Intelligence MEMOS

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To: Governing Council, Bank of Canada

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Re: **Slumping money growth may prefigure a slumping economy**

Growth of Canada's money stock has dipped sharply. The year-over-year growth rate of transactions money, M1+, has fallen from double digits to around 7 percent – its lowest rate since 2014. A broader measure of liquidity, M2++, is down to around 6 percent – its lowest rate since 2011. There was a time when the rapid money growth that prevailed until mid-2017 would have seemed a natural harbinger of the currently robust economy, and abrupt drops in growth would have raised concerns about a downturn. Does money's recent deceleration prefigure an economic slump in 2018?

Money growth (the Bank of Canada's full definitions of the Ms are here.) has attracted little attention from central bankers and forecasters for some time. Several decades have passed since the heyday of monetarism, when rampant inflation led advocates such as Milton Friedman to argue that reining money growth in would bring inflation down, and central bankers such as Paul Volcker at the US Federal Reserve followed that advice – with convincing success. During the 1980s and 1990s, many people inside and outside central banks closely followed money growth rates, and Canada was one country in which accelerations and decelerations of money supply quite reliably prefigured accelerations and decelerations of spending and ups and downs in inflation.

But money's usefulness as an indicator of activity and inflation, or a target for monetary policy, depends on its having a stable or predictable relationship to spending. Experience across countries shows that, over periods of many years, money growth does correlate with spending – which means that, after adjusting for growth in productive capacity, it correlates with inflation. In the shorter run, however – and especially over the timeframes in which central bankers make monetary policy – changes in money's velocity of circulation can make money growth much harder to interpret.

Since the 1990s, velocity has shifted a lot. Technologically aided cash management and other financial innovations have affected it. So have changes in regulations such as reserve requirements. Furthermore, while velocity's sensitivity to interest rates is familiar – when the cost of holding transactions money, which bears no or very low interest, is higher, people economize on it – interest rates have been so low for so long since 2008 that we are in uncharted territory.

The drop in Canadian money growth since mid-2017 may simply reflect a return to more normal monetary conditions. Interest rates, including the Bank of Canada's policy rate, have been expected to move, and are moving, up from emergency levels. But if that were the whole explanation, we would expect to see growth in narrow money falling faster, since people would be foregoing some low-yielding balances such as demand deposits for the sake of higher-yielding balances such as money-market mutual funds. Remarkably, the deceleration of broader money stands out the most: M2++ is rising at its slowest annual rate in six years, and a deceleration this sharp has not happened since the financial crisis.

Notwithstanding money's less-than-stellar performance as a leading indicator of the economy in recent years, the slump in growth of M1+ and M2++ merits some attention. It may reflect further changes in the financial industry and adjustments to interest rates, in which case it is nothing to worry about. But if it signals that Canadians are holding – that our financial system is creating – less transactions money for other reasons, such as the risks highlighted in the Bank of Canada's latest Monetary Policy Report, it would prefigure a weaker economy in 2018, and undermine the case for further policy rate increases in the coming months.

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