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* Monetarism gains in importance within central banks

* Low rates make policy communication more difficult

* ECB's criticised two-pillar strategy shows advantages

By Sakari Suoninen

FRANKFURT, March 19 (Reuters) - While John Maynard Keynes has become the darling of governments seeking to stimulate their way out of the recession, major central banks are taking a different tack by moving towards monetarism.

Keynesian and monetarist economics are usually portrayed as conflicting ideologies, but now governments and central banks are using them respectively to achieve the same end.

All the big four central banks, apart from the European Central Bank, are now buying assets to supplement interest rate cuts. On Wednesday the U.S. Federal Reserve joined the Bank of England and the Bank of Japan in purchasing government debt -- a move right out of the monetarist textbook.

Keynes, a British economist, advocated massive state spending to tackle the Great Depression of the 1930s, and many governments are using his theories to tackle the current crisis.

By contrast the monetarist theories of U.S. economist Milton Friedman are associated with the tough policies used to tackle high inflation in the 1980s.

Monetarists argue that inflation is always a monetary phenomenon and can be controlled by limiting growth of money supply. It was embraced by the economic team of former U.S. President Ronald Reagan in the early 1980s.

Germany's Bundesbank also pursued monetary targeting from 1970s onwards, and was integral in including a monetary target in the European Central Bank charter a decade ago, even though it had fallen out of fashion elsewhere.

Now many nations face the threat not of inflation but of deflation, which could make the current Great Recession much worse if it takes hold. Therefore, the reverse of the 1980s argument can be applied: deflation can be prevented by increasing money supply growth.

Central banks are turning to monetarism for practical reasons, rather than becoming ardent followers of Friedman.

With most major economies in recession and interest rates approaching zero, they are looking at boosting money supply to get the global economy going again. Their actions show they are closer to monetarism than their words would suggest.

Morgan Stanley economist Joachim Fels calculates that the monetary base has more than doubled in the United States over the past year, and is up 40 percent in the euro zone and 30 percent in Britain over the same period. This is working its way to such money supply figures as M1 and M3.

"Conventional and unconventional monetary easing has in fact started to lift money supply in major economies," he said. "Money supply is a key indicator to watch in order to gauge whether monetary policy action will find traction."

Some policymakers have said a rise in money supply could help. "Increasing the rate of growth of the monetary base would be one way to pursue additional policy easing," ECB Governing Council member Athanasios Orphanides said last month.

HELICOPTERS

Policymakers have so far largely brushed aside suggestions of persistently falling consumer prices, but deflation has at least entered their vocabulary. Monetarists say printing money to decrease its value would get rid of deflation.

In 2002 Ben Bernanke, then a Federal Reserve governor and now its chairman, quoted Friedman in suggesting that money should be dropped from helicopters if the economy slid into deflation. The nickname "Helicopter Ben" has stuck to him.

With U.S., Japanese and British interest rates close to zero, their central banks have turned to "quantitative easing".

Under this, a central bank switches to targeting the amount of money, instead of the price of money through interest rates. Communicating this may be easier if the central bank uses monetary aggregates to justify its actions.

A common criticism of monetarism is that it does not take into account money circulating more slowly when an economy slows down, weakening the impact of the rising money supply.

But this increase makes up for the tendency of money to change hands more slowly during recessions, Morgan Stanley's Fels said, adding that money supply is a more reliable indicator than credit, which lags the economic cycle.

This could boost the economy in the short-term, allowing companies to borrow more easily and staving off deflation.

ECB'S MONETARY PILLAR

The ECB is alone among major central banks in using monetary data to cross-check signals from its economic analysis. The two-pillar system may help in justifying and communicating policy at a time of unorthodox measures.

"The question comes up, how do you communicate policy when interest rates are zero?" said Volker Wieland, Director of Frankfurt's Center for Financial Studies.

"The ECB is lucky that they have the monetary pillar ... It was heavily criticised but now again, I think, this is a very useful concept," said Wieland, who co-authored with Orphanides an influential paper in 1999 on monetary policy at zero rates, when they both worked for the Fed.

But the ECB does not see increasing money supply as a long-term solution to boost the economy. In a 2004 book on monetary policy it said controlling money supply alone does not lead to long-term growth: "In the long run, the central bank cannot influence economic growth by changing the money supply."

This has not stopped the ECB from fighting the recession with monetary measures. It has boosted the monetary base by providing banks with unlimited liquidity since the financial crisis heightened, and has said it is studying the possibility of further unconventional measures.

"I think this is very pragmatic, very much driven by the events and primarily by the fact that central banks need to keep the momentum," said Nomura analyst Laurent Bilke.

"The main goal is to avoid negative confidence effects from the fact that central banks

would be at the end of the road."

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