The Monetary Explanation of Recession and Recovery

Scott Grannis, the former chief economist of Washington Asset Management, provides a monetary explanation for the recent recession and the ensuing recovery. To learn about his approach, consider the Equation of Exchange, \( MV = GDP \). Here,

- \( M \) is the “broad” money supply (M2), which includes currency, checking deposits, retail money market funds, and small (less than $100,000) saving deposits;
- \( V \) is the velocity of money: the average frequency with which a unit of money changes hands in a year; and
- \( GDP \) is the nominal Gross Domestic Product: total output of final goods and services valued at current market prices.

From this equation, the velocity of money is \( V = \frac{GDP}{M} \). The inverse of this measure, \( \frac{1}{V} = \frac{M}{GDP} \), is the money demand: how much of a year’s spending the economy wants to hold in money.

The following two charts illustrate the growth of the velocity of money (M2 Velocity) and the growth rate of the money supply (M2 Growth). The first chart shows that over the past 50 years, the velocity of money, varying between 1.6 and 2.1, had a mean of about 1.8.

According to the monetary explanation, the recent recession (December 2007 - June 2009) was caused by a huge surge in the money demand, and the resulting crash of the velocity of money. Grannis states that “People thought the end of the world was approaching, and so they stopped spending and started hoarding cash; the demand for money surged, and money velocity collapsed.” Indeed, the velocity of money dropped nearly 13 percent during the recession, which was the largest decline in velocity on record. In the ensuing recovery, though, the velocity of money has grown 1.9 percent. With improved consumer confidence, households are beginning to un-hoard some of their cash and spend it.

Grannis foresees healthy economic growth for the fourth quarter of 2010 and beyond. In the third quarter of this year, M2 grew at an annual rate of 5.0 percent and the GDP grew 4.4 percent. He expects M2 to rise at least 6.0 percent this quarter. Assuming the velocity of money to remain stable, GDP will expand 6.0 percent. While adjusting for 2 percent expected inflation, the GDP would grow at a “real” rate of 4.0 percent:
I know there are a lot of assumptions behind this forecast, but I don’t think I’ve made any that are unreasonable, so I’m sticking with my call for 3-4 percent growth for the current year and for the average of the next several quarters. If I’m wrong it won’t be by much. And given the market’s penchant for seeing a double-dip recession around every corner, even if growth this year comes in at 2.5 percent that will be more than what I think the market expected to see.

The expected annual growth rate of 2.5 percent is less than the historical average of 3.0 percent. Therefore, there will continue to exist an “output gap” and excessive unemployment. Keeping inflation under control, the “real” GDP growth must exceed 3.0 percent for a sustained period of time in order to see a significant reduction in the unemployment rate.
Grannis is optimistic that the “real” GDP growth would exceed 3.0 percent with the subject to three conditions: (1) slowing the growth of government spending, (b) rolling back the health-care reform (which has not happened), and (3) extending the Bush tax cuts (which has already happened). Upon satisfaction of these conditions, he foresees improvements in business confidence resulting in a surge in new investment and new jobs and a boost to the velocity of money.

Source: