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'There is no money multiplier'

Posted by **Tracy Alloway** on Aug 12 10:42.

Here's an elegant solution to the problem of the US's missing money multiplier.

Just declare it doesn't exist. Or at least, not as we know it.

That's just what Seth B. Carpenter and Selva Demiralp are arguing in a new Federal Reserve working paper. It's not necessarily a new argument, by any means, but it's one that seems to be gaining traction.

The suggestion is that the US money multiplier has not just temporarily gone walkies, but actually doesn't exist in its textbook form. Here's Carpenter and Demiralp:

> *Reserve balances have recently increased dramatically, going from around $15 billion in July 2007 to over $788 billion in December 2008. Despite this increase by a factor of 50, no similar increase in any measure of money, as suggested by the multiplier, could be found. Hence, while the actual multiplier was about twice the theoretical multiplier in 2003, it was about 1/50th of the theoretical multiplier in 2008. Considering other measures of money, the monetary base, the narrowest definition of money, doubled over that period while M2 grew by only 8½ percent.*
>
> *Casual empirical evidence points away from a standard money multiplier and away from a story in which monetary policy has a direct effect on broader monetary aggregates . . .*

And after testing some of their theories (about 50 pages of results here) they conclude:

> *Since 2008, the Federal Reserve has supplied an enormous quantity of reserve balances relative to historical levels as a result of a set of nontraditional policy actions. These actions were taken to stabilize short-term funding markets and to provide additional monetary policy stimulus at a time when the federal funds rate was at its effective lower bound. The question arises whether or not this unprecedented rise in reserve balances ought to lead to a sharp rise in money and lending. The results in this paper suggest that the quantity of reserve balances itself is not likely to trigger a rapid increase in lending. To be sure, the low level of interest rates could stimulate demand for loans and lead to increased lending, but the narrow, textbook money multiplier does not appear to be a useful means of assessing the implications of monetary policy for future money growth or bank lending.*

The implication is that the Fed may well be even more parabolic than was thought when it comes to encouraging banks to start lending again, or stimulating the real economy. Increasing bank reserves via QE *was* meant to encourage banks to lend as they try to re-establish their target ratio of reserves to their balance sheet. We referred to it in early 2009 as "basic money multiplier stuff."

The Fed itself, in case you're wondering, seemed enamoured of monetary transmissions when it began its unconventional policies in late 2008. Back then it was so concerned with the link between money and monetary policy that it wrote about "divorcing" the two — something which came to pass when it began paying interest on reserves that year. Anyway, the over-arching point is that if the multiplier doesn't exist, then the QE process won't work, and the Fed will be left with few other options.

The low interest rate one mentioned in the paper, incidentally, certainly isn't guaranteed to work. There's already been some discussion, that ultra low rates are actually bad in terms of bank lending.

Does the Fed have any other ideas?

Related links:
Money multiplier – missing feared dead – Billy blog
Reserves and reservations – Japan's QE redux - FT Alphaville
The parabolic Fed: divorcing monetary policy from money - FT Alphaville

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Comments

The multiplier only exists as long as we are calculating it as a ratio of money supply and monetary base. But the point is that this ratio is useless because we are actually living in a Basel II system, not in a fractional reserve system. The thing you have to look for is obviously Tier 1 ratio. The result of QE was in fact an increase in Tier1 capital ratios of the largest banks because their toxic assets with high risk-weights were exchanged for cash(reserve balances at the Fed) with 0% risk-weight. It is an open question though if banks would like to get exposure to risks (via lending and decreasing Tier1 ratios) in the near future.

If the mutliplier doesn't exist, then QE will not work in the sense that it will not encourage banks to lend.

However, Bernanke has always said (see his speech at the LSE in January 2009: http://www.federal...nanke20090113a.htm) that what the Fed is looking to achieve through its asset purchases is credit easing (ie the lowering of credit spreads), rather than QE.

Richard W

Actually, the wci post you link to (as opposed to its comments) argues, as I do in my comment at 12.57 (in which I should have written "neither" instead of "either" in case that is not obvious), that both capital and reserves can be regarded as factors of production for bank lending. As such, there should be a relationship between the availability of reserves and bank lending, but that relationship shifted and was therefore obscured as (a) the need for and expense of bank capital increased at the onset of the financial crisis (b) the precautionary demand for reserves not associated with bank lending increased (as Izabella remarks) and (c) interest began to be paid on reserves, which lowered the opportunity cost of holding them. And of course, bank lending is a function of demand as well as supply.

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shrivti1 - fixed.

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tested some of THEIR theories. THEIR. Tsk tsk.

There is no money multiplier. The modern banking system is never reserve constrained. The only constraint on their business is capital and credit worthy borrowers.

This model by JKH is a pretty accurate description of the banking system. It is a long post but worth reading.

http://worthwhile....e20120a6eb7061970b

Is the money multiplier not also a function of risk appetite? If unsecured lending has vapourized -- and most assets are impaired anyway -- there is naturally going to be reserve hoarding.

August 2005

Mortgage broker:
"Well you see Mr Sullivan, with this interest rate and the way property prices are motoring, this is a once in a lifetime opportunity. You