

**Why did Monetarism have so much Trouble in the Early 1980s?: 1. The Missed Targets**

*From an article 'Why has monetarism failed so far?: 1. The missed targets' in The Banker, March 1982.*

*The rapid growth of bank lending to the private sector in the recession of 1979–82 was unexpected. It was the principal reason that monetary growth exceeded target. The article blamed the vigour of the private sector's demand for credit on the interaction of financial deregulation with a tax system which was too friendly to borrowers. It therefore pointed an accusatory finger at such features of the tax system as full deductibility of business interest as an expense and of mortgage interest from personal incomes. Some of these aspects of the British tax system have subsequently been*

*changed, with, for example, the 1984 Budget lowering the standard rate of corporation tax, and so making borrowing and leasing less attractive to companies.*

Monetarism has received a great deal of criticism and even a certain amount of mockery over the last two years. A few months ago many journalists were deriding it as intellectual junk which, because of its association with the deepest recession since the 1930s and the resulting unemployment, could never be salvaged. Although signs of a more cautious and ambiguous assessment are now emerging because of the tentative recovery in the economy, something has clearly gone wrong. There is no doubt that British economic policy has been broadly monetarist in character in recent years and that it has not matched its supporters' original expectations. Economists need to ask in what respects and for what reasons monetarism has failed so far.

Most indictments of monetarist policies have been marked by great vigour, but also a curious inconsistency. On the one hand, they have emphasized the Government's inability to meet its own targets. As heavy political capital was invested in sterling M3 and the public sector borrowing requirement as symbols of successful financial policy, the charge seems to be that the Government has been incompetent according to criteria it recognizes. On the other hand, the losses of output and employment in 1980 and 1981 have been condemned as too high a price to pay for too small a reduction of inflation. As the Government's main aim was to lower inflation and it never denied that higher unemployment might occur, this second charge focuses on a policy objective to which the Government did not – at least initially – pay all that much attention. The critics' inconsistency arises because, if the financial targets had been met, their first point would not apply, but the jobless total would have been far worse and their second point even more emphatic. A logical anti-monetarist cannot simultaneously level both charges against official policy.

However, a monetarist sympathizer should consider each of the two problems. The missed targets and the mass unemployment have been equally embarrassing, if in different ways. Although the two disappointments are related, we shall examine only the failure to achieve monetary targets in the present article. This failure has been essentially in the operation of monetary policy. In a subsequent article [reprinted here on pp. 95–104] we shall consider the question of why the consequences of the particular monetary stance chosen by the Government have been so damaging for the 'real' economy.

There has been a persistent tendency to exceed official money supply targets in the last two years. Previously they were met, if not very convincingly. In 1978/79 sterling M3 went up by 10.9 per cent against a target band

of 8 per cent to 12 per cent, and in 1979/80 by 11 per cent against 7 per cent to 11 per cent. Only in 1980/81, when sterling M3 surged by 20.9 per cent compared with another 7 per cent to 11 per cent target, did control disintegrate. Another large overshoot seems likely in 1981/82. The main headache for the money supply managers in 1980/81 and 1981/82 was the obstinate refusal of private sector demand for bank credit to decline despite a very depressed economic background. Every new loan creates a new deposit and every new deposit counts in sterling M3.<sup>1</sup> With bank lending to the private sector at record high levels, the sterling M3 targets were wrecked. This much is well known and familiar. What is far less certain is why loan demand remained – and indeed remains – so buoyant.

There is a temptation to suggest an explanation merely by providing a narrative of events. The first sign of serious trouble came in August 1980 when, following the abolition of the 'corset' in June, the full scale of credit growth over the previous two years was revealed. This credit growth had been channelled into some very obscure interstices of the financial system and no one appreciated how large it had been. Most of it had gone to the corporate sector. Despite the ruinous impact on the money supply targets, the furore caused by the abolition of the corset had died down by early 1981. With many observers confident that loan demand had begun to subside, Minimum Lending Rate was cut to 12 per cent in the March Budget. By September and October it was clear that, once again, the problem had been underestimated. Bank lending was surging forward at an underlying rate of over £1 billion a month, with personal sector borrowing for house purchase this time being the most dynamic element.

But to focus on the sequence of specific episodes which together constituted the Government's policy failure evades the serious issues. It implies that bank lending could have been curbed if the Bank of England had changed its tactics a little on one or two critical occasions. This is almost certainly an illusion. A persuasive explanation for the strength of loan demand should instead relate it to deep-seated structural characteristics of the economic system. As it happens, a good argument can be made that the credit boom of 1979 to 1982 was the culmination of powerful trends which had been working, although often artificially suppressed, for over 30 years. To understand these trends it is necessary to recall Britain's economic situation in the 1950s and 1960s.

In those years the Government's priority was to raise economic growth by encouraging investment. A succession of legislative changes gradually improved the tax advantages of owning capital assets. Capital allowances of 100 per cent on plant and machinery became accepted by the early 1970s and, in the November 1974 mini-Budget, the principle was extended to

stocks as well. These changes were designed to stimulate the acquisition of real assets, if necessary by the incurral of paper liabilities. Other characteristics of the fiscal system, notably the tax deductibility of interest payments, were of long standing, but strengthened this effect. With inflation rates creeping upwards, the attractions of holding real assets increased further. Interest payments became equivalent to early repayments of capital, but they had the merit that a proportion of the cost was effectively borne by the Exchequer. There was a gradual spread of understanding about the most efficient methods of minimizing tax bills and maximizing protection against inflation. The answer, as more and more people realized, was to borrow money and invest in goods or property.

The combination of more worthwhile government investment incentives and rising inflation expectations generated a growing demand for credit. The problem had already surfaced by the mid-1950s. At that time, with economic policy subordinated to the need to maintain a fixed exchange rate, an early consequence of excessive credit expansion was to cause a run on sterling. A characteristic 'stop-go' pattern developed. Rapid credit growth would lead to a sterling crisis, forcing the introduction of direct restrictions on bank credit. As the balance of payments convalesced, these restrictions would be withdrawn and another burst of credit would be unleashed, only to end in another sterling crisis.

There was a definite incoherence in official policy. Repeated statements were made by politicians, businessmen and financiers on the need to increase investment and raise Britain's position in the league table of economic growth. Tax legislation was progressively altered in response to this clamour. By the mid-1970s Britain's investment incentives were the most generous of any advanced industrial nation. But the Government did not allow companies or individuals to take full advantage. Whenever the private sector began to invest heavily, imports of capital goods jumped and the balance of payments went into deficit. Quantitative restrictions on bank credit would then be imposed, neutralizing the effect of the investment incentives. There was a continuous unsatisfied demand for credit which would have passed through the banking system if it had been free to do so. The favourable tax treatment of investment collided head on with the monetary authorities' desire to restrain bank credit.

Quantitative limits on bank lending in the 1950s and 1960s had several harmful consequences. They handicapped banks subject to them, particularly the clearing banks, in their rivalry with other banks; they penalized the banking system as a whole in its competition with non-bank financial intermediaries; and they obstructed the efficient distribution of credit to profitable borrowers prepared to pay high interest rates. The concept of 'financial repression' has been proposed by Professor McKinnon, an American econo-

mist who specializes in developing countries' monetary systems, to describe how government interference with interest rates and credit allocation can hamper economic growth by reducing total investment and directing the investment which does occur to the wrong places. Britain is not a developing country, but an argument could be made that its economy suffered from several features of financial repression throughout the stop-go era.

Because of the restrictions on the banks, the demand for credit was met by other institutions. Medium-term finance was available from the capital markets, with new debenture issues being particularly active in the late 1960s. Mortgages for house purchase were provided by building societies, while hire purchase companies and finance houses answered the personal sector's need for consumer credit. The banks continually lost ground to these other intermediaries.

In 1971 the Bank of England, with the full approval of the Government and most academic economists, decided that the process had gone too far. The Competition and Credit Control reforms were intended to put banks and non-banks on a more equal footing in their struggle to capture an increased share of financial intermediation. All restrictions on bank credit were abolished. Over the two years from September 1971, bank lending to the private sector doubled and was largely responsible for two consecutive years of 25 per cent money supply growth. The rapid monetary growth lay behind a powerful boom in economic activity, which by late 1973 was causing sharp deterioration in Britain's overseas payments position. The authorities reverted to direct quantitative restrictions on banks' balance sheets by introducing the 'corset'. Although specified in terms of deposit liabilities, the corset's aim – and, to some extent, its effect – was to check the expansion of bank lending.

But the Competition and Credit Control reforms had not been entirely pointless. Although lending to the personal sector, a boom area in 1972 and 1973, showed little growth in the mid-1970s, the banks' entry into the market for medium-term finance was a permanent change. Whereas in the 1960s a company requiring medium-term finance would try to raise money through a debenture issue, in the 1970s its first step was to apply to a bank. The character of banks' liabilities adjusted to this innovation in their lending. An increasing proportion of their deposits was 'wholesale' money, typically with a one-month or three-month term, in contrast to the traditional current accounts and seven-day deposits. The banks were so successful in satisfying the need for medium-term credit facilities that the debenture market was snuffed out. Partly as a result of the Competition and Credit Control reforms, the banks had taken opportunities for financial intermediation away from the capital markets.

Between 1973 and 1980 the banks continued to be subject to a range of official interferences which hampered their expansion. The most obtrusive

was the corset, which was in force, if over three separate phases, for more than half the period from December 1973 to June 1980. But also important were qualitative guidelines discouraging credit to the personal sector, including loans for house purchase. As a result, the building societies' expansion was – almost without interruption in the 1970s – at a faster rate than the banks'. Apart from these direct constraints on banks' balance sheets, they also suffered from the costs of the reserve asset ratio and, like other businesses, from the exchange control regime. The reserve asset ratio obliged them to keep part of their assets in relatively unprofitable investments, while exchange controls prevented them from lending in sterling overseas. In addition, the clearing banks suffered from the minor irritation of having to maintain 1½ per cent of their eligible liabilities in non-interest-bearing balances at the Bank of England.

Since 1979 all these regulations have been scrapped. The third instalment of the corset was withdrawn in June 1980. The circumstances in which this occurred were very humiliating for both the Bank of England and the Government when it became known that sterling M3 had risen by 5 per cent in July. The 1980/81 money supply target was ruined by just one month's figures. The banks concluded that the corset would never be imposed again. In consequence, they felt free to market their corporate lending facilities even more aggressively than they had done in the 1970s, with leasing being one new area of business which showed particular promise. The ending of all restrictions on lending to companies in 1980 was followed by the ending of nearly all restrictions on lending to persons in 1982. No formal announcement was made, but the banks were given to understand that they would be allowed to give mortgage finance to house-buyers, while more conventional personal sector borrowing would no longer be hindered. The distinction implicit in many earlier Bank of England announcements, between wicked lending to persons for consumption and benign lending to companies for investment, seemed to have been forgotten. Other reforms also expanded the banks' opportunities for business. The abolition of exchange controls in October 1979 gave them the chance to lend sterling to foreign borrowers. Initially most loans were directed to foreign banks in the Eurosterling market, but there has been an increasing tendency to direct funds to ultimate borrowers through syndicated credits. This development was certainly unexpected when the Conservatives came to power in May 1979, but even more so was the outcome of the debate on monetary control. Although its theoretical focus was supposed to be the merits of monetary base control, its practical effect was to remove regulations on bank balance sheets. The reserve asset ratio and the 1½ per cent cash requirement on the clearing banks lapsed in August 1981.

Although informal understandings about banks' appropriate liquidity norms remain, these changes have left the British banking system relatively little burdened by central bank superintendence of its assets. In most countries the central bank enforces direct restrictions on the amount and the allocation of new lending business; in the United States and West Germany, two countries where such restrictions are absent, banks are required to maintain central bank reserves much above their true business needs. The contrast between either arrangement and the existing very liberal regulatory framework in Britain is sharp. It is not hyperbole to say that banks in Britain now operate in a freer and more relaxed environment than anywhere else in the world.

The sequence of liberalization moves between 1979 and 1981 may be interpreted as the second stage of a process begun by the Competition and Credit Control reforms in September 1971. Their motivation was to establish equality of competition between different kinds of financial intermediary, as it was felt – notably by senior Bank of England officials – that the quantitative bank lending limits of the 1950s and 1960s had unfairly penalized the banks and benefited their rivals. The great freedom currently enjoyed by the British banking system has arisen as a reaction to the excessive, if rather spasmodic and diffident, interventionism which characterized the 40 years until 1979.

Before 1971 the gradual increase in investment incentives provided by the tax system was not fully translated into credit growth because of crude quantitative controls on bank lending. Between 1971 and 1973 the banks were free from restraint – and the result was monetary bedlam when the Heath Government botched 'the dash for growth'. Interventionism, although in a milder form than before 1971, was renewed between 1973 and 1979. Since 1979 all restraints have been taken away. The precise date at which the new freedom began is open to question. Arguably, the ending of exchange controls in October 1979 was the turning-point because it rendered the corset ineffective as a device for controlling bank credit. (Banks merely lent to British companies from an offshore branch, bypassing the controls on their domestic activities.) But in some ways the August 1981 changes, in conjunction with the virtual demise of official guidelines against personal sector credit, were more important.

In the 1950s and 1960s there was persistent – and indeed growing – incompatibility between the ever more helpful tax treatment accorded to purchases of plant, equipment, houses and other capital assets, and the authorities' anxiety about the damage to the balance of payments from excessive credit growth. Over the last two years this incompatibility has been progressively reduced. It is now non-existent. Here, in a nutshell, is the explanation for the bank credit boom of 1979 to 1982. Whereas the credit demands fomented by the tax system were for long either frustrated or

Table 4.1 The growth of sterling advances in 1981

	Total			Increase	
	At 19 Nov 1980 (£ million)	At 19 Aug 1981 (£ million)	At 18 Nov 1981 (£ million)	Year to 18 Nov 1981 (%)	Quarter to 18 Nov 1981 (%)
Total advances to UK residents of which:	48 483	55 329	58 298	20.2	5.4
Manufacturing	13 004	13 052	12 909	-0.7	-1.1
Other production	6 041	6 883	6 856	13.5	0.3
Financial services	5 979	6 752	6 899	15.4	2.2
Professional, scientific and miscellaneous	14 420	17 149	18 817	30.5	9.7
Persons	5 947	7 555	8 439	41.9	11.7
House purchase	9 040	11 543	12 816	41.8	11.0
	2 755	3 809	4 714	71.1	23.8

*Note*

The 'advances' figure does not cover all lending, which also includes acceptances. Acceptance lending over the year to November 1981 was largely to manufacturing, which helps to rectify the sharp divergences between sectors shown by the 'advances' totals.

Source: *Financial Statistics*



channelled through non-bank intermediaries, over the last two years they have passed through the banks. There is no sign that these credit demands are fading away. On the contrary, they seem to be accelerating. In the three months to January, sterling bank lending to the private sector and overseas was increasing at about £2 billion a month. This may somewhat overstate the underlying position, but a trend figure of £20 billion a year is not a wild exaggeration. The outstanding total of sterling bank lending at the end of the third quarter of 1981 was about £72 billion. It follows that, if the £20 billion a year figure is right, banks' loan books are currently growing by nearly 30 per cent a year.

Heavy emphasis has been placed in this article on the tax system as a prime culprit for the lending boom of 1979 to 1982. Can this be substantiated by the evidence? Have tax-sensitive types of credit seen the most rapid expansion in the last two years? Some relevant statistics are given in Table 4.1. It shows how different sectors' bank advances increased over both the year and the quarter to the mid-November 1981 make-up day. This quarter is particularly interesting as it was the first after the final liberalizing changes last August.

The salient feature is the wide variation between the borrowing behaviour of different sectors. Advances to manufacturing industry barely changed in the two periods under consideration. Manufacturing has always been deemed a virtuous activity, high on the list of government priorities. As a result, loans to it have not been thwarted by official restrictions, and there was no major backlog of suppressed credit demand at the end of 1980. The 'other production' and 'financial' categories also registered quite moderate growth rates in 1981, with a tendency towards deceleration.

There were only two conspicuous growth areas – 'services' and 'persons'. But the expansion of loans to the service sector was driven by one particular sub-category, 'professional, scientific and miscellaneous'. Over the year to mid-November this sub-category went up by 41.9 per cent and in the final quarter by 11.7 per cent, equivalent to an annual rate of 55.7 per cent. 'Professional, scientific and miscellaneous' sounds like a rag-bag and so appears to say nothing about the business motivation behind the loans. But the explosive growth of this type of lending is almost entirely attributable to one constituent – leasing.

The detailed logic behind leasing is quite complicated, but its essence is simple. An industrial company which is investing as much as its taxable profit cannot reduce its tax bill further by increasing capital expenditure. It has fully exploited the fiscal incentives for investment. But a financial institution, such as a clearing bank, benefiting from high interest rates, may have a taxable profit much above the sums needed for its own investment programme. Of course, if the financial institution could buy capital goods, it

could cut its tax bill as effectively as the industrial company. The solution is for the financial institution to buy capital goods and to lease them to the industrial company which needs them.

The rental charged in the lease has two elements, one amount to recover the capital outlay and another which represents the rate of interest due on the investment. Because the financial institution receives a 100 per cent capital allowance, its tax bill (at a 52 per cent corporation tax rate) is halved and this interest rate may be 8 per cent rather than the 16 per cent implied by 14 per cent base rate plus a margin. Leasing has created, in effect, a market in tax allowances. It is clear that all bank loans which result from it are a by-product of the tax system and, in particular, of the exceptionally favourable treatment of investment.

The amount of new lending for leasing purposes is difficult to estimate precisely, but it is a plausible surmise that it accounted for £500 million to £600 million of the additional advances to the 'professional, scientific and miscellaneous' sub-category in the quarter to mid-November. At that stage it was growing at an annual rate of about 60 per cent. In 1982/83 new lending for leasing may approach £3 billion, which by itself would cause a 3½ per cent increase in sterling M3. Against tax-subsidized opponents like these, money supply targets of 5 per cent to 9 per cent, or even 7 per cent to 11 per cent, are hopelessly outnumbered. There is also no chance of a revival of the debenture market. From the leasing subsidiary of a clearing bank, a company can obtain medium-term finance at 8 per cent or 9 per cent (sometimes fixed rate); from the capital markets similar money would cost 16 per cent.

Although leasing is growing quickly, far more public comment has so far been directed at the banks' entry into housing finance. The figures in Table 4.1 indicate why. In the three months to mid-November bank advances for house purchase rose by almost a quarter. At present they are running at about £300 million a month or £3½ billion a year, again very large in relation to official money supply targets. Part of the reason for such heavy borrowing by individuals is the tax benefit of having a mortgage. As is familiar, all interest on a mortgage up to £25,000 can be deducted from taxable income. However, this is not altogether persuasive as an explanation because many bank loans for house purchase are bigger than £25,000. Continuing expectations of house price appreciation above the rate of interest, combined with the amenity value of living in a larger home, seem to have been the main influences on the heavy demand for mortgage finance. As building society lending has not fallen much, the big increase in funds channelled to the housing market appears to be attributable to the removal of official restrictions on the banks.

The buoyancy of lending for leasing and house purchase, both responding to tax advantages, confirms our thesis. The credit boom of 1979 to 1982 was

caused by the liberalization of the financial system interacting with a fiscal regime designed to promote investment. Its origins are to be sought in two characteristics of the British economic debate in the 1960s – widespread dissatisfaction with the repercussions of quantitative bank lending restrictions on the efficiency of financial intermediation; and a very general anxiety about the presumed link between low investment and low economic growth.

The Government's failure to meet its money supply targets has almost nothing to do with its refusal to introduce monetary base control, as many academic monetarists, particularly from the American Mid-West, believe. These academics often seem to regard monetary base control as a universal panacea, regardless of the local context. As we have seen, the causes of the missed targets are instead parochial and specific; they can be understood most easily by an economist who has followed British governments' persistent tendency, over many years, to pursue irreconcilable economic objectives with a great deal of noise, enthusiasm and naivety. (Ironically, the Conservatives' record in controlling the monetary base is immaculate. In the period from June 1980 to November 1981 it increased by 3.1 per cent, compared with 29.6 per cent for sterling M3. It is since June 1980 that academic monetarists have complained most loudly about the Bank of England's supposed incompetence and blamed it on the absence of monetary base control machinery.)

The question arises of what the Government should have done at the beginning of the whole process. Surely, critics might claim, the Treasury and the Bank of England are full of clever people who should have realized that financial liberalization would cause the release of pent-up credit demands and a switch of business towards the banks, which together would lead to rapid growth in bank deposits and the destruction of official sterling M3 targets. Perhaps these clever people should have realized, but no one outside these institutions foresaw what was coming.

In fact, the authorities were in an impossible dilemma. The sequence of reforms introduced from October 1979 (the abolition of exchange controls) to August 1981 (the ending of balance sheet requirements for the banks) were all desirable. Whereas the financial system was subject to quite severe restriction for most of the 40 years to 1979, it is now exceptionally free from government regulation. There is much evidence from developing countries that liberalizing the money side of the economy has favourable effects later on the 'real' side.<sup>2</sup>

But suppose that in mid-1979 Sir Geoffrey Howe, aware that liberalization would cause a credit boom, had said: 'Our sterling M3 targets in 1980/81 and 1981/82 will be 13 to 17 per cent and 12 to 16 per cent. These are much higher than recent rates of increase, but reflect the distortions arising

from a number of forthcoming measures intended to strengthen competition in the financial system, and should not jeopardize the Government's objective to achieve a lasting reduction in the rate of inflation. We cannot measure the distortions exactly, but believe they will be large'. Who would have taken the statement seriously? How could a government, publicly branded as monetarist, have announced that it would allow an acceleration of money supply growth?

Of course, neither Sir Geoffrey Howe nor his cohorts of advisers inside and outside the government machine appreciated in advance the potential scale of the 1979 to 1982 bank lending explosion. As a result, the presentation of policy has suffered a heavy blow. One objective of the Medium-Term Financial Strategy, declared in the 1980 Budget, was to mould inflation expectations favourably by projecting a gradual deceleration in target money supply growth in future years. That objective has not been fulfilled. But there have been pluses as well as minuses. It was because of the Medium-Term Financial Strategy that the Government raised taxes so vigorously in the 1981 Budget, a very courageous move which has had the effect of making Britain's public sector finances stronger than most other industrial countries'; and it was because money supply targets were in being that the authorities kept interest rates so high for so long. Without these interest rates, credit and money growth would have been even faster – and inflation would not now be heading for single figures. The decision to keep interest rates at such levels was broadly correct.

If the argument of this article is right, there will continue to be severe difficulties in reconciling money supply restraint with a free financial system, a tax system promoting investment and high inflation expectations. Because of the benefits a free financial system gives to the real economy, it would be a mistake to return to the interventionism of the 1950s and 1960s. Arguably, the tax system is too friendly to investment and is the main culprit for the recent credit boom. Its reform might make some contribution to solving the problem of monetary control.

#### Notes

1. The implied approach to monetary control is to regulate the credit counterparts to bank deposits. This approach, which is broadly that adopted by the Bank of England, is very different from the banking multiplier theory found in the textbooks and academic monetarist writings. An account of how the credit counterparts approach works (if not very well) is given in T. G. Congdon, *Monetary Control in Britain* (London: Macmillan), 1982.
2. There may be a connection between the 1979–82 credit boom, relatively high capital investment and the recent rapid growth of productivity. The possibility was analysed in 'The boom in bank lending: is it related to the surge in productivity growth?', accompanying the 22 January 1981 issue of *Messel's Weekly Economic Monitor*.