



Investment Perspective

Invesco Fixed Income



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Keeping an Eye on the Money Multiplier

What the pace of bank loans says about inflation prospects

The Federal Reserve (the Fed) has roughly tripled the size of its balance sheet to add liquidity to the troubled financial system, yet inflation has remained relatively tame, in part because an indicator known as the “money multiplier” has fallen. To avoid a difficult situation of both high unemployment and high inflation, the Fed will have to keep a watchful eye on the money multiplier in deciding when to remove some of the liquidity it has provided to the financial system.

What is the money multiplier?

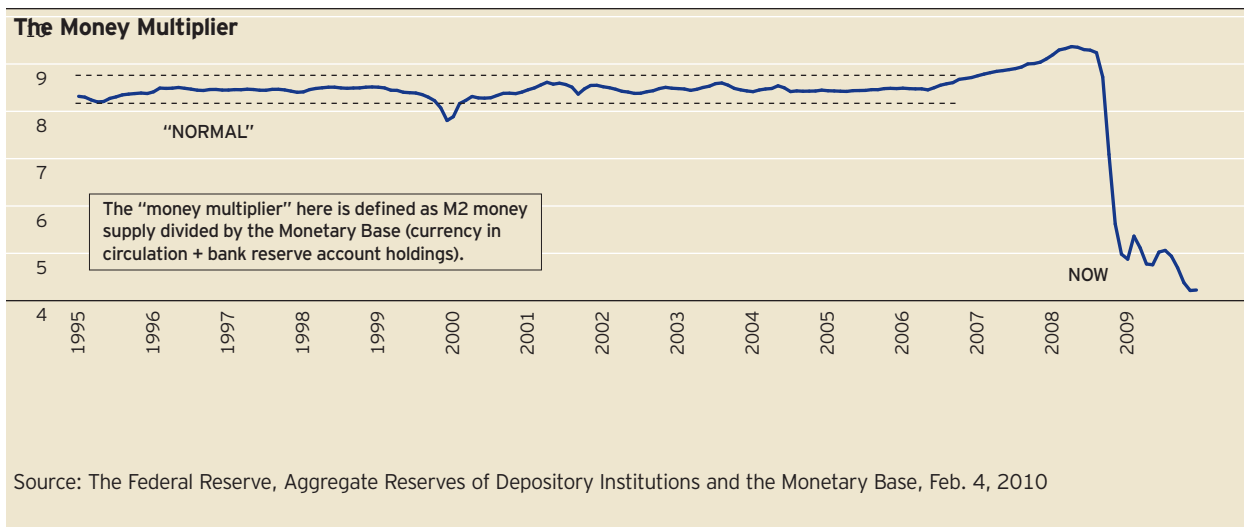
When the Fed adds money to the financial system, it creates that money from scratch, either buying or borrowing assets in exchange for newly created money. Banks must keep a relatively small percentage of deposits in either vault cash or a reserve account at the Fed. The rest they can lend. Those loans result in new bank deposits, which the banks largely lend. Those loans generate more new deposits, which the banks largely lend, and so on. To the extent newly added Fed liquidity flows into bank reserve accounts, banks then have more capacity to extend loans against their deposit base.

Via that cycle, each dollar the Fed adds to the financial system turns into more than one dollar of money supply – this is the “money multiplier” effect. Regulatory policy will influence the size of that multiplier, but recent history suggests that each dollar the Fed adds to the financial system typically turns into somewhere around \$8.50 of M2 money supply (M2 money supply includes currency, checking accounts, savings accounts, time deposits (CDs) and retail money market funds).

Where does the money multiplier stand today?

The past few years haven’t exactly been typical. As banks faced capital losses, they reined in lending. As businesses and consumers faced a daunting economic outlook, they had less interest in taking on additional obligations and demanded less credit.

These dynamics converged to push the money multiplier down to a 4x to 5x range – for each dollar the Fed has added to the financial system, there’s been only a \$4 to \$5 increase in the money supply. This helps illustrate why inflation has remained so tame in the face of such large liquidity injections by the Fed.

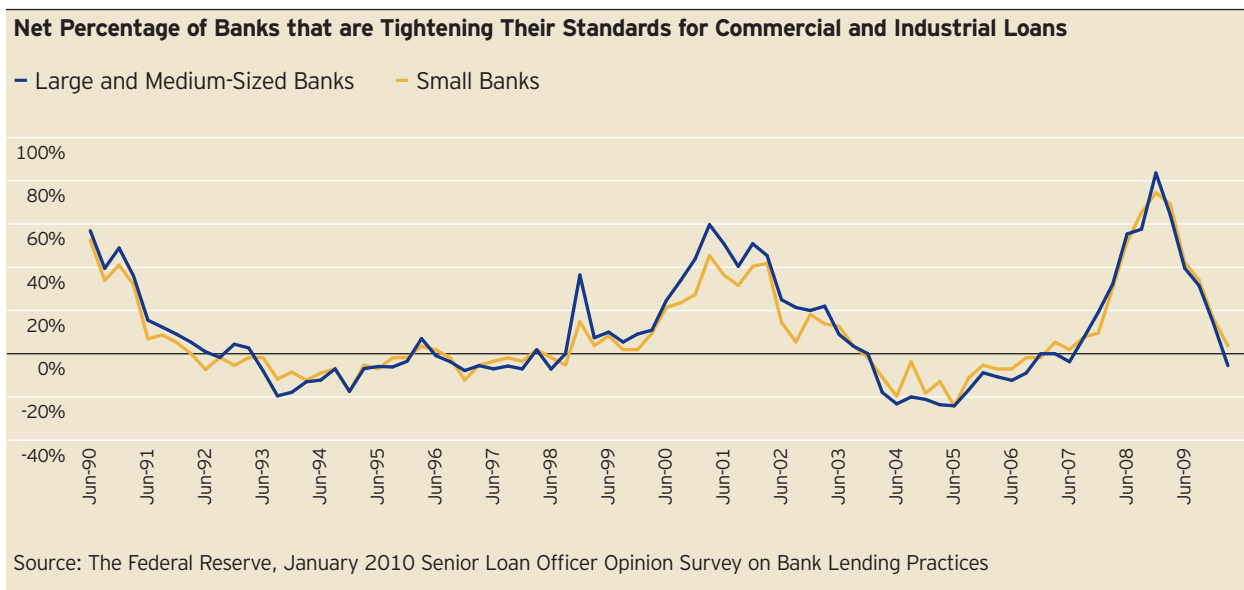


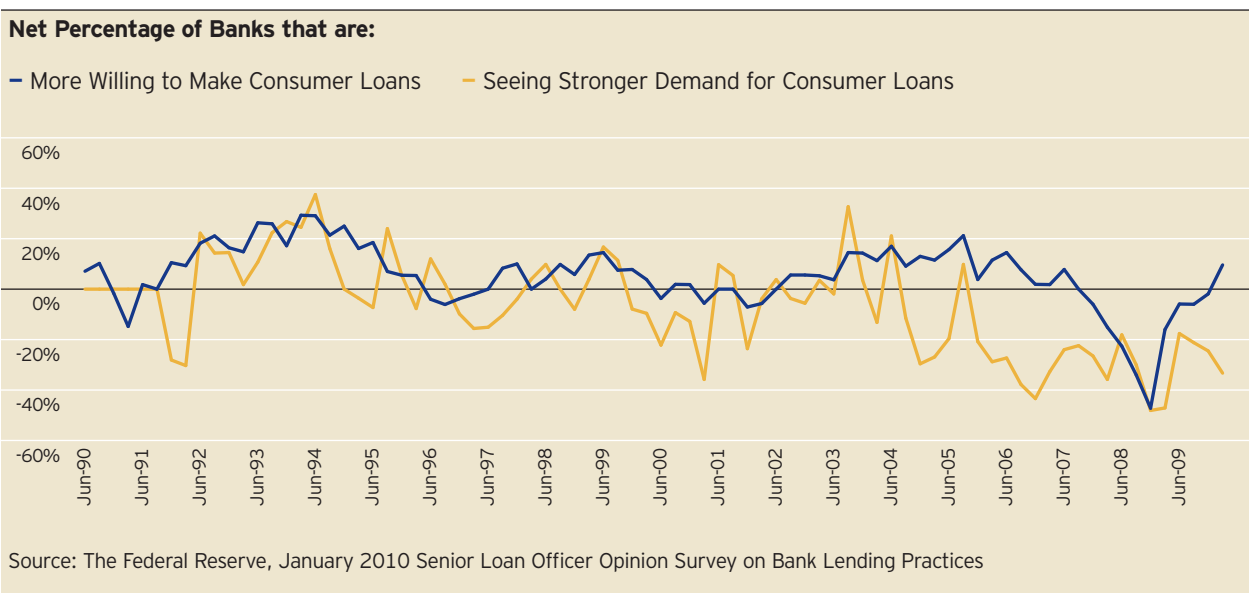
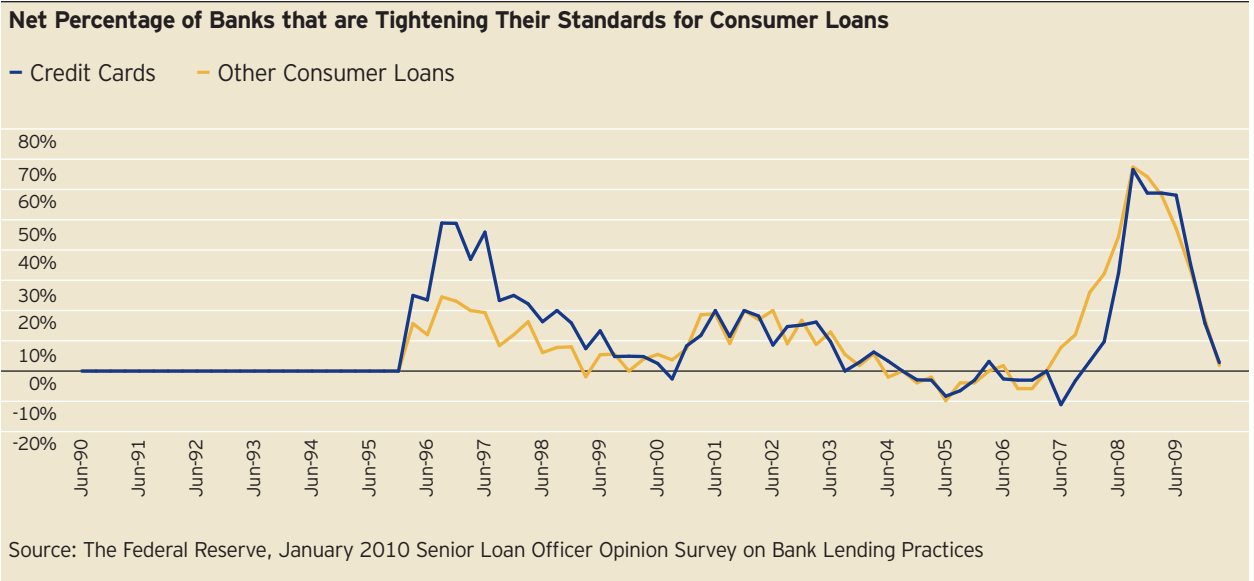
Bank lending – is the tide turning?

Still, the Fed has added close to \$1.5 trillion in liquidity since the third quarter of 2008. This is substantial. M2 money supply totals around \$8.5 trillion. At some point, will the Fed's actions fuel inflation?

The answer depends on how that liquidity translates into growth in the money supply. The multiplier has fallen due to factors the Fed doesn't control – the slowing pace of bank lending and the lack of loan demand by businesses and consumers. However, if banks start lending to willing borrowers, the money supply will start growing. Absent any counterbalance from the Fed to remove liquidity, inflation becomes a real concern.

How close are we to an environment where banks and borrowers start turning an ocean of liquidity into money supply growth via an expanding money multiplier? It's difficult to predict. In early February, the Fed released its Senior Loan Officer Opinion Survey on Bank Lending Practices for January 2010. The survey revealed that banks are increasingly willing to extend credit – fewer banks are tightening commercial and industrial (C&I) and consumer lending standards. But on the other side of the equation, demand for C&I and consumer loans remains weak.





Looking ahead

At this point last year, investors feared a protracted recession or even a depression. Though some commentators point to the possibility of a double-dip recession, or at least a double-dip slowdown, it seems we've avoided the more dire scenarios. This indicates that the Fed's liquidity injections into the financial system were successful.

A failure to remove that liquidity in a timely fashion, however, could raise the risk of inflation. Caution and fear have pushed the money multiplier lower than what we've typically experienced historically. But while it fell rapidly, it can also rise rapidly if the current slowdown in lending reverses. Such is the nature of dynamics fueled by human emotion.

For the time being, the borrower side of the lending equation seems fairly muted from a demand standpoint. The Fed, however, will have to keep a close eye on the money multiplier in deciding when to rein in the liquidity it has provided to the financial system.

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