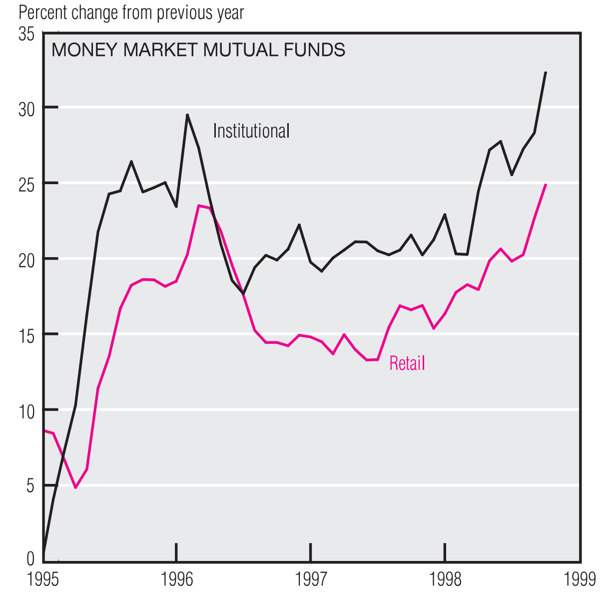
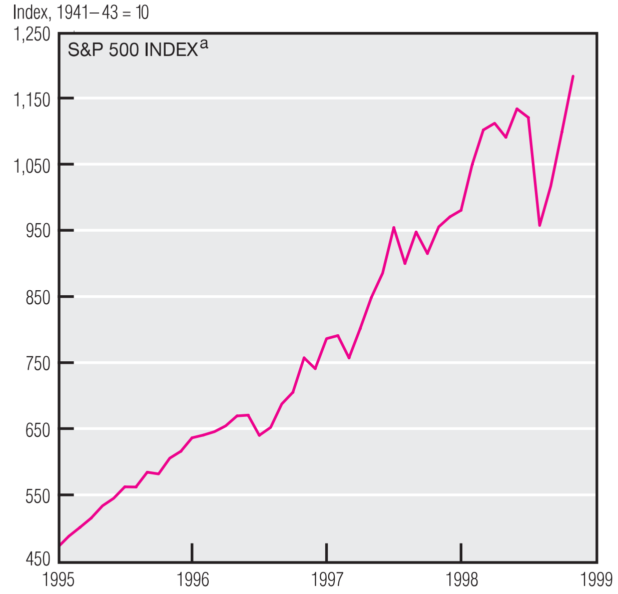
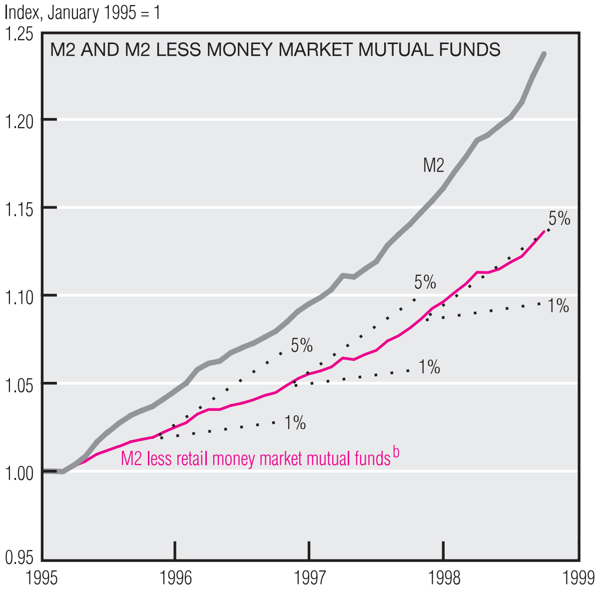
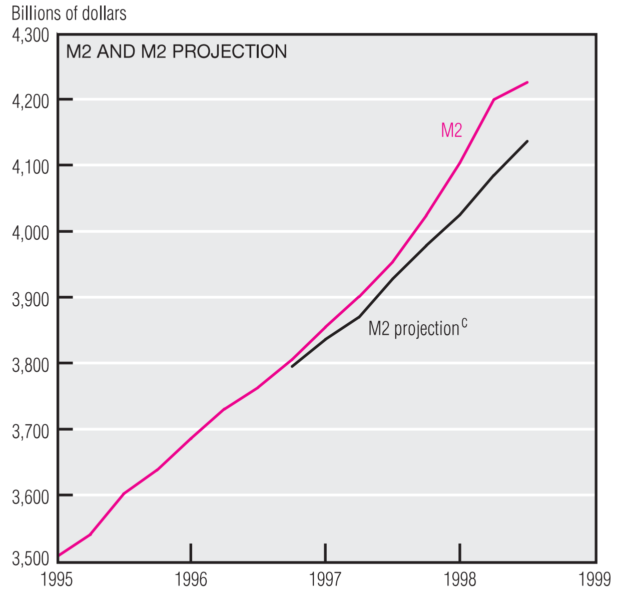
Money Growth and Stock Market Volatility









a. The data are end-of-month closing values. The last point is the closing value of the index on November 24, 1998.
b. Dotted lines correspond to FOMC-determined provisional ranges for M2 and are for reference only.
c. M2 projection is an out-of-sample estimate from a quarterly model that includes an estimated effect of positive and negative movements in the S&P 500 Index, using data from 1964:IQ through 1996:IVQ.
NOTE: Money market mutual funds and M2 data are seasonally adjusted.
SOURCES: Board of Governors of the Federal Reserve System; Federal Reserve Bank of Cleveland; Standard and Poor's Corporation; and DRI/McGraw–Hill.

Rapid money-supply growth in recent years has received scant attention in the financial press. Since 1996, the M2 measure of money has increased at an average annual rate of more than 7%. With little or no evidence of accelerating inflation, strong money growth has been eclipsed by concerns that troubled foreign markets could undermine domestic economic conditions. Policy actions seem to have focused on assuaging fears that financial market disruptions in Asia and Eastern Europe could continue to spread.

But what accounts for the strength in money? One hypothesis is that households and investors typically increase their holdings of money market funds when equity prices and transaction volume swing sharply. Both retail and institutional money funds serve as a temporary parking lot for funds associated with stock transactions, and retail funds are included in M2. Moreover, skittishness about stock prices leads to increased demand for relatively safe assets during periods of turbulence.

Preliminary research suggests that large movements in stock prices, whether up or down, are indeed associated with rapid money-fund growth. Since money funds comprise more than 28% of M2, much of the M2 bulge has been attributed to recent stock market conditions. Estimates of the direct effect of stock prices on M2, however, are less supportive of the hypothesis. Although statistically significant, such effects do not account for all the strength in M2. Thus, much of the recent strength in money remains a puzzle.