitative easing treason, but the preeminent monetary scholar, Milton Friedman, castigated the Federal Reserve for *not* pursuing a quantitative easing policy in the early 1930s.
- Friedman argued that the severity of the recession that began in 1929 could have been mitigated had the Federal Reserve pursued a quantitative easing policy.
- Friedman recommended to the Bank of Japan that it pursue a policy of quantitative easing policy in the 1990s in order to bring the Japanese economy out of its deflationary stagnation. The Bank of Japan did *not* take Friedman's advice.
- A careful reading of one of the icons of the Austrian school of economics and a noted libertarian, Friedrich Hayek, also recommended a form of quantitative easing in an economic environment such as the one now exists.

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How does quantitative easing stimulate domestic demand?

- The Federal Reserve purchases securities from a pension fund with cash that the Federal Reserve “creates” through a bookkeeping entry.
- The pension fund now has more cash and fewer interest-earning investments. The pension fund’s bank now has additional cash reserves. Because these new cash reserves were created just created by the Federal Reserve, the banking *system* has net new cash reserves.
- At the same time, a business issues new bonds to finance the purchase of some new computers.
- The pension fund uses the cash “created” by the Federal Reserve to purchase the new bonds issued by the business.
- Net *new* credit has been created in the economy. The Federal Reserve has increased its holdings of “old” credit (i.e., the securities it purchased from the pension fund) and the pension fund has acquired the *new* bonds issued by the business.
- The net new credit creation has resulted in net new spending in the economy.
- Under normal circumstances, the banking *system*, now having a net addition to its cash reserves as a result of the Federal Reserve’s purchase of securities from the pension fund, would create net new credit on its own by some multiple of the addition of cash reserves provided by the Federal Reserve. However, under the abnormal conditions of capital-adequacy concerns, the banking system does not create any new credit above what the Federal Reserve created.

What might guide the Federal Reserve with regard to how much credit to create if it were to engage in quantitative easing?

- In recent past episodes of quantitative easing, the Federal Reserve has specified a *dollar* amount of securities it intended to purchase within a certain time period regardless of the behavior of depository institution credit.
- Because the essence of quantitative easing is for the Federal Reserve to create the credit that depository institutions would otherwise be creating under *normal* circumstances, rather than specifying ahead of time the amount of securities it would purchase, the Federal Reserve should purchase an amount of securities such that *combined* Federal Reserve and depository institution credit *grow* at some specified *target rate*, perhaps consistent with some desired rate of growth in nominal domestic demand.
- By targeting a growth rate in *combined* Federal Reserve and depository institution credit, the Federal Reserve would have the added benefit of guidance with regard to its "exit" strategy.
- As depository institutions become able to create more credit, the Federal Reserve would begin to scale back its purchases or engage in sales of securities so as to not exceed its target growth rate of *combined* Federal Reserve and depository institution credit.

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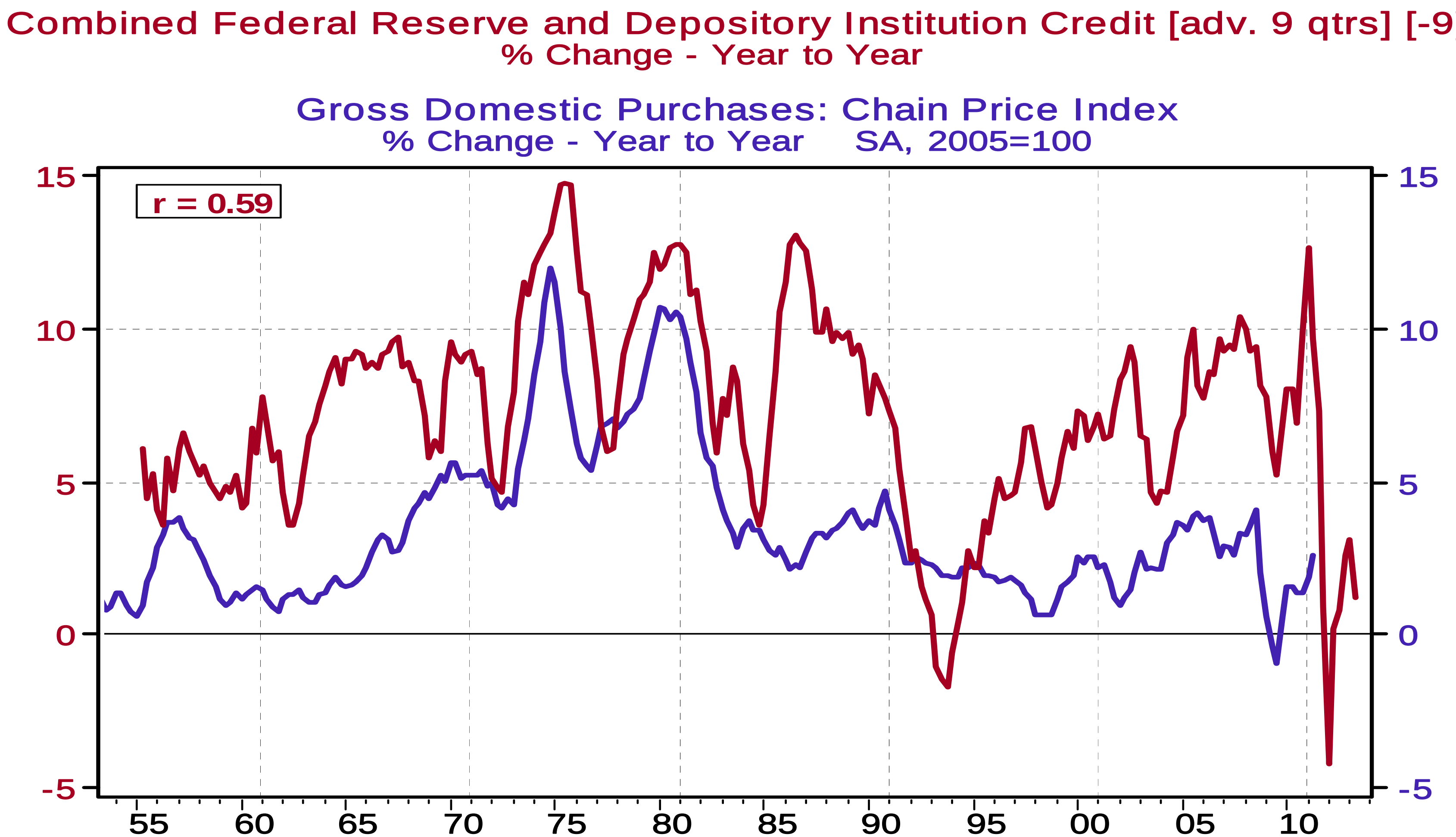
Will not Federal Reserve quantitative easing lead to a higher prices?

- Quantitative easing most likely *will* lead to a higher goods/services and/or asset prices *than otherwise would be the case.*
- But in the face of weak and/or contracting growth in depository institution credit and the absence of quantitative easing, what otherwise might be the case could be *declines* in goods/services and/or asset prices, similar to what occurred in the early 1930s.
- If the Federal Reserve conducts its quantitative monetary policy so as to achieve a rate of growth in *combined* Federal Reserve and depository institution credit consistent with some moderate rate of growth in nominal domestic demand, say 5%, then there will *not* be excessive *sustained* increases in the prices of goods and services nor will there be asset-price bubbles.

Historically, growth in combined Federal Reserve and depository institution credit tends to lead growth in the prices of goods and services by a little over 2 years.



Source: Haver Analytics

Conclusions

- The principal factor accounting for the current exceptionally weak economic recovery is *not* unusually high "uncertainty," too burdensome regulation and taxation, excessive federal government spending and/or debt or a major structural change in the economy, but rather *inadequate depository institution credit creation*.
- The reason depository institutions are not creating normal amounts of credit is that they suffered enormous losses after the residential real estate bubble burst and they remain concerned about current and/or future capital adequacy.
- Today's economic/financial environment is similar to that of the early 1930s.
- Despite a high degree of "uncertainty," increased government regulation of business and unprecedented peace-time federal government spending for that era, the economy experienced a vigorous recovery in the years 1934 through 1936 as growth in depository credit resumed.
- Increased government spending and/or decreased tax rates alone will *not* spark a more vigorous economic recovery in the quarters ahead.
- Rather, what *will* spark a more vigorous recovery is the resumption of more normal credit creation by depository institutions or sufficient credit creation by the Federal Reserve to make up for the lack of depository institution normal credit creation.
- Some dare call Federal Reserve credit creation under these circumstances treason. If so, Milton Friedman would likely have been labeled a traitor.

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