The Lawson Boom in the Light of the Crash

Tim Congdon

Will the 'Lawson Boom' have the same consequences as that of Anthony Barber? Tim Congdon, of Shearson Lehman, argues that the rapid monetary growth of the past years could have serious consequences for inflation, unless the Government takes immediate preventative action.

In its section on the UK the Group of Seven (G7) statement of 23 December 1987 remarks that 'The Government, in the context of the British economy's vigorous growth of output and domestic demand, coupled with sound public finances, will continue to strive to reduce inflation by pursuing a prudent monetary policy.' The bland and colourless phrasing, presumably the work of senior Treasury officials, may seem appropriate coming from an august international gathering. In fact, it is a tribute to its authors' sense of humour. The remarks on vigorous output growth and sound public finances are fair enough, but the reference to 'prudent' monetary policy must have been written with mandarin tongues firmly in embarrassed official cheeks. The truth is that monetary growth in the UK is grossly excessive, that excessive monetary growth is fuelling an unsustainable boom in the economy and that the boom will be followed by a significant increase in

the Lawson boom

inflation. There are ample grounds for calling the current period of economic excitement the 'Lawson boom', just as its forerunners in 1964 and 1973 are associated with the names of Maudling and Barber.

However, the G7 verdict on the UK is not altogether facetious. There was a period, in the very recent past, when it was legitimate to talk of the prudence of British monetary policy. In early 1985 the Government could fairly claim to have reduced the rate of inflation by the determined and consistent pursuit of a responsible monetary policy. At that time, as for nearly all of the previous decade, the centrepiece of monetary policy was a target for the growth of broad money which was intended to constrain, in a rough-and-ready way, the rate of increase in nominal gross

broad money

domestic product. With the underlying growth rate of output set by the economy's supply-side characteristics, the limit on nominal GDP secured control over inflation. It was essential to the whole approach that the budget deficit, as measured by the Public Sector Borrowing Requirement, was not used to manage the amount of demand in the economy, but was restricted to a level compatible with the monetary targets. But in mid-1985 broad money targets, and most of the so-called 'monetarist' framework of financial control, were abandoned.

At the end of 1984 broad money was under reasonably good control, with sterling M3 (i.e. notes and coin, and sterling-denominated bank deposits held by UK residents) showing an annual growth rate of about 10 per cent. The figure of 10 per cent was at the top end of the official target range of 6 to 10 per cent, but was broadly comparable to a figure of 11 per cent recorded at the end of 1983 and 9 per cent at the end of 1982. As high real interest rates and certain institutional changes in the banking system were tending to increase the economy's propensity to hold money, money supply growth of about or slightly above 10 per cent was consistent with inflation of 5 per cent and real growth of 3 per cent. Indeed, the economic stability of these years was an impressive endorsement of the monetarist system of financial control which by then seemed well-established.

Despite the sound financial environment, officials in Whitehall and the Bank of England became dissatisfied with monetary policy. Exactly why they became dissatisfied is far from obvious, but Mr Lawson, as Chancellor of the Exchequer, was readily persuaded that change of some kind was needed. In May he gave a foretaste of what was to come by stating that the significance of sterling M3 had 'somewhat diminished'. Shortly afterwards the authorities decided to end a method of determining official gilt sales, known as 'overfunding', which had been essential to monetary control over the previous four years. The demise of overfunding — which was confirmed in the September *Bank of England Quarterly Bulletin* — was made to appear purely technical in import and not given much attention in the financial press. But it had a crucial consequence. The Government could no longer adjust gilt sales flexibly to meet broad money targets. In the Mansion House speech on 17 October Mr Lawson announced that the sterling M3 target for 1985/86 had been suspended.

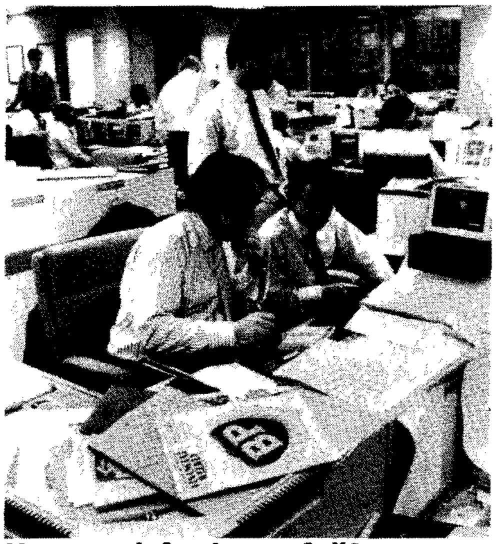
The scrapping of the monetarist policy framework was soon followed by an acceleration in broad money growth. In the six months to January 1986 sterling M3 grew at an annualised rate of 15 per cent. This was followed by 18 per cent in the year to January 1987 and over 20 per cent in the year to November 1987. By the beginning of 1988 the economy had had two-and-a-half years of broad monetary growth in the region of 15 to 20 per cent. The contrast with the preceding four years of 10 to 12 per cent growth is clear and definite.

acceleration in monetary growth

Moreover, this contrast is not an accident, but the logical result of a deliberate shift in government policy. Mr Lawson was very articulate in his justification of this policy shift when it was made.

No one — and certainly none of the small and dwindling band of 'monetarist' commentators in the City — expected the acceleration in monetary growth to be followed in short order by an exactly commensurate acceleration in inflation. On the contrary, past experience suggested that the initial impact of excess monetary growth would be felt on asset prices (houses, commercial property and shares) and on economic activity. The usual pattern was that output growth picked up nine to 18 months after the increase in monetary growth, while inflation responded after a long lag of three or more years.

The behaviour of the economy in 1986 and 1987 fitted in neatly with the standard monetarist timetable. Output started to move ahead strongly about three quarters after the acceleration in monetary growth. Gross domestic product (as measured by the output estimate) increased by 1.3 per cent in the second quarter of 1986, by 1.2 per cent in the third quarter and 1.0 per cent in the fourth, implying an annualised rate of advance in every quarter of over 4 per cent. The most buoyant component of



Press Association

How much further to fall?

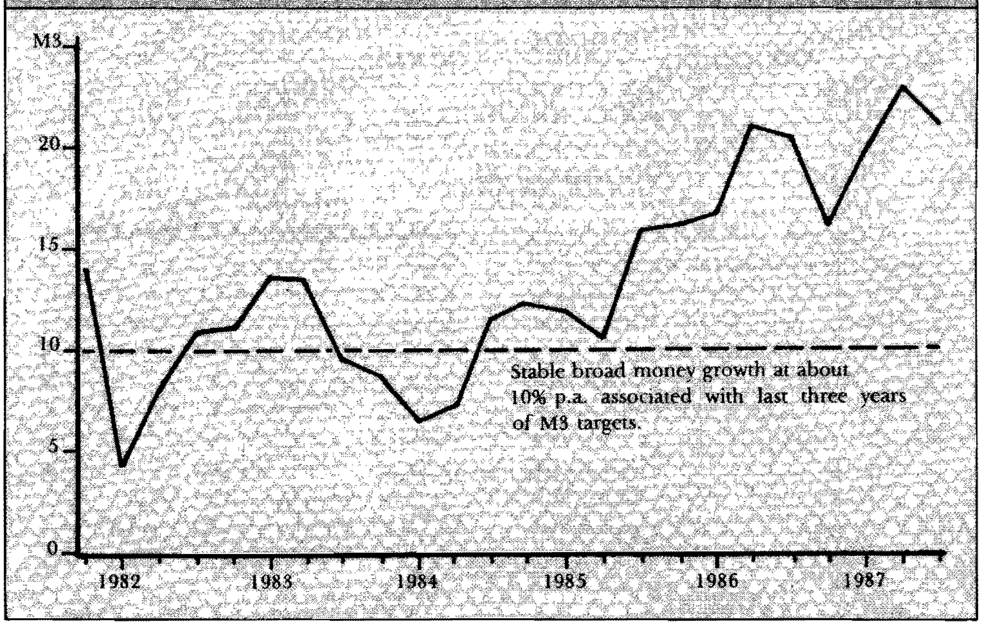
expenditure was consumption, which soared by 6 per cent in the year.

The consumption boom was widely attributed to the ready availability of personal loans and was associated in the public mind with the proliferation of credit cards. While these were notable aspects of the consumer scene, they were completely overshadowed in scale by an upturn in mortgage lending. Net mortgage advances totalled £19.1bn. in 1985 and £25.8bn. in 1986, a multiple of borrowing on credit cards which was under £1bn. in both years. Through a process known as 'equity withdrawal' a high proportion of mortgage finance escaped from the housing market and was used to finance increased purchases of consumer durables. In this way the high level of mortgage lending was a major reason for an extraordinary leap of 17 per cent in sales of consumer durables between the second quarter of 1985 and the third quarter of 1986. Nevertheless, there was still enough money remaining in the housing market to initiate a surge of house price increases. According to the Building Societies Association index, house prices were 13.9 per cent higher in December 1986 than a year earlier.

Houses were not the only assets to increase sharply in price. As rapid monetary growth meant that people had a far higher level of bank deposits than they needed to carry out their usual transactions, they were keen to transfer the excess deposits into more attractive investments. Inflows into unit trusts soared, while insurance companies found it easy to sell policies and put on record amounts of new business. Because of all this extra money, the long-term savings institutions (insurance companies, pension funds, unit trusts) had £24bn. to invest in 1986, significantly higher than the £20.9bn. in 1985. Here was the financial raw material to support a substantial rise in share prices. The stock market advanced particularly briskly in the months leading up to March 1986, when the *Financial Times* industrial ordinary index stood almost 50 per cent higher than nine months earlier.

Faster output growth in 1986 cannot be attributed to an easing of fiscal policy, since public sector borrowing was kept under tight control, or to more buoyant international economic conditions, since the growth of the world economy was roughly the same in 1986 as in 1985.

Figure
The Acceleration in M3 Growth Since Mid-1985
(Annualised Six-monthly Percentage Change of M3)



Instead the upturn in Britain bore the strong imprint, in both its timing and character, of the increase in broad money growth. There were obvious parallels with the Barber boom of the early 1970s, which saw a jump in sales of consumer durables of 28 per cent in the year to the second quarter of 1972, a rise of almost 40 per cent in house prices in the year to December 1972, and a spectacular bull market in equities with the *Financial Times* industrial ordinary index up by 65 per cent between March 1971 and May 1972.

In 1987 the expansion broadened and gathered pace. Investment overtook consumption as the most dynamic category of demand, with construction activity showing particular vigour. The buoyancy of sales and orders came as a surprise to most businessmen, who initially met higher demand partly by running down their stocks. By the end of the second quarter the stock/output ratio in manufacturing was at its lowest level

too much money

in the post-war period. It was necessary and inevitable that companies rebuild their stocks. The process began in the third quarter and caused output growth to move into a higher gear. The average measure of GDP went up by 2.2 per cent, implying an annualised growth rate of 9 per cent.

As the economy gathered momentum, the private sector's demand for bank credit strengthened and the pace of monetary growth increased. In these circumstances institutional cash again grew very rapidly, propelling a further surge in share prices. In July the *Financial Times* industrial ordinary index was 45 per cent higher than at the end of 1986 and almost double its level of two years earlier. House price inflation also accelerated, suggesting a generalised condition of 'too much money chasing too few assets'.

The speed of economic growth in the third quarter was not known in full until the release of the relevant GDP data in December. But there were many symptoms of excessive demand. Fears about future inflationary trouble gained new cogency when information became available about a £4.5bn. leap in bank lending in July. At the behest of the Bank of England clearing bank base rates were raised from 9 to 10 per cent on 9 August, with domestic monetary conditions cited as the principal justification. Bad August trade figures,

Popperfoto

London dealing room, 19 October 1987

released in September, were another warning that the boom was running out of control. Despite these jolts to confidence share prices remained at such high levels that companies felt they had to raise money by rights issues. At the same time the Government was eager to press ahead with its privatisation programme. In the three months from August to October about £7bn. was taken out of institutional cash holdings by rights issues, new privatisations, calls on old privatisations, offers for sale and other kinds of corporate money-raising. By mid-October, for the first time in several years, the institutions were short of cash.

The scale of the cash drain left the stock market vulnerable to disappointments. On 19 October — ahead of a week which included potentially troublesome statistics on the money supply, bank lending and the trade balance — share prices collapsed. Although foreign stock markets also fell heavily, worries about domestic inflationary trends within the UK were undoubtedly a bearish influence on London equity prices.

But Mr Lawson and his advisers did not see it that way. In their view the economy was growing at about the right rate and the prospect, even before the Crash, was for a slowdown in 1988.

lower interest rates

Their new anxiety was that the drop in share prices would seriously undermine economic activity, turning the slowdown into a recession. Instead of interpreting the Crash as a warning about excessive growth, they saw it as liable to precipitate unnecessary contraction. They reacted by reducing interest rates. Base rates were lowered to 9.5 per cent on 23 October and to 8.5 per cent in two further falls in the next few weeks.

It soon became obvious that these interest rate cuts were inappropriate. At the time of writing (early January) there are few indications of weakening demand and many signs that demand is growing faster than ever. Retail sales and car registrations in November showed increases from October and very large increases compared to a year earlier; the trade figures for November were disturbingly bad, with a current

sales demand

account deficit of almost £600m. in the month and of £1,800m. (the equivalent of 1 per cent of gross domestic product) in the most recent four months; labour shortages are being widely reported, with widely shared concern over a shortage of nursing staff being given considerable media coverage; and retail spending over Christmas and at New Year sales appears to have been unusually buoyant. Moreover, the portents are for an intensification of excess demand pressures in the early months of 1988. The December CBI survey had the highest proportion of companies reporting above-normal order books since the mid-1970s; the rise in mortgage credit, arguably the financial dynamo behind the Lawson boom, is due to gain momentum in the next few months because of promises to lend already made by building societies and banks. Manpower, the staff consultancy, has said that more companies plan to recruit people in early 1988 than at any time in 1987, while the number of vacancies notified to Jobcentres is rising every month and is now higher than for most of the late 1960s.

At this point in a standard UK stop-go business cycle the pound usually suffers a speculative attack on the foreign exchanges. A sterling crisis is the financial markets' characteristic reaction to loose monetary policy and the Government responds by raising interest rates. Higher interest rates then serve the dual function of bolstering the international value of the pound and moderating the growth of domestic credit. However, at present the pound is very firm on the foreign exchanges, largely as a by-product of dollar weakness. The dollar's problems are therefore disguising the irresponsibility of UK policy, and allowing the Government to postpone the necessary restrictive action.

A strong pound contains the domestic price level because it reinforces foreign competition. For the time being the excessive growth of credit and money will tend to damage the balance of payments rather than inflation. But the foreign exchanges will not for ever remain indifferent to the UK's worsening payments position. As long as the growth of the money supply continues to be three or four times faster in the UK than in West Germany and the USA, and the trend in the balance of payments is remorselessly into more substantial deficit, a sterling crisis is inevitable. After sterling has fallen in value, inflation will increase. Precise medium-term inflation forecasts are difficult to make because the price level is subject to random influences such as world commodity prices and government policy towards public sector pricing. All one can say on past form is that an acceleration in monetary growth normally hits the inflation rate about three years after it began. A reasonable expectation is that sterling will weaken in early 1988, perhaps in conjunction with falling oil prices, and that the inflation rate will rise for much of late 1988 and 1989. Alternatively, the weakness in sterling may be combined with a transitory phase of renewed confidence in the dollar.

Since monetary growth has been 5 to 10 per cent more than in the stable

the crash

period before the middle of 1985, it would be logical to envisage the rate of increase in nominal GDP also rising 5 to 10 per cent above the 8 per cent figure associated with that period. But this may overstate the inflationary threat. The last three years may have seen a continuing and more pronounced increase in the economy's propensity to hold money, because of institutional changes. Moreover, because unemployment was so high before the Lawson monetary stimulus much of its impact will be felt in higher output rather than a rise in the price level. A cautious view is that inflation will increase significantly, but should not move above the 8-10 per cent area. Although that would be modest by the standards of the last fifteen years, it would be regarded as a major setback for the Government. In particular, it would cast doubt on the wisdom of the strategic decision to abandon broad money targets in mid-1985 and on the tactical decision to cut interest rates in October and November 1987.

The Government made two mistakes after the Crash. The first was to underestimate the vitality of the pre-Crash economy. This is clear enough both from the pattern of events and from official statements. The Chancellor and his colleagues failed to recognise that — in the absence of the Crash — the economy would have had considerable forward impetus. Growth, even though it might have moderated to less than the startling 9 per cent annualised rate seen in the third quarter, would still have remained much above the trend rate of about 3 per cent.

The second mistake was to overestimate the effects of the Crash. A fall in share prices does — by itself — tend to slow the economy down, but its impact is marginal. As direct personal sector holdings of shares are less than a tenth of total personal wealth, it is implausible to expect changes in their value to have a particularly powerful effect on consumer attitudes or behaviour. Indirect holdings (through insurance companies, pension funds and other institutional intermediaries) are more significant, but one of the purposes of investment in these channels is to muffle the impact of market volatility on the individual saver. (Most unit trusts carry a specific 'health warning' that share prices can go up as well as down and that investment should be regarded as long-term in nature; pension funds typically determine their solvency position not by looking at the market value of their equity holdings, but by applying a discount rate to expected dividend receipts.) In any case, direct and indirect share holdings combined are overshadowed in terms of value by the housing stock and other kinds of property (agricultural land, buildings and plant owned by unincorporated businesses, commercial buildings). In the year to October 1987 house prices, as measured by the Buildings Societies Association average house price series, rose by 18.3 per cent, indicating a massively positive 'wealth effect' on consumption. Two further points should be emphasised: first, despite the October Crash, share prices were higher in November 1987 than in November 1986; and, second, since the gilt market rallied on the news of the equity slump, higher gilt prices partly outweighed the effect of lower equity prices on personal wealth.

The Crash is an important incident in the Lawson Boom. But it is no more than an incident. If the 30 per cent fall in share prices had been spread over six months instead of compressed into two days, it is unlikely that economists would have made much fuss. (Most of the major macro-economic models do *not* have share prices as an independent variable in their consumption or investment equations, or, indeed, anywhere else.) The key problem for the British economy today is to rein in the excessive growth of credit and so curb the rapid monetary growth which lies behind an unsustainably rapid increase in demand and output. It would be a tragedy if the Lawson boom of 1986-88 follows largely the same course as the Barber boom of 1971-73. But, in the words of the American philosopher George Santayana, those who cannot learn from history are condemned to repeat it.