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Quarterly Review and Outlook

Third Quarter 2024

The Rules of the Game

Throughout history one of the most significant features of the global business cycle is the synchronization of individual country economies. For the last one and two-third centuries, the world has had three different currency regimes:

1. The full-fledged Gold Standard ran from 1871 to 1933 in the U.S.
2. The fixed exchange rate Bretton Woods System lasted from shortly after World War II until 1971.
3. The current floating exchange rate system was ushered in when President Nixon closed the gold window for foreign official transactions in August 1971.

Under the post-1971 regime, the U.S., as the central bank of the world reserve currency, has exerted significant inflationary or disinflationary pressures on the global economy. This influence has been determined by U.S. monetary posture. Notably, significant gold discoveries during the Gold Standard days had similar effects on world money growth. The closest equivalent measure to this period is the current Federal Reserve's holdings of U.S. Government and Agency securities plus U.S. Government and Agency securities held in custody for foreign official institutions, which can be defined as world dollar liquidity (WDL). The evidence suggests that world money growth also surged when WDL increased in 2020-22, mirroring the impact of earlier significant gold discoveries (Chart 1).

Regardless of the system in place, as world money growth expanded and contracted, the global economy fluctuated from expansion to contraction. Similarly, inflation reversed direction, although invariably with a lag. Synonyms for fluctuations in economic growth and inflation include booms, busts, slumps, panics, manias, crashes, depressions (both mini and Great), recessions, high prices, low prices, price wars, price gouging, deflation, and disinflation. Under the gold standard, the process was called both 'The Price-Specie Flow Mechanism' (originated by David Hume in his 1752 paper "On the Balance of Trade") and the 'Rules of the Game' (a term used by J.M. Keynes and many others). This similar process of variation in output and prices describing the prevailing modern era came from refinements of Irving Fisher's equation of exchange by Milton Friedman, Karl Brunner, Alan Meltzer, and Ronald McKinnon to name a few. One of the most unique books on the subject was the late Stanford professor McKinnon's 1996 book, *The Rules of the Game: International Money and Exchange Rates.*

Reflecting a record post-1976 rate of

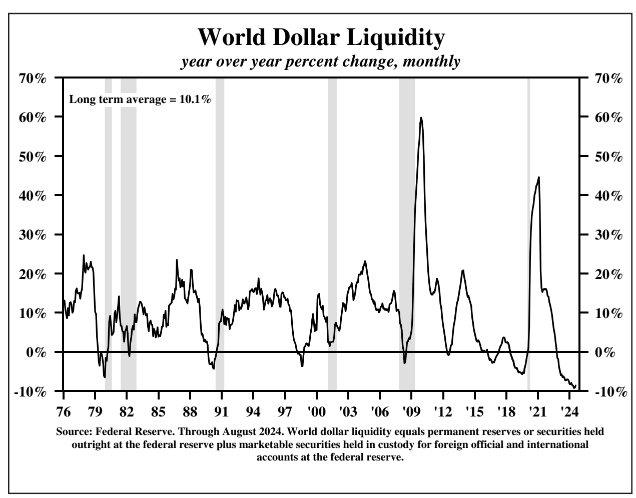


Chart 1

decline in WDL and detrended real money growth in the United States, the E.U., China, Japan, and the U.K., inflation followed suit, contracting sharply. Hard times ensued in these economies, except the U.S. Given the slow working nature, but ultimate power, of real money growth demonstrated by this well-worn historical record, the pattern of disinflation and subtrend growth in the world's economy will likely persist.

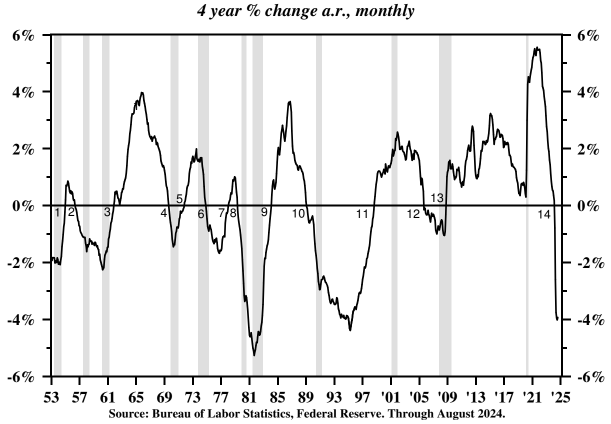
Whether the Economy will be Too Hot or Too Cold

An economy will grow at the Stable Growth Rate (SGR) when actual real money (M) growth equals the trend growth rate in real M and velocity (V). Because M and V are the two components of the Equation of Exchange, both must be utilized for detrending. An SGR has happened in fourteen instances since 1953 in real U.S. M2 (Chart 2). As such, U.S. real M2 was only stable during transitory phases when central bank policy shifted from over- or under-stimulative. Above zero, the U.S. economy was on the path to overheating, and below, the U.S. economy was heading toward a downturn and disinflation.

Detrended real M growth has fallen far below the SGR rate for four economic regions – the U.S., China, The Euro Area, and the U.K. (Table 1, col. D.). (The latest four-year moving averages are used since M in each country surged rapidly in 2020-21 and reversed dramatically since then). Japan's SGR is still slightly positive, possibly reflecting their prolonged real growth slump.

Detrended Real M2

4 year % change a.r., monthly



Source: Bureau of Labor Statistics, Federal Reserve. Through August 2024.

Chart 2

Peak to Latest Contractions in Detrended Real Money Supply

4 year % change a.r., quarterly

		First Data Point	Peak	Peak Date	Latest	Peak to Latest (B-D)
		A.	B.	C.	D.	E.
1.	United States	Q4 1959	5.6%	Q2 2021	-3.3%	-8.9%
2.	China	Q4 1998	7.6%	Q1 2012	-1.6%	-9.2%
3.	Euro Area	Q1 1995	5.6%	Q3 2008	-1.8%	-7.5%
4.	Japan	Q1 1970	8.2%	Q1 1974	0.3%	-7.9%
5.	United Kingdom	Q2 1982	10.3%	Q4 1989	-5.0%	-15.2%

Source: Bureau of Economic Analysis, Federal Reserve, Bureau of Labor Statistics, Statistical Office of the European Communities, European Central Bank, Cabinet Office of Japan, Bank of Japan, Ministry of Internal Affairs and Communications, Office for National Statistics, Bank of England, Haver Analytics, Rosenberg Research .

Table 1

Complementary to the low real M growth, V is dramatically lower in all five economic regions, with the Chinese and Japanese levels being the lowest (Table 2, col. E and F). Also, the latest V for each country was far below their average. The lower the V, the less effective the monetary policy.

All five economic regions have registered record detrended real M contractions from their peak four-year growth rates in 2021-22 to their most recent four-year growth rates (Table 1, col. E). For detrended real M, the most pronounced swings were in the U.K., China, and the U.S. But even in the Euro Area and Japan, the swings were more than seven percentage points.

Detrended Real Money Supply and Components

quarterly

		First Data Point	Average Real Money Supply (4 yr. % change)	Average Velocity (4 yr. % change)	Trend Rate of Growth (A-B)	Average Level of Velocity	Latest Level of Velocity
		A.	B.	C.	D.	E.	F.
1.	United States	Q4 1959	3.2%	-0.6%	3.70	1.77	1.37
2.	China	Q4 1998	12.1%	-2.3%	14.39	0.60	0.43
3.	Euro Area	Q1 1995	3.5%	-2.1%	5.63	1.15	0.91
4.	Japan	Q1 1970	3.7%	-2.1%	5.76	0.95	0.49
5.	United Kingdom	Q2 1982	4.7%	-2.3%	6.95	1.22	0.91

Source: Source: Bureau of Economic Analysis, Federal Reserve, Bureau of Labor Statistics, Statistical Office of the European Communities, European Central Bank, Cabinet Office of Japan, Bank of Japan, Ministry of Internal Affairs and Communications, Office for National Statistics, Bank of England, Haver Analytics, Rosenberg Research .

Table 2

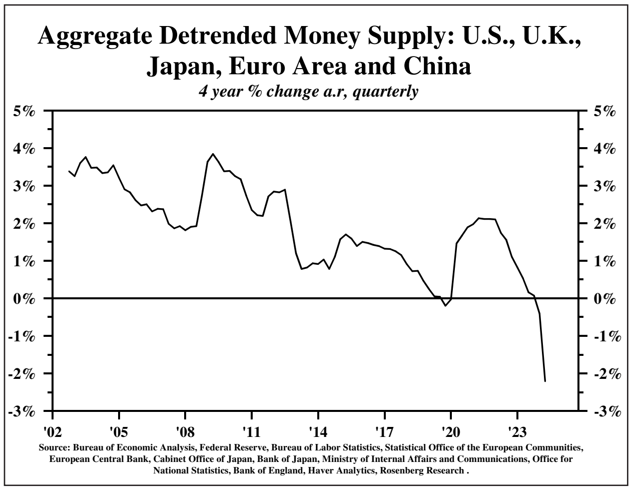


Chart 3

A Single Globally Weighted Monetary Barometer

The situation in these individual regions can be consolidated into a global directional indicator of monetary thrust that provides a comprehensive view of the monetary situation across these regions (Chart 3). This indicator is the most restrictive in the past twenty-two years, meaning that these five central banks, collectively, have significantly increased the risk of severe disinflation and poor economic performance. The combined detrended real M growth for these five economic regions is weighted by its contribution to world GDP. China's M is only available since 1998 and as four-year moving averages were employed, the series could only start in 2002. But it is critical to the value of the series to include China, because it is 19% of the global economy. Each country's yearly GDP, as measured by the World Bank, is weighted by its relative contribution to global economic output. Over this twenty-two year span, the four-year moving average of detrended global M has fallen to a record low in the latest reading. Although a limited sample period, it contains one extremely relevant comparison point. The slowdown in M growth during the Great Financial Crisis pales in comparison to the current situation.

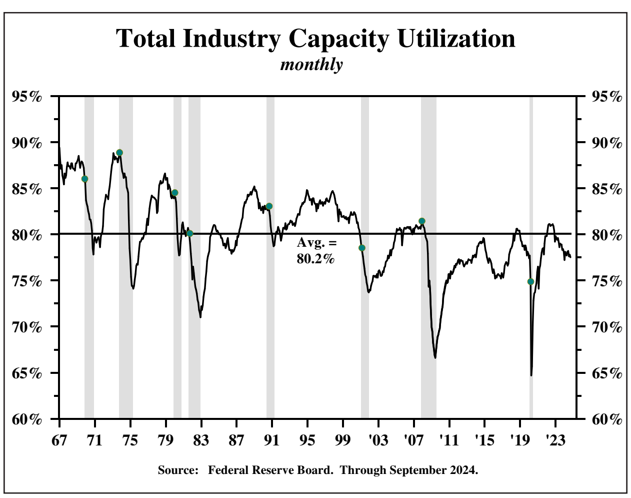


Chart 4

The Treasury Bond Market

With the September 50-basis point cut in the Federal funds rate, all five central banks have lowered their policy interest rate. However, reducing the policy rate differs from sharply accelerating real detrended M growth and boosting its much more crucial multi-year trend growth. The demand for real M is highly unresponsive to changes in the overnight interest rate, indicating high inelasticity. This causes a significant lag between an initial monetary policy action and a meaningful impact on economic activity and inflation.

The headline and core inflation rates will continue to recede in an environment of more excess capacity combined with the monetary restraint of the past two years, which is still working its way into economic conditions (Chart 4). Accordingly, the Federal Reserve will have the latitude to lower the policy rate further. Moreover, additional cuts will be needed to reverse the multi-year decline in real detrended M growth. At the same time, long-term U.S. Treasury bond yields will follow the downward path in inflation. This pattern has been extensively researched and well-documented. The current evidence of the slow growth of real M globally and its impact on the world economy suggests the pressure for long term treasury yields to fall is increasing.

Hoisington Investment Management

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